II. Advice on Fiscal Policy and the Development of Trust

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I. INTRODUCTION

1. **Fiscal policy is central to the domestic and external balance of an economy and thus a necessary component of the advice provided by the IMF.** Actions in the fiscal area, however, carry social and political implications that can make advice on these matters a fraught issue. In particular, fiscal consolidation is a course of action not generally welcomed by policymakers who must bear the brunt of the reaction of those affected in the process. This colors the receptiveness of authorities to such advice and may affect their attitude towards the provider of the advice.

2. **In principle, trust in advice on economic matters should depend on the appropriateness and relevance of the advice, on its technical quality, and on factors such as the atmosphere in which it is given or the personal chemistry among the parts.** Trust seems also easier to establish when the authorities and staff share a common view on what needs to be done or when staff reinforces views already held, or decisions already taken, by the authorities. Indeed, relations flow more smoothly when times are good and when the advice does not imply undue hardship or difficult political decisions. Turning this argument around, it appears that ease of implementation of the advice—the likeability of it—plays a part in the trust such advice inspires. When the advice implies unpalatable actions, as is commonly the case with fiscal adjustment, it tends at first to be rejected in the search for more agreeable alternatives. Carrying the argument to the point of caricature one might say that "people tend to trust the advice they like."

3. **The interviews and surveys conducted for the IEO's evaluation "*The Role of the IMF as Trusted Advisor*" (*RITA*) revealed indications of a shift in perceptions regarding the IMF's advice on fiscal matters, particularly among emerging and developing economies.** A common view held by authorities in these interviews was that "the IMF has tempered its emphasis on fiscal adjustment and is now more attuned to the social and economic development needs of the country." Did the IMF actually change or did the countries' structural circumstances change? The answer seems to be both: the ***RITA*** evaluation covers a period where, for several reasons, the economic situation and the policies in most countries had, already before the global financial crisis, shown a marked improvement and also where, in the wake of the crisis, the IMF proved able to adapt to the worsened cyclical circumstances and become a strong proponent of short-term fiscal stimulus, temporarily dampening its preoccupation with fiscal consolidation.

4. **This note seeks to document the factors behind this perceived change, with particular focus on the fiscal stance.** To this end, it examines official statements of the institution, such as those made by Management or the assessments included in the *World Economic Outlook* (*WEO*) publication, as well as the views included in staff reports on the 54 countries whose authorities were interviewed in the context of the ***RITA*** evaluation.

II. THE ECONOMIC SITUATION AND POLICIES

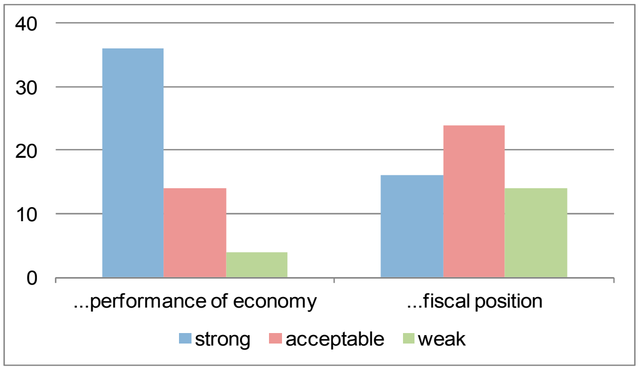
5. **Official IMF statements as well as the staff's views on member countries included in surveillance or use of Fund resources (UFR) reports indicate that already in the years before the global financial crisis the IMF had markedly attenuated its discourse on the need for fiscal consolidation.** Since the Fund's mandate to promote sustainable macroeconomic balance continued to be in place, this reduced emphasis on fiscal discipline likely reflected the reduced need for it that was being perceived. Indeed, the years around the middle of the past decade witnessed a generalized improvement in the fiscal position of member countries, which allowed staff to take a more relaxed attitude on fiscal matters. This may be attributed to several factors:

