The IMF and Macroeconomic Stabilization

The International Monetary Fund

Macroeconomic Adjustment and Structural Reform
Charter of the IMF - 1944

- Consultation on international monetary problems
- Expansion of trade and employment
- Promote exchange rate stability & orderly markets
- Elimination of restrictions on trade & payments
- Lending for Balance of Payments needs
  - safeguards for repayment = “conditionality”
  - avoid measures destructive of prosperity
- Shorten duration of payments disequilibria
What is the IMF?

- 183 member countries
- $272 billion in quota contributions
- 24 member Executive Board
  - votes proportional to quota (US 17% of total)
- Staff of 2,500 from all member countries
- Outstanding loans $65 billion to 90 countries as of June 30, 2001
- Technical assistance and training
Members with Ten Largest Quotas

(Percent of total quotas)

- United States: 17.6
- Japan: 6.5
- Germany: 6.2
- France: 5.1
- United Kingdom: 5.1
- Italy: 3.36
- Saudi Arabia: 3.3
- Canada: 3.02
- China: 3.02
- Russia: 2.8
Internal and External Balance
- Domestic resource gap
- Financing vs. Adjustment

Stabilization policies
- Expenditure-reducing policies
- Expenditure-switching policies

Structural policies
- Price liberalization
- Budgetary reforms
- Privatization of State Enterprises
- Financial sector reforms

Stabilization and Growth in Transition Economies
Internal and External Balance

- **Internal Balance**: full employment & price stability
- **External Balance**: sustainable current account position, reasonable debt levels
- **Domestic Resource Gap**:
  \[ Y - A = S - I = X - M + Y_f + Tr_f = CAB \]
  - Absorption \( A = C + I + G \)
- **Excessive Spending** \( A > Y \Rightarrow CAB < 0 \)
Financing vs. Adjustment

Choice depends on

- availability of assets or borrowing capacity
- expected length of shortfall in income

Adjustment is costly in short-run

Borrowing may be costly in long-run
Stabilization policies

- To restore internal and external balance
- Growth cannot be sustained without stability in prices and balance of payments
- Inflation is damaging to growth prospects
  - distorts saving and investment, reduces financial intermediation
- Payments problems damage ability to export and import, limiting growth
Fiscal policy affects taxes and government spending
\[ Y - A = S - I = S_g + S_p - I \] and \[ S_g = T - G \]

Monetary policy affects money supply, interest rates, and inflation
\[ \Delta M = \Delta NFA + \Delta NDA = CA + \Delta FI + \Delta NDA \]

Control of bank lending to government (\( \Delta NDA \)) allows control over reserves and BOP (\( CA \))
Expenditure-switching policies

Exchange rate adjustment

– real exchange rate: \( RER = eP_f / P \)

– \( RER \) measures relative price of domestic and foreign goods, competitiveness of domestic goods

– Exchange rates are easier to change than prices in case of external imbalance
The Equilibrium Real Exchange Rate

\[ R = \frac{eP_f}{P} \]
IMF Monetary Model

\[ Y = \nu M_o \quad \text{Demand for Money} \]
\[ Y = \text{nominal income}, \ M_o = M2 \text{ money stock} \]
\[ M = mY \quad M = \text{imports} \]
\[ \Delta M_o = B + \Delta D = \Delta F + \Delta D \quad \text{Money Supply} \]
\[ \Delta F = \bar{X} - M + \bar{K} \quad \text{Balance of Payments} \]

Source: Polak & Argy, *IMF Staff Papers*, 1971
“Domestic Credit and the Balance of Payments in Ghana”

(Franco, *J. Dev. Studies* 15(2), 1979,

\[ Y = 3.93M_o \]

\[ M = 231 + 0.15Y + 0.81\Delta F_{-1} \]

\[ M_o = D + F \]

\[ \Delta F = X - M + K \]

\[ \Delta Y = -\frac{\Delta F}{0.15} = 4(\Delta D + \Delta F) \]

\[ -\Delta F = 0.60(\Delta D + \Delta F) \]

\[ \Delta F = \frac{-0.60}{1.60} \Delta D = -0.37\Delta D \]

\[ \Delta Y = \frac{-0.37}{-0.15} \Delta D = 2.47\Delta D \]

\[ \Delta M_o = (1 - 0.37)\Delta D = 0.63\Delta D \]

