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Rathin Roy *and* **Raquel Almeida Ramos**
International Policy Centre for Inclusive Growth (IPC-IG)

International Policy Centre for Inclusive Growth

International Policy Centre for Inclusive Growth (IPC - IG)
Poverty Practice, Bureau for Development Policy, UNDP
Esplanada dos Ministérios, Bloco O, 7º andar
70052-900 Brasilia, DF - Brazil
Telephone: +55 61 2105 5000

E-mail: ipc@ipc-undp.org ▪ URL: www.ipc-undp.org

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1 INTRODUCTION

When the International Monetary Fund (IMF) was created during the United Nations Monetary and Financial Conference in 1944, its purpose was "to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth." In that context of the Bretton Woods system, the Fund's main responsibility was to support the operation of the new system of fixed exchange rate regimes. With the breakdown of the par-value system in 1971, the Article on exchange rate arrangements, Article IV, had to be revised to legalise the choice for a floating exchange rate regime.

In accordance with the new principle of guaranteeing a *stable system of exchange rates*, the Article stated that member countries should seek a *stable exchange rate arrangement* and mentioned policies they should pursue to achieve these goals. The Article makes reference not only to external aspects, such as exchange rate manipulation, but also to the domestic side—"orderly economic growth with reasonable price stability" and "orderly underlying economic and financial conditions".

This focus on domestic policies differs from the Article's first version, which was centred on exchange rate policies and on exchange arrangements exclusively. This important shift extended members' obligations and the Fund's jurisdiction (IMF, 2006).

Another important attribute of Article IV is that it foresees the exercise of surveillance by the IMF on member countries' policies: "[the IMF shall] exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." This surveillance process takes the form of 'Article IV Consultations', which are normally done annually by the staff and result in a report in which the IMF's Executive Board presents its view on a country's policy and indicates recommendations. These reports can be made public or not, depending on the preferences of the countries' authorities. Article IV Consultations are now the main instrument through which the IMF exercises its *bilateral* surveillance activity. The Fund also exercises *multilateral* surveillance, looking at regional and global trends.

As the representation of the IMF's view on countries' fundamental policies, Article IV reports can have important impacts on domestic policy debate and policy decision-making. It is important to mention that more than representing the opinion of an international organisation, these are also the view of the institution to which countries would turn in case of crisis. In fact, it is not surprising that the Fund's resources play an important role in the

* International Policy Centre for Inclusive Growth (IPC-IG).

implementation of its advice. As Feldstein (1998) highlighted, during the period of economic adjustments in Latin America following debt crisis, the Fund provided "moderate amounts of credit to indicate that it was satisfied with the policy progress that the debtors were making". In the case of assistance given after the collapse of the Soviet Union, it argues that the IMF's "substantial financial rewards" encouraged acceptance of the Fund's advice, as there was no consensus on the "usefulness" of these recommendations.

As the author rightly put it, there is no consensus on whether the policies the IMF recommended to or imposed on countries were the best options. On the contrary, they received sharp criticism from a number of scholars. Two episodes deserve deeper attention: the Structural Adjustment Programs (SAP) implemented in response to the debt crisis in Africa in the 1980s, and the response to the Asian crisis in the late 1990s.

With regards to the first case, it has been argued that these programmes increased social deterioration and social unrest, rather than mitigating the problems. Regarding the advice given to Thailand and Indonesia, these have been argued to have increased, rather than reduced; the effects of the crisis (see Stiglitz, 2002; and Ito, 2007). As Stiglitz (2002:105) explains, East Asia was threatened with a major downturn and, therefore, needed economic stimulus. On the contrary, the IMF recommended austerity. As a consequence, the crisis deepened and spread widely among a number of countries in the region.

Another important criticism is that IMF advice in these two episodes was very similar, which is seen as evidence of a lack of consideration of particular circumstances in different countries. For instance, in both cases the policies included austerity actions, reductions in state and government spending and removal of state protection measures for the market (see Stiglitz, 2002; and Ito, 2007).

In addition to criticism of the policy recommendations themselves, the fact that they were given in the form of conditionalities to the Fund's resources is also a matter of concern. This attitude has been perceived as intruding on domestic political and economic decisions, which undermines national sovereignty (Stiglitz, 2002:9). As Feldstein (1998) highlighted, these were *structural reforms* that the IMF was imposing as conditions to loans. Moreover, the author argues that, in the case of Korea, these reforms were imposed in the interests of American and Japanese firms in the country.

Scholars are not the only ones to have criticised IMF policy recommendations; the Fund's Independent Evaluation Office (IEO) has also published reports on the subject. An evaluation of IMF publications carried out in 2011 concluded that many presented not enough country and institutional background, and that findings seemed to be biased towards current IMF policies. In fact, the majority of IMF staff indicated that they felt pressure to align their conclusions with IMF policies and positions, and a number of country authorities and researchers noted that IMF research tended to follow a pre-set view with predictable conclusions that did not allow for alternative perspectives. Other severe criticism includes that policy recommendations provided in some research publications did not follow from the research results. Furthermore, the report found that among authorities there is a widely held perception that IMF research is message driven (IEO, 2011).

Apart from these issues, it is important to bear in mind that to provide policy recommendations has not always been the Fund's role. As mentioned above, the Fund was created to support the operation of the par-value system. With the collapse of this system, the

IMF's role evolved towards policy recommendations and the use of conditionalities. Feldstein (1998) highlights three main episodes that determined major changes in the institution: the debt crisis in Latin America, the collapse of the Soviet Union, and the Asian Crisis. In the first case, the Fund assumed a role of monitoring the economic adjustments that the national authorities were putting in place. In the second, the IMF was already increasingly assuming responsibilities for providing advice on a number of economic issues. In the third, the IMF imposed structural reforms as condition to its loans.

Indeed, the Fund had assumed that conditionalities were part of its assistance by 1998, when Stanley Fischer stated: "we [the IMF] stand ready to do our duty, which is to help stabilize economies that may need financial assistance, *provided that they are willing to undertake appropriately ambitious economic reform and adjustment programs*" (Fischer, 1998).

Such a position is based on the argument that conditionality helps countries solve balance-of-payment problems. In keeping with this, the IMF often mentions that conditionalities are needed to ensure that member countries repay their loans.

Many of the IMF's loan facilities are conditional on the implementation of specific policies. However, according to the Fund, its position towards conditionalities has changed. Specifically, this change would have started in 2002, with the revision of the "guidelines on conditionality", and an important step was the implementation of a new lending facility which has a *new concept* of conditionality—the Flexible Credit Facility (FCL). As the IMF puts it, this new credit line is a major reform, as its conditionalities are ex-ante. This means that resources are conditional on *previously* implemented policies, instead of being conditional on implementing policies afterwards. As ex-ante criteria, the IMF mentions the importance of "very strong economic fundamentals", having "a sustained track record of implementing very strong policies" and the commitment to continue doing so in the future. Examples of "strong policies" are given: low and stable inflation, sound public finances and a comfortable reserve position (IMF, 2011d).

However, moving from ex-post to ex-ante conditionalities will not decrease the IMF's interference in national policymaking, because even with ex-ante conditionalitites, it is still up to the IMF to define what strong and sound policies are. With this new kind of conditionalitity, the IMF's policy recommendations would *always* have to be taken into consideration by member countries in case they want to remain eligible for this lending facility. This is indeed an important shift from implementing the IMF's policy recommendation as a one-time occurrence to doing so *constantly*. Therefore, the new lending facility does not decrease but rather increases the importance of IMF Article IV reports and the acceptance of IMF policy recommendations even further.

At the same time that reforms are demanded regarding the IMF's role and interference in domestic policymaking, a rethinking of economics as a whole has also been taking place since the recent crisis. An important focus was given to supervision and regulation, especially on the challenge of having *national* regulations and an *integrated* financial market. As a result, a new Basel Accord, the Basel III, was developed.

A second point of great attention was the role of the international financial architecture. The IMF itself acknowledged that public liquidity and loans to support adjustments were not sufficient to fill gaps adequately to prevent the spread of the crisis. It has also supported the view that regulation and supervision of international financial institutions did not provide a sufficiently robust framework to allow problems to be resolved smoothly. However, the IMF's response to these issues does not seem comprehensive, as it only argues for a reorientation of surveillance activities towards providing clear warnings and practical advice to policymakers (IMF, 2009b).

In the field of policies, which are the main concern of this paper, greater attention can be identified in the use of different instruments to fight inflation, in the role of capital controls, in the use of automatic stabilisers and in the importance of social stability to growth. The IMF has contributed to this debate and defended new positions with regards to these topics with several papers, conferences and speeches (see Claessens et al., 2010; Ostry et al., 2010; Ostry et al., 2011; Blanchard, 2011; and IMF, 2011d).

The motivation for this paper lies in this combination of the issues presented in this introduction. First, the IMF plays a significant and growing role in developing countries' decision-making by its policy recommendations, although this was not the Fund's initial purpose. Second, the policies the Fund recommended to developing countries have received significant criticisms from economists outside and inside the IMF. Third, there has been a demand for reforms in economics since the recent crisis to which the IMF's research department and top directors have shown support.

Against this background, the paper aims to analyse: a) whether IMF policy recommendations are based on a deep analysis of the countries' specific circumstances; and b) whether current IMF policy recommendations reflect the rethinking seen in economics and in the new positions defended by the Fund.

We analyse IMF policy recommendations proposed to 26 developing countries in 2010 through its Article IV reports. The countries were chosen with the aim of having a diversified sample both geographically and in terms of per capita GDP. The selection of the countries was also based on the availability of Article IV reports, as these are released throughout the year and some countries prefer not to have their reports published.

The 26 countries are: Albania, Benin, Botswana, Cameroon, Cape Verde, China, Colombia, Egypt, El Salvador, Ethiopia, Guinea-Bissau, India, Indonesia, Jordan, Kazakhstan, Malaysia, Moldova, Nepal, Panama, Paraguay, Peru, Senegal, South Africa, Thailand, Turkey, and Vietnam. Five of them are classified as low-income countries, 13 are lower-middle-income, and eight are upper-middle-income.[1]

To have a broad view of IMF recommendations, four main areas were chosen: exchange rate assessments, inflation, fiscal consolidation, and employment and other social policies. Each of the next four sections focuses on one of these areas. The last section concludes.

2 IMF ARTICLE IV REPORTS: AN ANALYSIS OF EXCHANGE RATE POLICY RECOMMENDATIONS

The IMF's Article IV emphasises the importance of maintaining "a stable system of exchange rates" due to the Fund's *essential purpose* "to provide a framework that facilitates the exchange of goods, services, and capital among countries." Accordingly, the Fund's annual consultations on exchange rates, and on policies that affect them, are a crucial part of bilateral surveillance activities.