- ***A rising tide lifts all boats.*** There was a strong, broad-based, expansion of the world economy in the years after 2003, with global output growing at rates in excess of 4 percent a year supported by buoyant financial market conditions and accommodative macroeconomic policies. Inflation concerns were generally subdued, while rapid growth of world trade and robust demand conditions sustained momentum across emerging market and developing economies. The rising levels of income and employment strengthened fiscal positions in most countries and/or eased fiscal adjustment where required.
- ***Emerging market economies were buying crisis insurance.*** Several emerging market countries had been severely hit by the debt and financial crises of the 1980's and 1990's and were bent on policies to ensure that those experiences would not be repeated. Most of them sought to reduce their dependence on short-term capital inflows and to increase their holdings of international reserves as a first line of defense against a sudden stop of outside financing. But mainly they endeavored to establish sustainable fiscal and debt positions, seeking to maintain primary, if not overall, fiscal surpluses and generally trying to put in place some sort of rule to ensure fiscal balance over the economic cycle.
- ***Developing countries benefitted from HIPC.*** By the middle of the decade most eligible developing countries had reached the completion point under the HIPC initiative and could avail themselves of substantial debt relief. This not only provided fiscal space for attending to social and development needs, but also a successful performance under the associated PRGF programs had helped establish a more sustainable fiscal position, that many countries then endeavored to maintain.

6. **The above factors were duly reflected in the staff reports—consultation or UFR—of those years.** An examination of the 2006–07 reports on the 54 countries whose authorities were interviewed for ***RITA*** shows that in the broad majority of the cases staff praised or at least was satisfied with the economic performance and the fiscal situation they found. Figure 1 below summarizes these findings. The immediate past performance of the economy in terms of growth, inflation and external current account position was assessed to be strong in 36 of the 54 cases—and in a further 14 cases it was deemed acceptable or other expression to that effect. Staff was, not surprisingly, less sanguine in its assessment of the

fiscal position, but nonetheless this position was deemed wanting in only 14 of the cases, with the remaining 40 cases being assessed as acceptable or strong (assessments that in some cases did not preempt the staff's opinion that some fiscal adjustment was still required).

Figure 1. Staff's 2006–07 Assessment of Prior Economic and Fiscal Situation
(Number of cases)



Source: Author's computations based on Article IV country reports.

III. The Stance of the IMF

A. Advice Provided in a Multilateral Setting

7. **The Fund's official position regarding advice in the fiscal area moved in line with the above developments.** Pronouncements by Management, or assessments in the *WEO*, which initially showed an unwavering commitment to fiscal discipline, gradually moved to acknowledging the good times and pleading to take advantage of them to prepare for less benign circumstances and, when the magnitude of the crisis became evident, to an outright advocacy of fiscal stimulus, wherever feasible. It needs also to be noted that, going beyond concerns about supporting global demand in the face of the crisis, the IMF had extended this more flexible approach to fiscal issues also to low-income countries (LICs), which were being hit during 2007–08 by world food and fuel price shocks:

> "...there are no easy solutions for countries with a deteriorating fiscal position. The reality is that countries that decide to postpone fiscal reform and adjustment for fear of the political and economic price that these would entail usually end up paying a much higher price when economic necessity forces them to act...it is possible to have what we call *expansionary fiscal contractions.*"
>
> (Rodrigo de Rato, Managing Director. November 2004)

> "...Directors reiterated their concerns regarding...long-standing challenges facing the global economy [including that] ...unsustainable medium-term fiscal positions remain a key risk...They underscored the importance of more ambitious fiscal consolidation in order to limit upward pressure on interest rates, reduce risks to macroeconomic stability, and improve the scope for a fiscal response to future shocks."
>
> (The Chairman's Summing Up, *WEO* Executive Board Meeting. March 2006)

"There are challenges for all countries. Among the industrial economies, there is scope for further fiscal adjustment, to aim for balance over the business cycle. Economies with high budget deficits in good times have little room for maneuver in more difficult times... In emerging market countries, governments need to press ahead with further fiscal reforms and with debt reduction..."