<table>
<thead>
<tr>
<th>91 countries 1973-91</th>
<th>Program Countries</th>
<th>Controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government Borrowing*</td>
<td>3.6%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Fiscal Balance*</td>
<td>-6.9%</td>
<td>-3.4%</td>
</tr>
<tr>
<td>Domestic Credit**</td>
<td>25.1%</td>
<td>20.4%</td>
</tr>
<tr>
<td>Domestic Credit to Government**</td>
<td>42.4%</td>
<td>15.9%</td>
</tr>
<tr>
<td>M2**</td>
<td>18.9%</td>
<td>19.7%</td>
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</tbody>
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*Median, as % of GDP; ** % change
Debt Dynamics

\[ D + rB_{-1} = \Delta B, \ D = \text{deficit}, \ B = \text{debt} \]

To keep \( B/Y \) constant if \( Y = (1 + g)Y_{-1}, \ B = (1 + g)B_{-1} \)

\[ D = (g - r)B_{-1} \]

\[ \frac{D}{Y} = (g - r)\frac{B_{-1}}{Y_{-1}} \cdot \frac{Y_{-1}}{Y} = \frac{g - r}{1 + g} \cdot \frac{B_{-1}}{Y_{-1}} \]

If \( r > g \), surplus is required to sustain constant \( B/Y \) ratio.
Structural reform policies

- Price liberalization
  - To eliminate losses and distortions
- Budgetary reforms
  - To provide revenue and avoid reliance on inflation tax
- Privatization of State Enterprises
  - To improve efficiency and reduce losses
- Financial and external sector reforms
  - To avoid distortions in investment and saving
  - Trade liberalization improves efficiency and growth
- Improved governance to reduce corruption
Moving Beyond the “Washington Consensus”

- The **micro underpinnings** of macro stability
  - Competitive markets
  - Financial reform
  - More effective government

- Does Globalization work for all?
  - Are capital flows always beneficial?
  - Are low tariffs always best?
  - Does IMF conditionality work?
Competitive Markets

Trade liberalization and privatization should be the means to creating competitive domestic markets and not ends in themselves.

– Regulatory framework
– Competition policy
Financial Reform

- **Importance of a well-functioning financial system**
  - Allocating capital; monitoring the use of funds; reducing risk; increasing liquidity; conveying information

- **Importance of good information (transparency)**

- **Importance of regulation**
  - safety and soundness (prudential regulation); competition; protecting consumers; access to capital for all
Problems of Globalization

- Capital mobility can expose countries to contagion
- Pegged exchange rates can expose countries to over-valuation and currency risk
- Low tariffs may not lead to growth
  - Need access to industrial country markets
- IMF conditionality is not a solution to all problems
  - Need for country “ownership”
  - Large number of conditions can be counter-productive
  - Poor governance can defeat good programs
Does Conditionality Work?

- Studies show that many programs lead to improved performance
  - improved balance of payments
  - improved GDP growth rate
- Some borrowers fail to complete programs or return soon to borrow again
  - lack of governing capacity or corruption
  - failure to implement programs
Stabilization and Growth in Transition Economies

- Stabilization a prerequisite for growth
- Importance of structural reforms
- Necessity of honest and efficient institutions

Chart 1. Estimated Growth Effect of Structural Reform in Transition Economies

Source: Berg, Borensztein, Sahay, and Zettelmeyer (1999), Table 4.
Measures of Transition

Chart 2. Measures of Transition

Source: IMF World Economic Outlook, October 2000

EU Candidates (Bulgaria, Czech Rep., Hungary, Poland, Romania, Slovenia, Slovak Rep., Slovenia)
Baltics (Estonia, Latvia, Lithuania)
Balkans (Albania, Bosnia-Herzegovina, Croatia, Macedonia FYR)
CIS (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Rep., Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan)
EE Asia (Cambodia, China, Laos P.D.R., Vietnam)
Reforms and Economic Progress