From the countries' standpoint, preventing real exchange rate misalignments is also of crucial importance given their impact on international trade and to prevent currency crises. Besides, exchange rate policies in one country have, by definition, direct impacts on exchange rates in other countries, which requires *multilateral* surveillance.

This section focuses on IMF Article IV reports' analysis and recommendations concerning exchange rate policies. These were grouped as follows: the methods used to assess real exchange rate misalignments; policymaking in case of excessive capital flows; and recommendations of allowing more exchange rate flexibility. These sub-sections are followed by concluding remarks.

2.1 EXCHANGE RATE ASSESSMENTS: METHOD SHORTCOMINGS AND LACK OF POLICY RECOMMENDATION

First, we look at exchange rate assessments which check for misalignment. Although most of the reports provide such an analysis, they suffer from several shortcomings related to: the methods used and the lack of consideration to real developments; the assumption that the country will follow IMF policy recommendations in the econometric exercises; and the downplay of the existence of a misalignment, which led to a lack of policy recommendation.

For most of the reports, the exchange rate assessment is based in an econometric exercise using three methodologies: the macroeconomic balance (MB), the external sustainability approach (ES), and the equilibrium real exchange rate (ERER). An evaluation of qualitative evidence, however, is only included in few reports. The IMF gives greater importance to such evidence in three of the reports analysed.

In the case of Malaysia, although the econometric assessment estimates undervaluation, the report presents a series of evidence that suggests a balanced exchange rate. These are: low core inflation, no asset price bubble, and prevalence of two-sided intervention in the exchange market (IMF, 2010n).

Thailand's report argues for no exchange rate misalignment. It presents both econometric estimations and qualitative evidences such as: Thailand's real effective exchange rate path against other regional currencies; the stability of the export market share; and the success in penetrating the Chinese competitive market (IMF, 2010w).

For China, the report concludes that the renminbi is "substantially below the level that is consistent with medium-term fundamentals" after analysing: the pace of accumulation of international reserves; the current account outlook; and the real exchange rate and productivity paths in the country in comparison to trading partners. The report does not present the results of the econometric estimations (IMF, 2010g).

Although such analyses of real developments are insightful in assessing an exchange rate misalignment, these were not provided for all the reports. In the reports lacking a factual analysis, the assessment is solely based on an econometric exercise, despite the broad acceptance of their limitations. These limitations stem from the fact that exchange rate regressions are based on simplifications, on imprecise estimations of parameters and on projections of volatile prices, such as commodities—which have important impacts in many developing countries. To quote the IMF itself "the use of regressions to generate estimates of the equilibrium values of exchange rates requires assumptions about the equilibrium values of the explanatory variables, which for some variables—in particular, the net foreign asset position—are subject to considerable uncertainty" (Isard, 2007).

Some reports mention that estimations are subject to uncertainties, but this acknowledgement does not prevent the report from using these estimations as the sole determinant of the assessment. Uncertainties are recognised in particular when estimations differ significantly across different methodologies or the assessments show a not-negligible misalignment. Another common practice across the reports is to highlight uncertainties and conclude that no misalignment exists, without mentioning that, given the uncertainties, the misalignment could actually be higher than estimated.

One example is the case of South Africa, where different methodologies point to significant misalignments—overvaluation of 20 and 15 per cent (ES and MB approaches) and no misalignment (ERER). Notwithstanding the importance of these estimations, the report indicates that the rand is "somewhat overvalued, although the range of uncertainty accompanying these estimates is wide." Another part of the text says "the real exchange rate could be around 5–15 per cent overvalued"—much lower values than the estimations themselves. In this case, the report does not consider the possibility that the uncertainties surrounding the estimations could actually understate the problem, but only overestimate it (IMF, 2010v).

In the case of Cape Verde, the different methodologies show significantly diverging results: from a 12.5 per cent undervaluation (ERER) to a 9 per cent overvaluation (MB). The report, however, highlights that "the analysis has a high degree of uncertainty and is sensitive to methodological differences" and concludes that the currency is not misaligned (IMF, 2010f).

In the report written for Colombia, the estimations of real exchange rate assessments varied from 12 per cent overvaluation (ERER) to 16 per cent undervaluation (ES). However, the report concludes that "the real exchange rate was broadly in equilibrium" (IMF, 2010h).

Although different methodologies can, and often do, result in different estimations, the practice in this case is for the assessment to be followed by a judgment of which of the methodologies is the most appropriate given the country's fundamentals. However, such a prioritisation was not done in any econometric exchange rate assessment. The IMF's practice in Article IV reports, on the contrary, consists of presenting an *average* estimation from the different methodologies.[2]

Isard (2007) provides a discussion on relevant factors to judge a prioritisation among different methodologies of exchange rate assessments and concludes that an assessment should be focused on aspects which are important for the country's growth outlook. In this sense, the paper argues for the greater relevance of two methods. The first is the "assessments of the competitiveness of the tradable goods sector", given the clear impacts of unhealthy tradable goods sectors on the country's growth prospects. The second is the external sustainability approach, given that this "bears on the financial capacity to defend against speculative attacks" and that the "large welfare losses associated with currency crises are regarded as the main potential costs of overvaluation in advanced and emerging market countries."

In this sense, the ES approach should be of greater importance for emerging economies receiving significant amounts of capital flows. This is the case of South Africa, for instance, where it is mentioned that the exchange rate has responded to an increase in capital inflows, which were "likely driven by portfolio inflows and a search for yield." Nevertheless, as mentioned above, the report's conclusion is based on an average estimation, while the ES approach indicates an important overvaluation of 20 per cent (IMF, 2010v).

Another common practice in exchange rate assessments is to present the assumptions used. This is rarely done in Article IV reports. The Chinese report is an exception. As the report presents the country's authorities' view on the econometric assessment and their disagreement with the assumptions used, some of them are presented (IMF, 2010g). In this case, the relevance of the model's parameter has become evident, as the disagreement was on a main parameter: the medium-term consumption pattern and the expected current account surplus.

Another problem detected among estimations is the fact that some models assume that countries will implement policies recommended by the IMF. This is the case of Botswana (IMF, 2010d). The report concludes that there is no misalignment, based on the assumption that "fiscal consolidation proceeds as anticipated and that the budget balance returns to a moderate surplus over the medium term"—as recommended by the IMF. The report also highlights that if policies are not implemented, the real exchange rate is expected to be overvalued by 9 to 10 per cent by 2015—which is only the result of the MB approach.

In the case of Guinea-Bissau, the estimation considers that the country has already passed through the debt relief programme,[3] which decreases the estimated real exchange rate overvaluation from 21 per cent to 3 per cent (IMF, 2010k). The significant misalignment is consistent with the estimation done for the CFA franc in general—an overvaluation of between 4 per cent and 11 per cent (IMF, 2011b)—and represents a not-negligible burden for a country whose exports represent more than 20 per cent of GDP and are based on one main product, cashews. Nevertheless, the report concludes that estimations "do not suggest that the exchange rate is overvalued" and focuses the discussion on structural factors only.

Similarly to the case of Guinea-Bissau, many IMF Article IV reports have understated the relevance of misalignment estimations. This is normally a result of the Fund's usual practice of considering the average estimation, without discussing the relevance of each methodology according to countries' specificities; drawing conclusions based on average estimations and emphasising the uncertainty inherent to the econometric assessments as if this would mean that the misalignment is overestimated; and neglecting real developments in the analysis.

The above-mentioned case of Botswana is a good example. The report concludes that "the exchange rate is broadly in line with its medium-term equilibrium level", although the box dedicated to the assessment itself presented estimations of overvaluation of 9–10 per cent (MB), 7 per cent (ERER) and 4 per cent (ES), which are based on the assumption of fiscal consolidation (IMF, 2010d).

In the case of Albania, estimations indicate overvaluation,[4] with the ES approach indicating the need for a 20 per cent depreciation. However, the IMF concludes that this does not pose risks to external stability,[5] because the exchange rate had passed through a 10 per cent depreciation in 2009. However, the analysis done in mid-2010 does not mention that this was a period characterised by a sudden reversal of capital flows and exchange rate depreciation in many developing countries and was, therefore, not an adjustment of the Albanian lek but rather an international and maybe short-lived movement (IMF, 2010a).

Also in the case of Senegal the report seems to understate the importance of the estimations: while the assessment presents estimations of overvaluation of 8 per cent (ES) and 5 per cent (MB), and no misalignment (ERER), the report concludes that the real effective exchange rate *may be modestly overvalued* and highlights that "the estimates are within the normal margin of error." Only medium-term policy recommendations were given, as *improving the business environment and governance* (IMF, 2010u).

For Cameroon, although the results of the methodologies indicate overvaluation—8 per cent (ES), 4 per cent (MB) and 2 per cent (ERER)—the report concludes that the country's real effective exchange rate "is broadly in line with fundamentals". In accordance, the report provides no real policy recommendation. It states that "this [moderate overvaluation estimated by the ES approach] could be corrected if the euro current weakness is sustained" and argues for the need of enhancing the "business environment". However, depending on the euro path against the dollar is not a policy option, and enhancing the business environment can only be a medium-term response, thus Cameroon is left without immediate policy recommendations (IMF, 2010e).

Benin did not receive much policy recommendation either, although estimations indicated an overvaluation of about 13–22 per cent. This significant misalignment is consistent with the estimation of the CFA franc in general (IMF, 2011b) and was already detected in the country's last Article IV consultation (in 2008). Despite acknowledging that the overvaluation of the real exchange rate "could jeopardize Benin's growth potential", the IMF draws medium-term policy recommendations only, as pursuing *prudent policies*, accelerating structural reforms and enhancing the business climate. Following these recommendations, the Beninese authorities began tightening their fiscal stance, which might not be the most effective policy to reduce inflation, given the significant weight of food prices in the country's Consumer Price Index (CPI) (IMF, 2010c). Moreover, some fiscal policies, such as the IMF's prior recommendation to increase electricity tariffs, can actually increase inflation and worsen the overvaluation of the real exchange rate.

2.2 RECOMMENDATIONS OF ALLOWING MORE EXCHANGE RATE FLEXIBILITY

The IMF's recommendation of allowing greater exchange rate flexibility is a common practice throughout the reports. Not only is this done to countries where this could result in real exchange rate misalignment, but also to countries where exchange rate stability is of crucial importance to keep inflation under control or to guarantee stability.

The IMF's recommendations of exchange rate flexibility are based on the benefits of this regime as a shock absorber. However, the exchange rate also has other important effects on the real economy that should not be overlooked—especially in developing countries, where, depending on country-specific circumstances, these tend to be higher. With regards to inflation, one such specificity is the exchange rate pass-through to domestic prices, which are found to be higher for developing and emerging countries.