(Anne O. Krueger, First Deputy Managing Director. June 2006)

"In most of the major advanced economies, fiscal consolidation in the face of aging populations remains a huge challenge... for most countries, trajectories going forward look unambitious, even assuming steady growth."

(*World Economic Outlook*. September 2006)

"High structural fiscal deficits and government debt are still problems in many countries, including in Europe. It is both easier and more economically sensible to reduce these deficits when the economy is strong than when it is weak."

(Rodrigo de Rato, Managing Director. January 2007)

"Substantial progress has been made toward fiscal consolidation during the present expansion in advanced economies, but more needs to be done to ensure fiscal sustainability in the face of population aging... Governments should adopt more ambitious medium-term consolidation plans... although in most countries there is scope to let the automatic fiscal stabilizers operate in the event of a downturn... A number of emerging markets still face overheating pressures... strong foreign exchange inflows are likely to continue to complicate the task of policymakers... Fiscal policy is likely to play a key role. While fiscal positions have improved... The avoidance of public spending booms... would help both in managing inflows and in continuing to reduce public debt levels."

(*World Economic Outlook*. October 2007)

"In a dramatic *volte face* for an international body that as recently as the autumn called for "continued fiscal consolidation" in the US, Dominique Strauss-Kahn, the new IMF head, gave a green light for the proposed US fiscal stimulus package and called for other countries to follow suit. "I don't think we would get rid of the crisis with just monetary tools," he said, adding "a new fiscal policy is probably today an accurate way to answer the crisis."

(*Financial Times*, reporting from Davos. January 2008)

"Unless the situation improves, the fiscal authorities in countries with low fiscal risks should prepare to exploit the headroom for timely and targeted fiscal stimulus... Of course, it has to be temporary—maintaining a sustainable medium-term fiscal position is still very important. But in a sense, medium-term fiscal policy is all about saving for a rainy day. It is now raining."

(Dominique Strauss-Kahn, Managing Director. February 2008)

"Macroeconomic policies in the advanced economies should aim at supporting activity...automatic stabilizers...should be left to operate freely... Discretionary fiscal stimulus can provide support to growth... In due course, offsetting adjustments to fiscal policies will be needed to safeguard medium-term consolidation objectives... However, in a number of other [emerging] countries, inflation pressures are still a concern...Greater restraint in public spending would help ease inflation pressures..."

(*World Economic Outlook*. October 2008)

"Let me start with fiscal policy. To put it bluntly, fiscal policies should counteract the crisis, not make it worse. As you know, the IMF has been at the forefront of the call for a global fiscal stimulus for countries with the fiscal space to do it. And owing to recent budgetary discipline and debt relief, many African countries have some room on this front. To the extent possible, we encourage letting automatic stabilizers work... In other countries, however, financing and debt sustainability constraints limit room for maneuver. In some cases, fiscal adjustment may be unavoidable. All countries should give priority to strengthening social safety nets, or at least shielding them from cuts—this is vital to protect the most vulnerable from the ravages of the crisis."

(Dominique Strauss-Kahn, Managing Director. May 2009)

"…in fact, the design of recent LIC programs has shown considerable flexibility, providing expanded policy space in the face of the crises…Fiscal policy has accommodated larger deficits…Most programs began to incorporate fiscal easing in 2007, with further relaxation of the fiscal stance in 2008 and 2009…Close to two-thirds of the programs designed in 2007–09 increased the level of spending over time, while revenue declined."

(SPR Department, "Creating Policy Space—Responsive Design and Streamlined Conditionality in Recent Low-Income Country Programs." September 2009)

"What we need now are strategies that can restore fiscal sustainability, but that do not jeopardize the economic recovery by withdrawing support too soon."

(Dominique Strauss-Kahn, Managing Director. March 2010)

"To date, few countries have made significant progress in exiting from fiscal stimulus… Many of those that have made progress were facing acute financing pressures that made delay unfeasible. The optimal timing of stimulus withdrawal will vary depending on macroeconomic and fiscal conditions… However, all countries should introduce structural measures now to strengthen their medium-term fiscal trends."

