Resistance to Change at the IMF*

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A chapter in the October 2020 edition of the IMF's biannual publication, Fiscal Monitor, argues that as a response to the Covid-19 pandemic, and to support the recovery as Covid-19 induced lockdowns are relaxed and the world moves to a post-pandemic phase, enhancing public expenditure is crucial. So, governments, the IMF argues, must bother less about increasing their levels of indebtedness and choose to spend instead. While the ongoing phase of partial lockdowns of varying severity, that spending must focus on saving lives and livelihoods, as these shut downs are relaxed and the world finally moves to a post-pandemic era, spending should be sustained to strengthen infrastructure with planning for long term infrastructural investment that is green, digital and inclusive. To anyone engaged with economic policy making in some form, that recommendation would sound like familiar sage advice received from a grandmother when young. Given the need to ramp up expenditures to address the health emergency, to support those whose livelihoods and businesses are threatened or lost, and address the pandemic's fall-out in the form of compressed demand and increased unutilized capacity in industry, this recommendation is nothing more than just obvious.

Yet, the IMF's view seems to be material enough to make the news and even headlines. The reason is not the substance of what the IMF is saying but the fact that it is the IMF that is saying it. For long the fountainhead of conservative fiscal policy, which recommended a stance that falls within the narrow range stretching from "fiscal discipline" to austerity, a plea for enhanced public expenditure from the IMF is seen as a telling shift.

Not that governments needed the IMF's advice to do what it recommends. Ever since the severe impact of the pandemic on economic activity was recognized, governments the world over have resorted to stimulus packages that relied heavily on borrowing. The magnitude of the immediate fiscal impulse has been estimated by European think tank Bruegel at close to 10 per cent of GDP in the US, UK and Germany and 5 per cent in France and Denmark, for example.

Given the exceptional nature of the Covid-induced crisis and the range of expenditures required to address the multiple challenges it poses, this was the route any half-sensitive government would follow. The IMF, to the extent it has modified its recommended stance, is only striving to remain relevant in a changing context. But even when doing so the IMF has by no means given up on its traditional conservatism. It identifies three phases and details phase-specific fiscal policy responses. In the first phase, with lockdowns of varying intensity, the focus of fiscal policy should, according to the Fund, be that of providing lifelines for people and firms, with some minimal spend on ongoing public sector projects and on maintenance. Meanwhile, planning must begin for larger spends in subsequent phases. In the second phase, when lockdowns are relaxed to restart activity wherever safely possible, the lifelines while continuing must be gradually phased out, support must be targeted, and workers must be persuaded to take up new jobs. In that phase too, public investment must be focused on maintenance and ready to implement projects which are labour intensive and have large multiplier effects. And finally, in the third, post-pandemic phase, innovative projects informed by the lessons of the pandemic and aimed at advancing a green, digital and inclusive agenda, which had been planned for in the preceding phases, need to be emphasized.

In some senses even these recommendations are a departure from tradition for the IMF. The organization is advocating increased public spending in the medium and long-term. It backs financing that spending with borrowing, even if at the expense of increasing public debt to GDP ratios. And, as opposed to the position it often adopted in the past that such spending “crowds out” private investment by absorbing credit and raising interest rates, it holds that public investment in fact “crowds in” private investment which is low and stuck in a trough.

The justification for this case for public spending is interesting, however. The conventional Keynesian case for increased spending in the midst of a recession is the presence of substantial unutilized capacity that depresses private investment and aggravates the recession. Public expenditure in that context not only revives demand and incentivizes private investment, but also increases tax revenues because of the resulting increase in output and employment, and therefore in part finances itself. The case here is increased public expenditure of any kind, with any preference for current or capital expenditures in the total being justified on other grounds.

As compared with this, the IMF’s case is primarily for an increase in debt financed public investment in infrastructure. The justification is also specific to circumstances and the type of expenditure. Thus, debt financed spending is considered acceptable because of the low levels of interest rates currently prevailing and that prevailed prior to the onset of the pandemic. That is, a proactive fiscal policy stance is seen as warranted because of the cheap and easy money environment created by the monetary policy stance that central banks, especially in the developed countries, have adopted prior to and after the 2008 global financial crisis. It is not the unutilized capacity resulting from the crisis, but the liquidity overhang and low interest rate regime created by monetary policy, that in the IMF’s view justifies debt financed spending.