Choudhri and Hakura (2001) estimated the exchange rate pass-through for emerging economies at 26 per cent, for non-G3[6] industrial economies at 12 per cent, and for G3 economies at 7 per cent. Also Hausmann et al. (2001) estimated emerging economies' pass-through as higher than those for non-G3 industrial economies or G3 economies (75 per cent, 19 per cent and 7 per cent, respectively).[7] This difference among countries in different stages of development was also found by Goldfajn and Werlang (2000): "The pass-through is substantially lower in OECD[8] (or developed countries) relative to emerging market economies."

The debate on the reasons behind the higher pass-through frequently links it to higher inflation and higher exchange rate volatility in developing countries. Choudhri and Hakura (2001) found a strong association between high pass-through and high inflation. Eichengreen (2002) also indicates an inflationary past as the reason behind the higher inflation pass-through in some countries.

Other studies give more emphasis to exchange rate-related aspects. Goldfajn and Werlang (2000) found that a real exchange rate misalignment prior to depreciation is the most important determinant of the pass-through in emerging markets. Ho and McCauley (2003) argue that emerging countries are relatively more exposed to exchange rate fluctuations than industrial economies. In a different approach, Farhi (2007) argues that the reason behind the important impacts of the exchange rate on inflation is the high exchange rate volatility in developing countries. As argued by the author, this reflects the fact that developing countries' currencies are not used as a reserve of value and, therefore, oscillate according to international liquidity.

Given this higher impact of the exchange rate on inflation, along with the problem of higher exchange rate volatility, a regime of flexible exchange rates might pose different challenges for developing countries' policymakers. This would explain why the "fear of floating" has in fact been called a "fear of inflation";[9] as argued by Ho and McCauley (2003), an emerging market's more interventionist approach to exchange rate markets is derived from the fact that its higher exposure to exchange rate fluctuations resulted in significant challenges to inflation targeting. As they show, 45 per cent of the missed targets between 1998 and 2002 were due to significant exchange rate depreciation.

This more interventionist policy stance was acknowledged and praised by Blanchard (2011), who affirmed that developing countries' central bankers were right to care about inflation, even when affirming that they allowed full exchange rate flexibility and fought inflation through the policy rate only.

Despite the significant body of research on the importance of avoiding excessive exchange rate volatility in developing countries and the recognition of this by IMF's chief economist, the IMF recommended greater exchange rate flexibility in many of the country reports analysed. In most of the cases, the reports themselves mention problems arising from exchange rate volatility in the past.

The case of Paraguay is one example. The report states that the country "has a sizable exchange rate pass-through". Since the monetary transmission mechanism in the country is weak, foreign exchange rate intervention becomes an important instrument to fight inflation. Nevertheless, the IMF considers that these interventions are a "confusing signal about its commitment to low inflation" and recommends avoiding them (IMF, 2010q).

Moldova also has a "still underdeveloped transmission mechanism", and inflation drivers are mainly cost-push. Moreover, the country has a relatively high degree of dollarisation which "exposes the borrowers and banks to exchange rate and credit risks". Nevertheless, the IMF recommends exchange rate intervention to be limited, aiming "at smoothing erratic movements" only (IMF, 2010t).

In the case of Egypt, the IMF recommends using sterilised intervention in the exchange market. However, it also highlights the importance of allowing greater exchange rate variability while the country moves to a full inflation-targeting regime. This advice is given despite acknowledging the impact of volatile portfolio flows in the exchange rate and its important role in forming inflation expectations. In this case, allowing greater exchange rate flexibility might have the opposite result: more inflation variability.

The country authorities, however, have "underscored the importance of protecting the economy from excessive volatility, including if driven by hot money inflows" (IMF, 2010b).

Furthermore, this recommendation is based on the argument that it would *limit one-way bets*. However, letting the exchange rate appreciate in case of continued capital inflows could increase foreigners' expected gains from an investment in the country—given by the asset's gain and the currency appreciation—increasing incentives to more inflows.

Peru is a "still highly dollarized economy", where the ongoing de-dollarisation process combined with significant and volatile capital inflows have increased exchange rate volatility. Nevertheless, the IMF recommends that the country allow greater exchange rate variability, arguing that this would reduce incentives for one-sided bets. The country authorities, however, have mentioned concerns with this policy, and noted that the policy of intervention in the exchange markets aimed at mitigating "the volatility of the exchange rate and its potential balance-sheet effects in the context of a still highly dollarized economy" (IMF, 2010r).

The recommendation given to Vietnam to move towards a more flexible exchange rate regime also seems a contradiction, as the IMF highlights the importance of maintaining exchange rate stability to attract foreign direct investment (FDI). It also argues that the medium-term economic outlook is favourable, given that the "the exchange rate stability is maintained." As the reports shows, the Central Bank authorities slightly disagreed with this recommendation. They reiterated their commitment to macroeconomic stability but added that they focus on stability under the current exchange rate regime (IMF, 2010y).

The IMF also recommended that China allow for greater exchange rate flexibility, allowing it "to respond more to the forces of demand and supply". However, differently from the other countries, China's report provides a detailed analysis of the impact of an exchange rate appreciation on different Chinese provinces (IMF, 2010g).

2.3 CAPITAL FLOWS AND POLICY RECOMMENDATIONS: CAPITAL CONTROLS?

Countries facing problems of excessive capital flows and exchange rate appreciation also received unsatisfactory policy recommendations. These were especially important for the "failure of expectations", as they do not reflect the debate seen in IMF publications on this matter, especially the reversal of the Fund's long-held position on capital controls.

After the sudden outflow of capital from emerging markets following the collapse of Lehman, some of these countries faced a surprisingly rapid rebound of portfolio capital triggered by the multi-speed feature of the global recovery. These two important shocks in a very short period posed different problems to several developing countries' economies, depending on their structures and on the features of their international integration. For some emerging market economies, the sudden capital outflow added the issue of lack of funding to the already complicated economic situation, and the sudden inflow posed challenges to policymakers, especially on the fight against inflation. Also very importantly, this turbulence brought uncertainty to the domestic economies. As a response, some of these countries imposed capital controls, which trigged a debate on how to better handle capital flows.

Capital controls are defended on the grounds that full capital account liberalisation can have important negative effects on developing economies such as intensifying boom and bust cycles. This happens because increased inflows in boom periods enlarge effects of bust periods, and due to the higher exposure to contagion from other economies (Rodrik, 1998).

This was seen in the late 1990s, when a sudden stop of capital flows led to a severe currency crisis and to the change of the exchange regimes in place in many countries.[10]

Indeed, some empirical studies on the expected causality between the openness of capital accounts and better economic performance could not find a robust correlation between the two (see Rodrik, 1998; and Grilli and Miles-Ferretti, 1995). Rogoff (2002) also considered that the liberalisation of short-term capital flows was done prematurely in some countries.

Against this background, policies of capital controls aim to limit the negative effects full capital account liberalisation can have on the economy. Therefore, capital controls are generally imposed at times of excessive inflows, sudden outflows or when the volatility of flows reaches excessively high levels. Capital controls can be qualitative, forbidding a certain type of flow; or quantitative, reducing the total amount by imposing a direct or an indirect tax.[11]

The effectiveness of these policies is the subject of many studies, as some authors argue that they are ineffective. The main reason behind this argument is that participants in the financial market would find loopholes in the legislation and ways to circumvent controls.[12] Although this might have happened in some cases, there is no reason to think that all types of controls will always be completely circumvented and, therefore, will never be effective.[13] Another problem with the analysis of the effectiveness of capital controls is related to the nature of the studies, which are sometimes not compatible with the basic features of the issue.

Some capital control policies target the exchange rate by changing capital flows. However, exchange rates are bilateral by definition; therefore, exchange rates movements are defined not only by domestic policies (or speculative movements) but also by changes in a second economy. Moreover, when exchange rates are determined by portfolio flows which aim at short-term returns from assets which are almost homogeneous throughout different countries (labelled as emerging markets only), flows to a country will be directly influenced by the situation in other countries (or assets) which are usually classified in the same group. Moreover, as flows are driven by the return differential, they will also be driven by changes in the funding conditions in the central economies. Summing up, apart from the changes in policymaking and economic situation in the country imposing capital controls, there are many other drivers for an exchange rate change. Apart from not being under the control of the domestic policymakers, these changes are evolving ones and very difficult to measure.

Given this very nature of exchange rates and portfolio flows, an assessment of effectiveness of controls that does not take into account the changes occurring in other economies is not appropriate. Panel studies which aim to assess the effectiveness of controls in several country cases often suffer from this problem. In this case, deeper assessments of a country's specific case are more useful.[14] Among papers that follow such an approach, it is important to highlight Epstein et al. (2003), which provides a comprehensive analysis of seven experiences of capital account management. Based on a detailed description of each context, the authors conclude that these policies were effective in a broad variety of "critical macroeconomic objectives".

The IMF's participation in this debate was very important. In a paper in 2009 the Fund stated that large capital inflows "can lead to sharp appreciations, often followed by abrupt reversals and strong effects on balance sheets" (IMF, 2009a). Later, in 2010, with more of a focus on emerging countries, it was acknowledged that, in some circumstances, capital controls should be part of the toolkit (Ostry et al., 2010). In 2011, a paper was published on the best design of capital controls in terms of effectiveness and efficiency (Ostry et al., 2011).

This was an important change to the Fund's earlier position of promoting capital account liberalisation which had its peak at its annual meeting of 1997, when proceedings were initiated to change one of its 'Article of Agreements' from the legitimisation of the use of capital controls to a commitment on full capital account convertibility. This attempt was abandoned with the Asian crisis that followed, although, even after the turmoil experienced, Stanley Fischer still argued that capital account liberalisation would only be a problem if the sequencing was wrong and defended that the Articles of Agreement should be changed—"an amendment of the Fund's Articles of Agreement is the best way of ensuring that capital account liberalization is carried out in an orderly, non-disruptive way, that understates the risks that premature liberalization could pose for an economy and its policy makers" (Fischer, 1998).

The change seen in the recent papers fuelled expectations that the Fund had finally acknowledged the importance of capital controls and of their use as part of a policy toolkit. This was expected to be seen in at least some circumstances: "if the country is operating near potential, if the level of reserves is adequate, if the exchange rate is not undervalued, and if the flows are likely to be transitory" (Ostry et al., 2010).

Despite this important change in the IMF's view on capital account liberalisation, an analysis of IMF 2010 Article IV reports reveals the neglect of capital controls as a policy tool in most of the country discussions.[15] The policy recommendations drawn for these countries are the topic of this next section.