(*Fiscal Monitor,* May 2010)

"What do we have to do? In the medium term, our message is clear: all countries—especially advanced economies with a high level of debt—have to go back to fiscal sustainability... But while the recovery is still fragile, all the fiscal room still available has to be used to boost growth. So we have to go for fiscally sustainable growth."
(Dominique Strauss-Kahn, Managing Director, October 2010)

"Growth was supported by a countercyclical policy response—a first for LICs in contrast to past crises when the fiscal stance was tightened. Most LICs let their fiscal automatic stabilizers operate, and the median increase in real primary spending was higher than in the previous five years…The appropriate macroeconomic policy mix in the recovery phase depends critically on a country's exposure to potential future shocks…a gradual reduction in fiscal deficits…could help keep public debt at manageable levels and allow a supportive or countercyclical response in the event of another shock."
(SPR, RES, FAD, and MCM Departments, "Emerging from the Global Crisis: Macroeconomic Challenges Facing Low-Income Countries." October 2010)

"[In the United States] there is a serious risk that hasty fiscal cutbacks will further weaken the outlook without providing the long term reforms required to reduce debt to more sustainable levels... In many advanced economies, immediate cutbacks to spending and tax increases should ideally be small while...reforms are being implemented that cut future deficits... In [emerging and developing economies] public deficits must be rolled back to rebuild fiscal policy room and—in some cases—alleviate strong domestic demand pressure."
(*World Economic Outlook*, September 2011)

B. Advice Provided in a Bilateral Setting

8. **Most of the discussion of fiscal issues occurs in the framework of the staff's interaction with country authorities during the consultations under Article IV or in the negotiation of programs to be supported by UFR.** In particular, it is the conditionality associated with the latter which has attracted most attention and where the IMF's reputation for single-minded pursuit of fiscal stringency has been formed. The staff's position in these interactions is included in the corresponding staff reports and, as can be expected, it reflects for each case the complexity of the economic, social and political realities that authorities and staff confront at the time of the discussions.

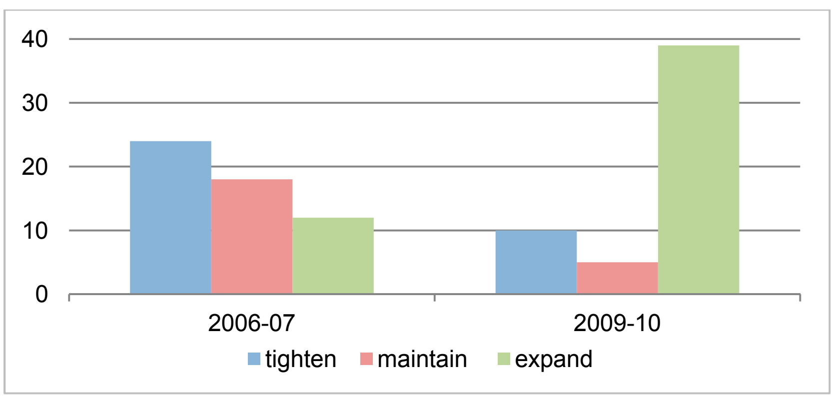
9. **A judgment on whether a given position adopted by staff implies an easing or a tightening of the fiscal stance needs to take account of these complexities and is not always a straightforward view on whether the fiscal deficit is to increase or decrease, or whether the fiscal accounts are in surplus or deficit.** Even in the face of a solid fiscal position, tightening may be in order —say to support monetary policy, to build fiscal reserves for the future, or to moderate trends that could lead to an unsustainable situation. Context is

crucial. By way of example: advice to cut the deficit by x percent of GDP when the country has suffered an exogenous shock that caused the deficit to increase by 4x percent would not be the same as advising a x percent cut after the country had missed the deficit target in a program by 4x percent of GDP; arguably the first case could be considered a tightening while the second would amount to condoning an expansion. Similarly, it is possible that a y percent of GDP increase in a deficit may be regarded as an easing by the staff but as a tightening by authorities that had planned a 2y percent expansion.