This ties in with the IMF’s position that, other than for the unavoidable increase in current expenditures needed to address the health emergency, the policy focus has to be on increasing capital expenditure in the form of public investment in infrastructure. Within infrastructural investment, the type of investment matters inasmuch as the focus has to be on “efficient” infrastructural investment involving projects that can be implemented quickly and which deliver the greatest impact in terms of generating jobs immediately and having large multiplier effects.

Thus, in phase two of the post-Covid recovery process, when the lockdown is withdrawn and economic activity revives, the IMF recommends spending on maintenance and renovation of pre-existing infrastructure and some investment in ready for implementation, small-sized, job-intensive projects with large short-term multiplier effects. The case is not just for just any autonomous spending (current or capital) that raises aggregate demand, improves capacity utilization, and triggers new private investment. Rather it is for a specific kind of capital spending. Paulo Mauro of the IMF, and one of the authors of the study, made this clear in an interview to the Financial Times, where he refers to John Maynard Keynes’ idea that in a recession public spending can even directed to employing workers to dig holes in the ground only to fill them up, since that would achieve the aim of increasing employment, incomes and demand with salutary multiplier effects that trigger further investment. “We are certainly not talking about digging holes,” Mauro reportedly said. “Investment provides an asset for the country and is not wasteful. Right now, we are not at the point of literally trying to stimulate aggregate demand.”

But even withing public investment the IMF emphasises infrastructural investment in particular. The IMF’s argument seems to be that investment in infrastructure in phase 2 of the recovery would deliver most in terms of jobs and growth. The authors of study hold that their estimates indicate that: “Increasing public investment by 1 percent of GDP could strengthen confidence in the recovery and boost GDP by 2.7 percent, private investment by 10 percent, and employment by 1.2 percent if investments are of high quality.”

The implication seems to be that governments should in the first instance focus on quick yielding projects and profitable projects that can be financed with cheap credit, and only in the longer-term plan for projects that are “green, digital and inclusive”. For reasons unexplained the IMF sees only infrastructural investment as possessing these characteristics. This also raises the question as to why the IMF’s favoured agents, private sector investors, cannot be called upon to take over this task. That cannot happen, the study argues, for two reasons. The first is the environment of uncertainty that has engulfed economies, resulting in a reticence on the part of private players to invest. The second is the burden of indebtedness carried by overleveraged firms, which will not be willing to borrow more to invest. That is the public sector is needed because private sector is unwilling or incapable of ramping up investment currently. The public sector must step in to revive private sentiment and crowd in private investment.

But there are conditions. Public spending cannot be of the Keynesian type but must focus only on investment spending. Second, investment must be in quick yielding infrastructural projects which while reviving private sentiment also makes up for long years of ideologically inspired public underspending in areas that the private sector has not found attractive enough to step in to make up for public sector absence. Having come in, the public sector must contribute to sustaining investment that meets longer term goals of rendering growth green, digitally empowered and inclusive. All routine profit-making opportunities must be left to a revived private sector.

In sum, the IMF has stepped beyond its conservative fiscal policy framework only because there seems to be no option to address the post-Covid growth crisis. This is as much an agenda for private sector revival as it is for economic recovery. And it is predicated on the existence of an environment where private financial markets can be approached for cheap credit to finance the required public spending. But there is a catch there. As the IMF economists themselves recognize, not all countries would be in a position to tap private markets for the cheap money needed to pursue this agenda. If that be the case, these countries should not be overambitious, but opt for “a gradual scaling-up of public investment financed by borrowing”, ensuring that “rollover risks (risks associated with the refinancing of debt) and interest rates do not increase too much”. In some cases, this would imply little or no additional investment.

This differential approach would mean that pre-existing international inequalities would only widen. But that is an unavoidable price to pay, the IMF would argue, for being fiscally “prudent” and focusing on the task of reviving the private sector rather than on pushing development with whatever means are available.

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