In the case of Egypt, the consequences of excessive capital inflows for growth prospects are clear in the report. Estimations of exchange rate misalignment indicate an average 7.3 per cent real overvaluation. The report also says that "further real appreciation driven by short-term capital flows could weaken medium-term growth prospects." Despite the importance of this exchange rate misalignment for Egypt's competitiveness, the IMF concludes that this is not causing competitiveness problems at the moment. The Fund's advice emphasises exchange rate flexibility and mentions implementing fiscal consolidation, a medium-term policy. In addition, it recommends the use of sterilised intervention, although reserves are already beyond threshold levels[16] (IMF, 2010b).

Indonesia's situation is similar to Egypt's, and the recommendations are comparable. The IMF's report recognises that continued capital inflows could weaken competitiveness, increase sterilisation costs and pose stability problems in the case of sudden reversal. Regarding policy recommendations, the IMF highlights the importance of maintaining exchange rate flexibility, mentions that reserves could be increased —although recognising sterilisation costs as *mounting* —and cites medium-term reforms: "measures to remove supply constraints, including developing infrastructure and improving the investment climate". The report also mentions the recently implemented one-month holding requirement on Bank Indonesia Certificates (SBIs), a policy that aims to curb volatility. IMF staff have not commented on the policy's impact on volatility, only remarking that its impact on sterilisation costs is not evident, as they could actually increase if "SBI yields rise to compensate for the lower liquidity" (IMF, 2010l).

Thailand is also in a similar situation. From a starting point where the real exchange rate is estimated to be close to equilibrium, the IMF recommends that the country let the exchange rate fluctuate according to changes in capital flows. However, as explained by the report, capital flows are volatile and related to risk aversion internationally. In this case, the IMF is recommending that Thailand allow the baht to be determined, in the end, by volatile external conditions, which would be an exchange rate misalignment. Furthermore, this recommendation does not take into account the especially significant impacts a misalignment can cause on the Thai economy, given its high degree of openness—as the report itself mentions, "one of the world's most open economies, where exports account for over 60 percent of GDP" (IMF, 2010w).

IMF recommendations for India on how to deal with a possible increase in capital flows are also focused on exchange rate flexibility and accumulation of reserves of foreign assets. Additionally, the report states that some exchange rate appreciation would be beneficial, as it would reduce incentives for additional inflows. This analysis does not consider that allowing further exchange rate appreciation could have the opposite effect if it creates an expectation of future appreciation, increasing foreigners' expected return from an Indian asset—as explained above for the case of Egypt. The IMF also highlights its recommendation of fiscal consolidation, which is expected to reduce the real appreciation.

Another policy recommendation was to expand the economy's absorptive capacity by "deepening domestic financial markets", "further developing the corporate bond market" and "liberalizing FDI", based on the assumption that these types of inflows have more benefits than the short-term ones. This advice considers these investment possibilities as substitutes, regardless of their significantly different fundamentals. If one assumes they are not substitutes, then the advice will lead to the opposite result—increased total capital inflows—as this creates new investment possibilities.

The IMF also recommends prudential policies, such as raising the cash reserve ratio, implementing macro prudential measures and tightening external borrowing regulations. Capital controls are only seen as a *last resort*. Nevertheless, the Indian authorities have mentioned that capital controls could be considered in case flows "exceed current levels by a large margin" and have highlighted the importance of push factors in advanced economies in determining these flows (IMF, 2011c).

South Africa's report presents the deepest discussion on possible policies to deal with the exchange rate overvaluation. The analysis considers, for example, that: an interest rate decrease would not be very effective, as flows are directed to stock markets; a fiscal tightening would not help to support the economic recovery; outflow controls should be removed only gradually, given the risk of sudden outflow. However, even this deep analysis has not followed the IMF's most recent papers' recommendations and does not consider the possibility of implementing capital controls on the grounds that these are claimed to be *ineffective* (IMF, 2010v).

2.4 CONCLUSION

This section has analysed IMF policy recommendations related to exchange rate policies: the assessments of misalignment, the recommendations of allowing higher exchange rate flexibility and the lack of advice on capital controls.

As seen, the methodology used in the country reports to check for misalignment is not in line with best practice. First, only a few middle-income country reports have had factual evidence considered in the assessments of misalignment, while the majority of the reports have drawn their conclusions from econometric estimation only, despite their well-known shortcomings. Second, diverging misalignment estimations were not prioritised according to the country's context. Instead, the Fund has drawn conclusions based on average estimations. Third, uncertainties inherent in estimations were highlighted as support to conclusions of no real exchange rate misalignment, even though they might indicate that the misalignment was in fact *under*estimated. Fourth, some econometric exercises carried out on low-income countries assumed the implementation of a policy recommended by the IMF, resulting in an artificial exchange rate assessment and in an additional pressure to implement the policy recommended.

Furthermore, the analysis has shown that based on these practices the IMF tends to conclude that no misalignment exists, especially in low-income country reports. In this case, many countries are left with no policy recommendation to deal with the possible misalignment. In other cases, the IMF has offered medium-term policy recommendations only.

This section has also shown that the IMF recommends that countries increase exchange rate variability despite the broad acceptance of the impacts the exchange rate can have on inflation in developing countries, in general, and the acknowledgement that this happens in the countries in question. Also important, the analysis of the reports shows that policymakers generally reacted against this policy advice, reaffirming the importance of avoiding large exchange rate changes as a way to increase macroeconomic stability. This might be additional evidence that central bankers' interventions in the exchange rate markets are based on the fear of inflation and instability in a more general sense.

Finally, the section has also identified problems with policy recommendations related to excessive short-term capital inflows—a problem that becomes of greater importance with the global financial crisis and has led to significant policy rethinking, even in the IMF itself. It was shown that despite the change in the position of the Fund's top economists and research department towards the use of capital controls, the Article IV reports have not incorporated them as policy tools.

3 IMF ARTICLE IV REPORTS: AN ANALYSIS OF POLICY RECOMMENDATIONS ON INFLATION

The fight against inflation has been an important topic of economic research. From the late-1970s onwards, after Fischer and Modigliani (1978), several papers were dedicated to the negative effects of inflation on economic activity. One of the most important negative effects of inflation is on investors' decision-making processes. As the evaluation of future price developments becomes more difficult, the uncertainty surrounding the return of an investment will be higher, which is a disincentive to investment. It is also argued that this same uncertainty would result in higher risk premiums for loans, and, therefore, credit would be more expensive. Other important costs of high inflation are the distortion it produces in relative prices and in taxation. Based on these assumptions, inflation would have a negative impact on growth (Freedman and Laxton, 2009).

Apart from the importance of inflation itself, the policies used to fight it are of growing importance, given the current mainstream framework, which focuses only on monetary policies to fight demand inflation and neglects the other effects of these policies. With the monetarist revolution in the 1970s and, specifically, the acceptance that discretionary policies have an inflation bias and are time-inconsistent (Kydland and Prescott, 1977), there was a significant shift towards rules-based policymaking. Based on this framework, central bankers should make a public commitment to follow a specific policy objective. This academic debate gained space in policymaking, and fighting inflation has been set as *the main* priority in many countries.[17] This focus was even more evident after many developing countries adopted a free floating exchange rate regime after the late 1990s crisis. Moreover, there was a convergence towards policies focused on demand inflation. In the words of Frenkel (2006), two trends can be observed. In the field of *targets*, "the anti-inflationary target moved the employment objective to a secondary position." And in the field of *instruments*, "monetary policy became established as the macroeconomic policy *par excellence*."[18]

In extreme cases, countries decide to implement the increasingly popular regime of inflation targeting (IT). This framework was first implemented in industrialised countries and has been gaining traction in developing countries. In the last 15 years, 18 non-industrialised countries implemented the IT regime (Berganza and Broto, 2011), and according to Batini et al. (2006), eight other countries were receiving technical assistance on the IT regime, and 17 countries had requested it.[19]

The IMF's role in promoting the regime is undeniable, as the Fund is responsible for providing technical assistance to many central banks and conducts annual evaluations of these policies, usually assessing them as positive and emphasising the respective central banks' commitment to the regime. Epstein (2007) also emphasises the IMF's efforts to promote the IT regime and its role in building this 'momentum' for fully-fledged IT in developing countries. He also recognises that this momentum is happening despite "little evidence concerning the success of inflation targeting in its promotion of economic growth, employment creation and poverty reduction, and mixed evidence at best that it actually reduces inflation itself".

Although some studies argue for the positive outcomes of the IT regime in developing countries, countries that have not implemented an IT regime have also been successful in reducing inflation (Angeriz and Arestis, 2006). These results reflect the fact that inflation, in the last decade, has not been as big a problem as it used to be—especially before the food price shocks. Still, the "single-minded focus on inflation" continues and has spread to developing countries (Epstein, 2007).

With the post-crisis rethinking, though, some IMF economists have also criticised the focus on one target and one instrument. As Blanchard (2011) states, "we had convinced ourselves that there was one target, inflation. There was one instrument, the policy rate (…) If there is one lesson to be drawn from this crisis, it is that this construction wasn't right, that beauty is unfortunately not always synonymous with truth. The fact is that there are many targets and there are many instruments." The author concludes that stable inflation does not guarantee a stable output gap, and even if these two are in check, other aspects of the economy might require policy attention.[20]

The significance of the effects of inflation policies, and of inflation itself, on a country's economic situation is the motivation for a careful analysis of the recommendations made by the IMF. This section focuses on the policy recommendations and, specifically, on identifying whether these recommendations reflect the Fund's current thinking. The sub-sections look at: i) the cost–benefit analysis done when recommending a specific inflation target, and how deep the inflation analysis is; ii) recommendations on supply-side inflation; iii) allowing for higher exchange rate variability regardless of inflation shocks; iv) recommendations given to countries receiving significant portfolio inflows; and v) recommendations related to the inflation targeting regime.

3.1 COST–BENEFIT ANALYSIS OF THE TARGETED INFLATION RATE

In the aftermath of the global financial and economic crisis, many countries needed a supportive monetary policy stance. Still, many policymakers have opted for a monetary tightening just a short time later, due to increasing inflation—which was mostly due to increasing food and oil prices. This behaviour, seen as premature by many economists, highlighted the importance of a debate on the cost and benefit analysis of a targeted inflation rate: are the gains of the lower inflation rate worth the negative consequences of a restrictive policy on the economy's output? [21]

This debate is even more important in developing countries, where the capacity to undertake an expansionary fiscal policy might be limited and the threshold at which inflation begins having a negative impact on growth is higher. There might be arguments against an exact threshold level. However, it is important to note that evidence on the subject found a significant difference in the threshold in developed and developing countries. Khan and Senhadji (2000) find the threshold to be 1–3 per cent for industrial countries and 7–11 per cent for developing countries; while Drukker et al. (2005) estimate this number at 2 per cent and 19 per cent, respectively.[22]

Considering that very low inflation levels can demand very high costs to growth, this debate on the adequate level of inflation is highly significant. Nevertheless, *none* of the 26 IMF country reports examined presented a cost–benefit analysis of the targeted inflation rate.[23]

The most complete inflation analyses were those done for India and China. The Indian analysis presents an extensive analysis on the sources of inflation, mentioning: capacity utilisation; service prices; anecdotal evidence on wage increases; rural income; and the elasticity of food supply (IMF, 2011c). The report on China also covers the sources of inflation and takes into account the positive impact of the current high level of investments and productivity growth on near-term inflation (IMF, 2010g).