10. **In the end, it is the authorities' perception about the stance advocated by staff that counts in terms of building trust, and this perception cannot always be gleaned from staff reports.** The above caveats are relevant for the examination of the reports on the 54 countries whose authorities were interviewed for the ***RITA*** evaluation. For each country, the examination included reports from 2006–07, before the global crisis became evident, and for 2009–10, after the institution had made explicit its approach to the handling of it.

11. **Figure 2 shows that indeed there was a marked shift in the stance advocated by staff between these periods.** Whereas before the crisis staff was recommending some sort of tightening of the fiscal stance in 24 of the 54 cases (44 percent), after the crisis began such a position was taken in only 10 of these cases. It is also notable that before the crisis and confirming the overall improved economic (and fiscal) situation mentioned in the previous section, staff had refrained from asking for fiscal consolidation in more than half of the cases. Furthermore, it was already advising fiscal expansion in more than a fifth of the cases. After the onset of the crisis, fiscal stimulus was advocated in almost 3 out of 4 of the cases under review.

Figure 2. Staff's Advice in the Fiscal Area
(Number of cases)

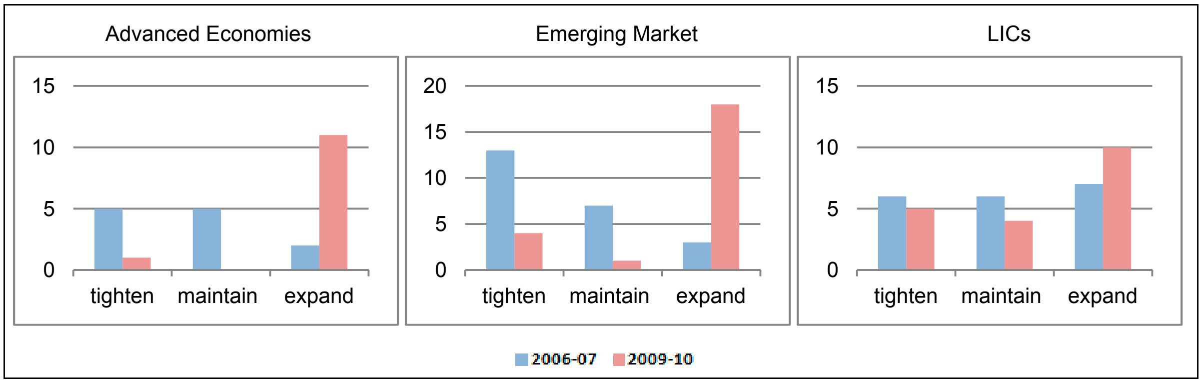


Source: Author's computations based on Article IV country reports.

12. **The shift in IMF advice to a more expansionary fiscal stance after the onset of the crisis applied to advanced, emerging, and developing economies alike.** When comparing the periods before and after the onset of the crisis, in all three groups there was a drop in the frequency with which staff advised fiscal consolidation, or the maintenance of the prevailing fiscal stance, in favor of the provision of fiscal stimulus (Figure 3). One may also

note the generally expansionary stance adopted by the IMF in LICs already before the crisis: in that period, fiscal tightening was recommended in only 6 of the 19 countries in this sample.

Figure 3. Staff's Fiscal Advice by Group of Countries
(Number of cases)



Source: Author's computations based on Article IV country reports.

IV. Concluding Summary

13. **In the wake of the global financial crisis, and faced with the threat of a widespread decline in economic activity, the IMF embraced the need for temporary fiscal stimulus in all economies that were in a position to undertake it.** This move was interpreted as a significant shift from the Fund's traditional preoccupation with the attainment of a sustainable fiscal position that would foster an economy's internal and external balance. This note musters evidence of this shift, but it also notes that already before the crisis there had been a marked improvement in the economic and fiscal situation in many countries that had reduced the need felt by the IMF to emphasize fiscal consolidation. To the extent that there is some truth to the notion that the degree of difficulty of the advice exerts an adverse influence on the willingness to accept such advice, the seemingly softer stance that the Fund adopted on fiscal matters may have contributed to the authorities' improved perception of the IMF.