Consideration of the impact of capacity utilisation and the pace of investment on future inflation is of great importance for countries where the investment rate is high. In these countries, the higher investment rate may increase inflationary pressure in the short term, but it is important to consider the effect of these investments in easing inflationary pressures in the near term. This analysis would have been insightful for emerging markets, but it was absent from other reports.

Considering the elasticity of food supply is also important, especially in countries where food prices have a substantial weight in CPIs and in light of the recent food crises. Though present in China's and India's reports, this analysis could not be found in other countries' reports. In one case—the report on Benin—the IMF mentions the government authorities' analysis that the decline in food prices was due to government incentives to increase food production (IMF, 2010c). Although this seems to be an adequate alternative policy, the IMF has not commented nor given any recommendation on it.

3.2 SUPPLY-SIDE INFLATION AND ANCHORING INFLATION EXPECTATIONS

Monetary tightening is designed to control demand-led inflation. However, as mentioned above, we have been facing a convergence towards the use of monetary policy only, regardless of the inflation source. Indeed, several Article IV reports argue for the need for a policy tightening as a means to keep inflation under control even in the case of supply-side inflation.

The report written for Indonesia, for example, presents inflation as *relatively low*, and below the country's target. It also mentions that "inflationary risks in 2010/11 arise from rising *commodity prices and supply-side constraints*" (IMF, 2010l). Nonetheless, the IMF's recommendations focus on monetary policies. The case of Jordan is similar. The IMF states that "inflation is projected to increase *in line with imported commodity (energy and food) prices*" and recommends that the Central Bank "tighten *monetary conditions* if inflation accelerates" (IMF, 2010m). In the case of Botswana, the sources of inflation are "increases in the rate of value-added tax (VAT), electricity tariffs and other administered prices", and IMF recommendations focus on *monetary and exchange rate policies* (IMF, 2010d). In Egypt, inflation stemmed from increased fruit and vegetable prices. Nevertheless, the IMF recommends that the Central Bank "stand ready to tighten *monetary conditions* if inflation does not abate" (IMF, 2010b).

In Colombia, inflation is also *driven by supply factors*, and the IMF also recommends that the Central Bank *stand ready to tighten* the policy stance at the first sign of domestic demand pressures. However, the focus here is on fiscal policies, as the country is receiving excessive capital inflows (IMF, 2010h).

The argument for the use of monetary or fiscal policies in the case of supply-led inflation is to control inflation expectations or to contain second-round inflation effects. All the reports quoted above justify using monetary policies due to this concern: "signaling a proactive stance is needed to anchor inflation expectations" (Indonesia); the rise of inflation "risk(s) inducing inflationary momentum through its effect on inflation expectations" (Jordan (IMF, 2010m)); "to ensure that inflation expectations become more firmly anchored" (Botswana (IMF, 2010d)); "persistently high headline inflation risks generating inflationary momentum through its effect on expectations" (Egypt (IMF, 2010b)).

Despite this general 'consensus' of focusing more on inflation expectations than on inflation itself, policy recommendations given to Colombia seem more coherent, as they consider the sources of inflation and the need to support the economic recovery. As argued: "the rise in inflation in 2010 would be driven by supply factors and should not call for an immediate policy response" and "with expectations still inside the target range, the monetary stance during 2010 should remain accommodative until there is clear evidence of a sustained recovery." Nevertheless, the report also mentions concerns with "the effects of higher food prices on inflation expectations" (IMF, 2010h).

The argument behind the policy framework developed to control inflation expectations is that agents consider monetary tightening as an indication of lower inflation in the future, regardless of the inflation source—given the need for effective communication, an interest rate change is the policy recommended, as it can be easily understood by the public. By having lower inflation expectations, they would remark their prices by a lower amount, reducing current inflation. However, why should policymakers fight inflation through its second-round effects on expectations only? Other mechanisms which affect current inflation by being coherent with the inflation source could lower inflation and, therefore, control inflation expectations as well.

Moreover, conducting monetary policies with the sole focus of controlling inflation regardless of the growth scenario is also not appropriate. This focus on inflation control is the result of an understanding that stable inflation results in a stable output gap.[24] However, this argument is also the concern of a deep rethinking. As stated by Blanchard (2011), "the link between inflation stability and the output gap is probably much less tight than we pretended

(…) If this is the case, then central bankers, when they care about macro stability, cannot be content just to keep inflation stable. They have to watch both inflation and the output gap, measured as best as they can. Nobody will watch the output gap for them."

As mentioned above, the report written for Colombia was the only one in which the IMF also considered the economic environment—not only inflation.

3.3 HIGHER EXCHANGE RATE VARIABILITY AND INFLATION SHOCKS

In several reports the IMF recommends or welcomes the use of a fully flexible exchange rate regime as a shock absorber. In this sense, recommendations to allow higher exchange rate variability are often given, despite acknowledging the impacts of exchange rate shocks on inflation rates in the past. This is further evidence of the focus of inflation policies on controlling demand-led inflation only, as argued above.

A common problem with fully flexible exchange rates in developing economies is the high pass-through of the exchange rate to inflation in these countries. As was seen in the section dedicated to the exchange rate policy analysis, these countries' exchange rates are more volatile, and their impacts on inflation are more significant. This was not taken into account in IMF policy recommendations.

For Paraguay, the IMF's report shows that inflation stems from external factors, such as commodity prices, demand in key trading partners, and weather cycles; the country has a high exchange rate pass-through to inflation; and the effectiveness of open market operations is limited. Given these restrictions, Paraguay has often relied on exchange rate intervention as a means of stabilisation. However, the IMF is of the position that this intervention gives confusing signs on the government's commitment to low inflation and recommends decreasing it (IMF, 2010q). Yet, against the Paraguayan background, it seems that exchange rate intervention plays a fundamental role in controlling inflation. If this is an instrument better suited to controlling inflation, why shouldn't it be a good tool to enhance government credibility as an inflation fighter?

Ethiopia has a managed float exchange rate regime, and the IMF recommends liberalising it on the grounds that this would: "benefit the economy through improved access for the private sector, increased confidence in the rate, and reduced economic losses from an active dual exchange market". However, the report does not consider the importance of a stable exchange rate in reducing the country's already high vulnerability to external shocks. As the report itself acknowledges, "the risk of exogenous shocks is high, given that, for the last decades, Ethiopia has experienced recurring adverse shocks every 5–7 years, stemming from droughts, terms of trade reversals (including high international commodity prices), and most recently the global recession" (IMF, 2010j).[25]

More exchange rate flexibility was also recommended to Egypt, even though the report recognised the importance of the exchange rate on the formation of inflation expectations. The authorities, aware of the importance of stability, disagreed with this recommendation and expressed concerns with "protecting the economy from excessive volatility" (IMF, 2010b).

For Moldova, the report showed that higher inflation was due to a sharp exchange rate depreciation. Nevertheless, the IMF recommended less exchange rate intervention. This focus on flexible exchange rates is because the Fund advises Moldova to implement IT and believes that the two are incompatible (IMF, 2010t).

However, although IMF recommendations discussed above focus on allowing fully exchange rate flexibility and fighting inflation through the policy rate, the Fund's economic counsellor recognises that "these were the words", but the actual "deeds" were that many emerging countries cared deeply about the exchange rate due to reasons even beyond its effect on inflation. Surprisingly, Blanchard stated that the central bankers were right to care about the exchange rate: "It is my sense that the deeds were right, not the word" (Blanchard, 2011).

3.4 IT-RELATED RECOMMENDATIONS

The IT regime was first implemented by New Zealand in the late 1990s, where it achieved positive results. The roots of the regime can be found in the discussion led by Kydland and Prescott (1977) on the benefits of having a rules-based policymaking instead of giving policymakers space for implementing policies discretionarily. Moreover, this policy framework obtained significant support from those who argue that fighting inflation is only effective if done by an independent Central Bank, where the government cannot induce inflation to decrease its real debt. In addition, the IT regime is based on the arguments of rational expectations and on the importance of credibility in forming inflation expectations: with a simple policy framework, the Central Bank's policy tightening changes the agent's inflation expectations towards the targeted rate, which changes inflation itself.

A credible and independent Central Bank is expected to change the monetary policy rate according to deviations of the expected inflation of the targeted rate. Consequently, rational agents will understand this move and remark their prices following the targeted rate. The expected result is that current inflation will follow the Central Bank's target.

Although this design suits several countries well, some countries do not meet all the assumptions held by the regime's design; therefore, the IT regime cannot be effective for every country. Nevertheless, the analysis of IMF reports showed that the Fund recommends the implementation of the IT regime or welcomes its use regardless of the countries' specificities.

One limitation of the IT regime is its focus on monetary policies only. As mentioned above, the framework has to be simple so that agents understand the change in the policy stance and realign their inflation expectations. With this objective in mind, the regime is focused on monetary policies only, basically through changes in the policy rate. This leads to two restrictions: the monetary policy transmission mechanism has to be effective for the Central Bank to be able to change the policy rate; and only demand inflation will be affected, as supply-side inflation will not respond to monetary policy.[26] One outcome of this framework is a need to maintain the Central Bank's credibility as an inflation fighter, which creates a bias towards restrictive policies.[27]

Moldova is one example where the limitations did not prevent the IMF from recommending IT. The report specifically mentions operating it with the Central Bank's "base interest rate as the main policy instrument" despite recognising the "still weak transmission mechanism" of monetary policy. Another limitation to the effectiveness of the IT regime in Moldova is that the country passes through significant *cost-push shocks*, which would not be affected by monetary policies (IMF, 2010t). Indeed, the IMF mentions the reasons for prior inflation as exchange rate depreciation and higher tariffs and taxes. In addition, if Moldavian authorities follow the IMF's advice of allowing for greater exchange rate variability, exchange rate shocks would be more frequent.

The IMF also recommends that Egypt implement an IT regime, despite recognising the importance of food prices on the inflation rate and how significant the exchange rate is in determining inflation expectations (IMF, 2010b).

Another restriction of the IT regime is that it is designed for forward-looking agents, so that inflation can be determined by inflation expectations and not by current or past inflation. That is not the case of South Africa though. According to the IMF report, the country has a "relatively sticky inflation series", the consequence of the behaviour of backward-looking agents. In fact, the report states that "expectations of next year's inflation are shaped by inflation outcomes some three to four quarters in the past" (IMF, 2010v).

Another problem with the IT regime in South Africa is the inflation source. As stated in the report, inflation was a result of higher administrative prices—which will not be affected by monetary policies. Although the IMF recognises these facts, it concludes that "the inflation targeting regime has served South Africa well."

3.5 RECOMMENDATIONS GIVEN TO COUNTRIES RECEIVING SIGNIFICANT PORTFOLIO INFLOWS

How to fight inflation in a situation of excessive capital inflows is an important policy challenge that several emerging countries faced after the global financial crisis, with the multi-speed global recovery. Although inflation pressures emerged in some countries, the usual increase in interest rates was not the most adequate option due to the complicated situation with capital inflows.

This challenge was recognised by the IMF and taken into account in the policy recommendations given to some countries. In the case of Peru, the IMF recommends that the country "start consolidating the fiscal stance in advance of increasing policy interest rates" (IMF, 2010r). In addition, the report mentions increasing reserve requirements before increasing interest rates. In the case of India, the IMF also states that fiscal, rather than monetary, tightening would suit the country better (IMF, 2011c). Here, capital inflows are not the only reason for this statement, but also the country's debt position. Such concerns were not considered in the reports written for Indonesia and Thailand though. In these reports, the IMF recommends monetary tightening, despite recognising that these countries are plagued by a problem of excessive inflow of volatile capital.

3.6 CONCLUSIONS

Inflation policies were subject to considerable policy rethinking, including inside the IMF. The main points discussed were that inflation could not be the sole target of policymakers, as low inflation is not sufficient to induce growth, and it should be combated through different policy instruments, rather than interest rates only (Blanchard et al., 2010). Nevertheless, inflation analyses in IMF Article IV reports were rather superficial, and recommendations mostly focused on the use of monetary policies only, regardless of the inflation source. Moreover, there was no assessment of the expected benefits from the suggested inflation rate or the costs which would result from the recommended policies. In other words, no cost–benefit analysis was presented as justification for the recommendation of reducing inflation.

The interconnections between the exchange rate and inflation were also not a concern in the analyses, with the IMF welcoming or recommending the use of a fully flexible exchange rate in cases where it recognises that prior inflation was related to erratic exchange rate movements. Moreover, the IMF has recommended that countries that had been receiving significant and volatile capital inflows should increase their policy rate as a means to curb inflation, which would complicate their already challenging situation.

With regards to the IT regime, the IMF had recommended its implementation or welcomed its use in countries whose fundamentals are different from the ones needed for the regime to be effective—such as having a low exchange rate pass-through to inflation, a strong monetary transmission mechanism and forward-looking agents. In such cases, the IT regime might only be effective in reducing inflation after a major monetary tightening, which can have significant output costs.

4 IMF ARTICLE IV REPORTS: AN ANALYSIS OF POLICY RECOMMENDATIONS ON DEFICITS

The IMF's recommendations on fiscal policies have been criticised for being focused on short-term stability and growth only, rather than on development. This short-term focus includes paying attention to efficiency issues—such as tax administration, enhancing tax collection and debt sustainability—instead of identifying policies which would enhance domestic revenue mobilisation (Roy and Heuty, 2009).

The short-term approach derives from the misleading definition of fiscal space itself. The IMF and the World Bank define fiscal space as "the gap between the current level of expenditure and the maximum level of expenditures that a government can undertake without impairing its solvency" (Development Committee, 2006:14).

This specification has been criticised for resulting in an analytical framework which is not designed for *long-term* fiscal policies (Roy et al., 2009). As mentioned above, there are two important differences in designing a long-term policy. The first is related to the endogeneity element. While the short-term different object of spending can equally enhance fiscal space, in the long-term the differences in what this fiscal space is used for is of crucial importance. The second point is derived from this idea. As current fiscal policy object plays a crucial role in tomorrow's economy and fiscal stance, different development situations will ask for different kinds of spending.

Roy et al. (2009) draw attention to the fact that the short-term focus can have a significant impact on development, as it tends to underestimate the long-term real impact of spending on development objectives. Based on this criticism of the consequences of the use of such a definition of fiscal space, Roy et al. (2009:33) propose the following concept:

> *"Fiscal space is the financing that is available to government as a result of concrete policy actions for enhancing resource mobilization, and the reforms necessary to secure the enabling governance, institutional and economic environments for these policy actions to be effective, for a specified set of development objectives."*
>
> (Roy et al., 2009:33)

Evidence of a short-term-oriented approach by the IMF was highlighted by Goldsborough (2007). The author mentions three important drawbacks of IMF programmes related to fiscal policies. First, these programmes neglect the longer-term supply-side effects of higher public spending in many macroeconomic frameworks. Second, they assume that lower fiscal deficits will lead to higher private investments without any consideration to other policies and country circumstances that might affect private-sector decision-making. Lastly, the author argues that the IMF rarely recommends that countries use aid for higher fiscal spending. On the contrary, this is done only in the case of high reserves and highly "stable" macro-conditions.

The joint IMF and World Bank Development Committee's report also shows evidence of this lack of long-term considerations. Although the report recognises the importance of fiscal policies in financing the provision of the public goods needed to achieve the Millennium Development Goals (MDGs), it deems fiscal expansion undesirable even if fiscal space exists, arguing that it compromises macroeconomic stability (Development Committee, 2006). In this case, the IMF/World Bank report reveals a preference for short-term macro stability over long-term development. Moreover, it ignores recent evidence that a scaling-up of public investments has long-term effects on macroeconomic stability which are not captured in short-term analysis (see Bruno and Easterly, 1998; and Gupta et al., 2006).

Also related to the IMF's short-term approach, Roy et al. (2009) highlight that the Fund's recommendations are based on an overall indicator of fiscal surplus that does not differentiate between current spending and infrastructure investment. This was also detected with regards to the IMF's SAPs, and recommendations of fiscal adjustments were indicated as "a major causal factor" for the decline in the public investment spending over recent years (Roy et al., 2006).

Recognising the important role fiscal policies play in development transformation, this chapter is focused on IMF policy recommendations in this regard. The sub-sections are divided according to the recommendations made: fiscal consolidation despite weak economic prospects; doubts whether fiscal consolidation was really needed; tighter fiscal policies aiming at credibility goals; tighter policies even when resources are available; increasing taxes in a consumption-based economy; external or domestic funding?

4.1 FISCAL CONSOLIDATION DESPITE WEAK ECONOMIC PROSPECTS OR SLOW RECOVERY FROM THE CRISIS

Macroeconomic stabilisation is one of the three functions assigned to fiscal policy, together with *resources allocation* and *income redistribution* (Musgrave, 1959). Stabilisation has a central role to play due to the importance of economic growth to development and to the problems brought by growth volatility. Apart from its impact on instability and expectations, a volatile growth pattern can hinder government's ability to mobilise resources, which can limit the implementation of projects dedicated to development. As ECLAC (2001) shows, extended periods of boom and bust in Latin America made multi-year planning impossible in the 1990s.

Nevertheless, counter-cyclical fiscal interventions to provide macroeconomic stability have been narrowly focused on price stability and fiscal solvency only. In response, authors have argued that a broader definition and use are needed, as macroeconomic stability "also entails avoiding large swings in economic activity and employment levels" (Vos et al., 2007). Moreover, a wide range of instruments have been proposed to reduce the variability of key macroeconomic aggregates—including safety nets, insurance schemes, social transfers and employer-of-last-resort plans and commodity revenues stabilisation funds (see Roy et al., 2009).

Given the significance of the crisis faced in 2008/09, it was expected that the IMF would recommend that countries make use of the stabilisation function of fiscal policies in 2010. However, not only was such advice absent from most of the reports analysed, but fiscal consolidation was actually recommended to countries which faced weak economic prospects after the global crisis.

In the report written for Jordan, the IMF mentions how the economy has slowed considerably due to the global and regional downturn. It is also shown how the outlook is *tilted to the downside*, with the unemployment rate being expected to remain at its current high level of 13 per cent. Nevertheless, the IMF recommends fiscal consolidation and emphasises the need for "further rationalization of public expenditures (particularly the size of the civil service wage bill) and additional revenue-raising". The report also sets tighter deficit targets for 2010 and for the medium-term (IMF, 2010m).

In Albania's report, the IMF clearly states that "notwithstanding a still fragile economic recovery, fiscal consolidation is a priority." Besides recognising that the recovery is fragile, the IMF and the authorities agree that the economy will face significant downward risks, not only from the external environment but also from domestic vulnerabilities. As already mentioned, "faltering confidence of households and enterprises may decrease consumption and investment more than anticipated" (IMF, 2010a).

Nevertheless, the IMF recommends the creation of fiscal rules with the target of reducing the debt-to-GDP ratio by 10 percentage points by 2013—from 60 per cent to less than 50 per cent of GDP. The argument is that such a rule would increase Albania's access to European funding without necessarily having to move the focus of the monetary policy away from the IT regime. This assumption does not take into consideration the government's opinion that Albania's economic growth prior to the crisis was not so tied to European capital flows as that of other Eastern European countries. Indeed, these different opinions led to a disagreement between IMF staff and the Albanian government on the country's expected GDP growth in 2010, which adds to IMF's belief that Albania would not be able to achieve its debt-to-GDP target.

In this case, the IMF's focus on policies to increase capital flows to the country might have been based on a general assessment of the post-crisis situation in Eastern Europe as a whole without a proper and deep observation of the country's specificities. The result is an inappropriate recommendation: fiscal tightening does not suit the circumstances of uncertain households and enterprises, especially in a country where remittances and, therefore, consumption have an important role.

Guinea-Bissau's economic outlook is, according to the IMF, "subject to substantial uncertainty" with downside risks resulting from *lower-than-expected fiscal spending due to financing constraints*—besides *weaker than expected exports prices and political disruptions.* Nevertheless, IMF conditionalities focus on tighter policies: a six-fold increase in government tax revenues in three quarters, downsizing civil services and having no public external short-term borrowing. Therefore, IMF conditionalities do not help Guinea-Bissau to overcome either the financing constrains or the pessimistic economic outlook (IMF, 2010k).

Also in the case of Nepal, the IMF described the economic outlook as *challenging* and risks as high, due to the likelihood that the harvest would be *poor*, remittances and exports would be *soft*, and monetary conditions should be tightened. According to the IMF report, the country has the needed fiscal space to counteract this negative economic outlook, and such spending is needed: "fiscal policy has continued to be broadly prudent and public debt has declined to 40 per cent of GDP. This has created fiscal space that could be used for much needed infrastructure, human capital, and the peace process provided spending quality is ensured."

Nevertheless, the Fund's analysis is focused on risks related to the exchange rate peg with the Indian rupee, as international reserves have declined with the crisis. With this in mind, the IMF recommends that Nepal aim at "containing domestic borrowing close to current levels" (IMF, 2010o).

In the case of Benin, the report shows that in response to the crisis the country had a fiscal stimulus plan in place, but this had to end due to lack of financing (IMF, 2010c). The report written for South Africa was different, concluding the need for policies to sustain the recovery. It was also atypical for its methodology. The analysis done considered not only the debt and the deficit level but also the fiscal impulse of the fiscal policy. In this sense, the IMF projects a rising debt-to-GDP level in tandem with a tighter fiscal impulse. The debt sustainability analysis done presents the results of stress tests and concludes that "South Africa's public debt position appears sustainable." In line with this assessment, and resulting from the careful analysis of the fiscal impulse and the pace of the economic recovery in South Africa, the Fund recommended "fiscal and monetary policies that will sustain the ongoing recovery while gradually shifting to a more neutral stance so as economic recovery takes hold" (IMF, 2010v).

4.2 IS FISCAL CONSOLIDATION REALLY NEEDED?

In different country reports the IMF recommended that countries implement fiscal consolidation despite a *not-bad* fiscal situation in terms of debt-to-GDP, debt outlook or debt sustainability analysis—when this was presented. This might indicate an excessive focus on fiscal consolidation which might be detrimental for development. Some reports describe risks related to debt distress as low and yet conclude recommending fiscal consolidation. This is the case of Colombia and Vietnam.

In the report written for Colombia, the IMF presents the country debt outlook as positive: "results from a debt simulation model suggest that there is a fifty percent probability that, by 2015, Colombia's public debt to GDP ratio will be below the level it had prior to the global crisis in 2008 (32 percent of GDP); and only a 25 percent probability that it will exceed 40 percent of GDP." Nevertheless, the IMF argues that "more ambitious medium term fiscal targets would be beneficial" to "create fiscal space to absorb fiscal risks if these were to materialize" and recommends broadening the VAT and phasing out tax incentives for investments.

It is also said that these measures "would likely improve the prospects for an upgrade from credit rating agencies" (IMF, 2010h). Therefore, IMF recommendations of tighter policies are based on an implicit analysis where the credibility gains coming from an upgrade would compensate the costs of tightening policies. According to the report, the Colombian authorities seem to be of the opinion that a more ambitious consolidation path is unnecessary, stating that although the country could benefit from lower debt levels, the current fiscal stance already ensures debt sustainability. Moreover, the credibility gains would not be as important, given that capital flows to the country were already higher than prior to the crisis and were actually posing policy challenges.

The IMF also recommends a more ambitious plan to lower the debt level to the Vietnamese authorities. Although the debt sustainability analysis undertaken “places Vietnam at a low risk of debt distress” and “indicates that external debt levels would be manageable”, the IMF, based on a *cross-country analysis*, considers that “the deficit level is quite elevated” and suggests that a lower level would be “a more prudent threshold of *emerging economies in general”*. Based on this assessment and on a list of risks—“Vietnam’s large state-owned enterprise (SOE) sector, prospective graduation from concessional financing, and vulnerability to refinancing and exchange rate risks”—the IMF proposed a revision of the debt-to-GDP ceiling down from 50 per cent towards 40 per cent of GDP. In this case, the IMF’s policy advice considered a cross-country analysis as more important than the country-specific circumstances of the debt sustainability analysis.

Moreover, according to the information provided by the report, lowering the deficit would be a significant shock for the Vietnamese economy, as the country is expected to face lower revenues with the fall in oil prices and import tariffs due to new Free Trade Agreements with the World Trade Organization (WTO), the Association of Southeast Asian Nations (ASEAN) and China. There is also a problem of coherence between the advice to cut expenditures and IMF’s comments on the need for “developing human capacity, improving infrastructure and business environment, and promoting supporting industries” (IMF, 2010y).

The reports written for Peru and Indonesia have contradictory statements on whether fiscal consolidation is needed. Yet they argue for deficit reduction. According to the report written for Peru, the country has a low debt-to-GDP ratio and low risk of debt distress: “the fiscal deficit is expected to decline gradually to a balanced budget, while public debt ratios will continue to decline to about 20 percent of GDP.” The report also mentions that “Peru has space to provide additional policy stimulus to limit the fallout.” Despite the country’s good fiscal position, IMF recommendations focus on reducing the deficit, as this “would help regain fiscal cushions and manage prospective large and sustained capital inflows to Peru” (IMF, 2010r). The Fund’s assessment of whether Peru needs to conduct fiscal consolidation is thus inconclusive.

The report written for Indonesia was also not clear on whether the country needs fiscal space or not. According to the IMF, the country had “expanded fiscal space for countercyclical policy” and a debt-to-GDP ratio around 30 per cent—a result of the fact that Indonesia has been achieving average GDP surpluses of 2 per cent since 2005. The report also shows that this fiscal space was not used during the crisis. In fact, Indonesia had a primary surplus of 0.1 per cent of GDP in 2009 (IMF, 2010l). Nevertheless, IMF recommendations are focused on reforms aimed at *creating fiscal space* for infrastructure investments. Despite this focus, the report does not mention how the IMF estimates the fiscal space for the country.

The case of Panama is similar. The country’s debt is lower than 40 per cent of GDP and expected to fall to less than 30 per cent due to fiscal consolidation at a faster pace than previously contemplated. Nevertheless, IMF recommendations emphasise the need to “allocate any over performance to a faster reduction of public debt” (IMF, 2010p).

4.3 CREDIBILITY OR INVESTMENTS?

In the cases of Colombia and Panama presented above, where the IMF recommended fiscal consolidation even if the fiscal situation did not necessarily demand it, one of the arguments used was that tighter policies would bring better credibility to these countries. To Colombia, it was said that: "while the fiscal position is not weak, lower levels of debt would help protect against risks, and improve prospects of regaining investment grade" (IMF, 2010h). In the case of Panama, the statement was: "To bolster fiscal credibility further, staff advised the authorities to adhere to their medium-term fiscal framework targets and allocate any over performance to a faster reduction of public debt" (IMF, 2010p).

In this case, credibility is given more importance than an analysis of the benefits of public investments themselves. A fiscal space analysis should not discard the possibility of using external resources in the future and, therefore, the credibility issue. Yet, assuming that development programmes would be welcomed in these countries, it seems inappropriate to discard an investment with the sole goal of enhancing the possibility of future funding.

4.4 FISCAL CONSOLIDATION DESPITE HAVING THE RESOURCES NEEDED FOR TRANSFORMATION

IMF recommendations on fiscal consolidation are also given to countries without funding problems due to important mineral resources, despite the recognition that more investments are needed.

Botswana is rich in diamonds and has a public fund of about 54 per cent of GDP. The IMF recommends fiscal consolidation based on the argument that this "will be needed to ensure fiscal and external sustainability". However, neither the fiscal nor the external situation in Botswana seems unstable. On the fiscal side, deficits have increased considerably during the crisis due to the government's counter-cyclical measures—from 6 per cent to 12 per cent of GDP—but Botswana's debt in 2009/10 stood at 14.5 per cent of GDP, which, added to the savings of the Pula Fund, makes the country a net creditor. Moreover, as the report mentions, the country ratings are A2 at Moody and A- at Standard and Poor. As expected, financing the counter-cyclical policies was not a problem: "going into the crisis, public debt levels were negligible and the government had accumulated substantial savings in the Pula Fund. Recent deficits have therefore been comfortably financed through a combination of increased borrowing and drawing on savings."

Additionally, the external side does not seem to be under pressure. Although the report argues that a deviation from the recommended fiscal consolidation "would risk depleting accumulated government savings in the Pula Fund and undermining the exchange rate regime", this Fund covers 19 months of imports, a more than appropriate level to protect the country's crawling peg.

Going forward, recommendations of fiscal consolidation to Botswana do not seem to be based on country-specific circumstances. One example is the IMF's argument that tightening the fiscal stance is needed to reduce "crowding out of the private sector" and to support private-sector-led growth. However, in light of Botswana's massive Pula Fund, the country does not have funding problems; therefore, higher public investments should not crowd out private investments. Moreover, Botswana's non-mining private sector is said to be of "modest size" and expected to decelerate as fiscal stimulus is withdrawn. Therefore, pursuing the IMF's lower targets for non-mineral deficit would be tricky and misguided.

Moreover, the report acknowledges that "Botswana's rapid economic growth during the 1970s and 1980s was largely the result of high public investment in human and physical capital." Such investments are also highly needed, "as social challenges are significant"—HIV/AIDS "national prevalence rate of 17.6" and "poverty, unemployment, and income inequality are also high" (IMF, 2010d).

The case of Kazakhstan is different: the country authorities had a fiscal consolidation plan, which the IMF deemed too ambitious. The Fund then recommended a softer fiscal consolidation plan—to decrease the non-oil sector deficit from 11 per cent to 6 per cent of GDP, rather than to 3 per cent, as envisaged by the authorities. Although softening the authorities' pushy consolidation plan seems appropriate, in this case the report could have gone further and focused their recommendations on how to make better investments with available resources (IMF, 2010s).

The same recommendation was made to Chile in 2001, when the country decided to use the resources accumulated in its stabilisation fund to stimulate the late-1990's crisis. As Stiglitz (2006) argued, the IMF treated stabilisation-fund spending like any other form of deficit spending. As a consequence, the Fund's estimates of the Chilean government's fiscal balance were worse than the country's own estimations,[28] which could increase interest rates that the financial markets demanded to lend to the country.

4.5 TAX INCREASE IN A CONSUMPTION-BASED ECONOMY?

Some of the consolidation plans involve increasing taxes, even for countries where private consumption is of significant importance. In the case of El Salvador, where remittances account for 16.5 per cent of GDP (2009), private consumption plays a significant role in economic activity—in fact, the contribution of private consumption to GDP in 2009 was of -10 per cent. This fact does not seem to have been taken into account in the IMF's analysis. First, the Fund welcomed the tax increases made at the end of 2009, a period when the Salvadorian economic outlook was still uncertain. Second, the country's three-year Stand-by Agreement signed with the IMF is based on a strategy of fiscal consolidation and increase in tax revenue, possibly also from tax increases. "Staff urged the authorities to stand ready to adopt the revenue measures envisaged in the pact should they be needed for meeting the targets in their fiscal strategy" (IMF, 2010i).

Moldova's economy also relies heavily on remittance-driven private consumption. Nevertheless, IMF staff welcomed the government's ambitious Economic Stabilisation and Recovery Plan which included an increase in VAT in 2009. Moldova has also signed an Extended Credit Facility with the IMF which includes fiscal consolidation and raising tax revenue (IMF, 2010t).

4.6 EXTERNAL OR DOMESTIC FUNDING?

Another important aspect with regard to public finance is the source of funding, as it has direct implications on its sustainability. Roy et al. (2009) highlight the importance of not relying on external sources, as they describe a sustainable fiscal policy as one that: "(a) does not undermine fiscal sustainability in the long term, and (b) that is not charity based or relying on exogenous, and as has been frequently pointed out, highly volatile sources of external finance, such as bilateral aid and concessional and non-concessional foreign borrowing".

Relying on domestic funding is especially important for countries where external funding is unstable or where the vulnerability to this funding is higher—such as countries with higher exchange rate volatility. On the other hand, some of the countries studied had few domestic funding possibilities, due to still incipient bond markets, which may be a reason for going for external funding. Moreover, the IMF reports analysed were written in a post-crisis period when interest rates in developed economies were low and, therefore, developing countries had cheaper external funding possibilities. This situation was used as an argument by the IMF in its advice to some countries on the use of external funding. However, these recommendations were sometimes given to countries with cheap domestic funding possibilities themselves, were not followed by an assessment of the risks involved and do not follow the principle of prioritising *sustainable* funding sources.

In the case of El Salvador, the report mentions that the 2010 deficit was being financed in the domestic market, while there was no congressional approval of the external loans. As El Salvador is a dollarised economy, its interest rates have been very low, and the IMF itself recognises that this funding has been done "at very low rates". Nevertheless, IMF "Staff urged the authorities to seek early congressional approval for the 2011 borrowing program and encouraged them to take advantage of current market conditions to refinance a US$650 million Eurobond" (IMF, 2010i). Moreover, the underlying argument of taking advantage of good external market conditions does not suit El Salvador, which, as a dollarised economy, has domestic funding at very similar rates as in the USA—and, therefore, a good part of external funding.

In the case of Egypt, the IMF considers that the debt maturity should be lengthened and that Egypt has "relatively small external debt ratio" (IMF, 2010b). Therefore, the IMF advises the country to seek foreign financing. In addition, the IMF recommends that Egypt allow for greater exchange rate flexibility, as a shock absorber, which could result in greater external shocks to the country. Moreover, the costs to serve the debt are not clear. Although the report mentions that these are significant, it also shows that real interest rates are negative.

In the case of Ethiopia, real interest rates have been negative over the last several years. Probably as a consequence of this, public debt is mainly financed domestically. In fact, as of 2007, public debt financed domestically accounted for 28 per cent of GDP, and 12 per cent of GDP was financed externally. The IMF opposes the use of domestic resources to finance public deficits, and IMF "Staff urges a de-emphasis of domestic financing." In this sense, one of the quantitative criteria for the Exogenous Shocks Facility Program financed by the IMF is a "limit on the net domestic financing of the general government". In accordance with the advice and conditionality, IMF projections show a switch of the debt composition. From the focus on domestic funds presented above, the IMF forecasts that by 2015 Ethiopia will have 29 per cent of GDP of public debt financed externally and 15 per cent of GDP financed domestically.

Apart from the fact that domestic funding is cheaper than external finance, this advice also seems incoherent because higher external debt could be an additional source of shock to Ethiopia—a country which, as the report mentions, suffers from "repeated large shocks" and severe droughts (IMF, 2010j).

In Cameroon's report, on the other hand, the IMF states that "to develop rapidly a regional market for government securities [is] a key step in reducing the current vulnerability to external financing shocks", after concluding that although debt distress risk is low, there is a lack of financing possibilities (IMF, 2010e).

4.7 CONCLUSIONS

This section has shown that IMF policy recommendations regarding fiscal policies are indeed focused on short-term aspects, confirming the criticism presented by other authors. This kind of approach was detected with regard to different aspects. First, the Fund failed to make use of the stabilisation function of fiscal policies and recommended tighter policies to countries that were either struggling to recover from the 2008/9 crisis or had weak economic perspectives.

Second, the Fund's focus on fiscal tightening led to recommendations of fiscal consolidation even in cases where the report showed that the countries had no problem of debt solvency—countries were classified as being in low risk of debt distress or with low debt-to-GDP ratios. In other words, even following the Fund's concept of fiscal space, there was no clear reason why these countries should cut investments.

Third, some of the Fund's advice on fiscal consolidation was given based on the argument that this would enhance credibility or lead to the achievement of a better grade by rating agencies. Therefore, even when countries' fiscal situations were described as positive and supposing investments towards development goals were needed, these were less of a priority than gaining credibility. Moreover, if a fiscal policy is designed with a focus on long-term equilibrium and development, why should this decrease a country's credibility?

Fourth, the Fund did not consider the stabilisation funds' resources as possible funds for investments with development goals. Indeed, the Fund recommended that resource-rich countries save more instead of building a development plan that could change their economic structure. This was even done to a country where unemployment is around 20 per cent and HIV/AIDS is a serious problem.

Fifth, the IMF advised remittance- and consumption-led economies to increase taxes. As some of these economies were still experiencing a fragile recovery, this policy does not seem to be appropriate, as it could be an additional burden.

Lastly, the IMF has failed to prioritise domestic sources of funding in some countries. With the argument that funding from developed countries was cheaper due to the crisis, the IMF recommended that developing countries use external funding. This advice was given even to countries where domestic funding was available and not expensive. This attitude represented a clear lack of consideration of the importance of the sustainability of the funding and to risks related to exchange rates.

5 IMF ARTICLE IV REPORTS: AN ANALYSIS OF POLICY RECOMMENDATIONS ON SOCIAL PROGRAMMES AND EMPLOYMENT

For a long time the IMF's surveillance activities and policy recommendations have been deviating from a focus on balance-of-payment stability to a broader analysis of member countries' domestic policies. As expected, this resulted in the Fund being held responsible for the social implications of its policy recommendations.

The IMF's analysis of social protection implies the value of policy both in preventing social problems and in stabilising or inducing growth. With regards to the stabilisation of growth, the Fund has indicated the use of automatic stabilisers, such as transfers to low-income households. As argued in a 2010 paper, the crisis has shown that automatic stabilisers can have an important role in dealing with a 'standard recession', as discretionary fiscal measures "come too late". A policy mentioned was "temporary transfers targeted at low-income or liquidity constrained households" (Blanchard et al., 2010).[29]

Regarding the impact of social policies on growth, Dominique Strauss-Kahn has highlighted the importance of tackling unemployment and inequality. As the IMF's former Managing Director stated, unemployment and inequality can lead to instability, which "undermine[s] the very achievements of the market economy". Therefore, it should be the Fund's agenda: "Ultimately, employment and equity are building blocks of economic stability and prosperity, of political stability and peace. This goes to the heart of the IMF's mandate. It must be placed at the heart of the policy agenda" (Strauss-Kahn, 2011b).

However, IMF policy recommendations to developing countries do not seem to reflect these views of the Fund's former Director and its research department, as not much was said about social issues in the IMF 2010 Article IV reports analysed.

5.1 SOCIAL PROGRAMMES

The social situation in 2010 was still fragile in some developing countries, due to a sluggish recovery from the crises and the impact of the increase in food and fuel prices on the budget of the poorest families. At that time, much was discussed about the benefits of using automatic stabilisers to rapidly counteract shocks and protect the most vulnerable (see Blanchard et al., 2010). Apart from that, it was evident from the crisis that countries with social protection programmes already in place benefited from the possibility of scaling them up during the crisis and, therefore, quickly answering the needs of the most vulnerable.

Nevertheless, the Fund paid little attention to either social issues or social programmes in the 2010 Article IV reports. Government social programmes, for instance, are mentioned in only six of the 26 reports analysed: El Salvador, Cape Verde, Guinea-Bissau, Peru, India and Botswana. In the first three countries the programmes are mentioned only superficially, without any deep analysis. The comments made about social protection programmes are presented below.

The report written for El Salvador cites the General Anti-Crisis Plan, which directs 1 per cent of GDP to social programmes, and concludes that this "has helped mitigate the effects of the economic slowdown on the most vulnerable populations" (IMF, 2010i). This, although short, is the only analysis that associated the importance of social protection programmes with the crisis scenario. The analysis in the report written for Cape Verde is more descriptive. It presents a box with some MDG indicators and a description of the government's key social programmes (IMF, 2010f).

In the case of Guinea-Bissau, the analysis goes somewhat deeper. The report mentions that the authorities' core objective from its social programme is to decrease poverty and that this "will require efforts on several fronts, such as improving access to basic services (health and education) and developing agriculture". Moreover, one of the conditionalities imposed by the IMF as part of its lending facility is focused on social programmes: a four-fold increase in "social and priority spending" (IMF, 2010k).

The report written for Peru is an exceptional case, with the IMF presenting the significant achievements in poverty reduction as a consequence of the government's social programmes and strong economic growth. It also mentions that these gains were due to "efforts to prioritize social spending" and have been sustained during the crisis thanks to "the government's fiscal stimulus plan". The report also presents the government's past measures, which included an increase in coverage and resources for one of the programmes. The government's agenda is also described as "focusing on further addressing challenges, including through the creation of a single registry of beneficiaries, and improving the quality of social programs through performance indicators" (IMF, 2010r). Still, no comment is made with regard to social spending when the report argues that Peru should decrease its deficit.

The analysis done for India highlights the fiscal side of social programmes. As argued in the report, the country's goal to achieve the fiscal consolidation target while increasing social spending and infrastructure spending is challenging. In an Annex, the report presents an analysis of several social programmes. Entitled 'Inclusive Growth and Fiscal Costs', the analysis mentions the importance of social programmes given the country's weak social indicators, always stressing their costs, implementation issues and possible negative impacts—such as to displace regular employment in the case of the National Rural Employment Guarantee Act (NREGA). In disagreement with the Fund's analysis, the government of India ensures that "growth in social sector programs will be taken up without affecting the fiscal consolidation process" (IMF, 2011c).

Apart from this separate analysis in the Appendix, recommendations provided in the main text were to cut subsidies and to improve the targeting of spending. With reference to the targeting issue, the report mentions that this could be "helped considerably by effective use of the Unique Identification number (UID), which should be exploited as soon as technically feasible". Although this policy avoids programme overlap (duplicating assistance provided to families), the problem of targeting is likely to benefit more from an increase in the frequency of surveys—to detect who the beneficiaries are—than by the use of the UID.

Recommendations on ways to improve the social programme were also given to Botswana. The report mentions that the "value for money appears weak" in social safety net programmes, as 57 per cent of beneficiaries are non-poor households. The IMF advised the country authorities to improve the targeting of the programme through "better and more regular information (for example, poverty assessments and household income and expenditure surveys)" (IMF, 2010d).

Apart from the above-mentioned recommendations to improve targeting, another frequent recommendation was to reduce subsidies and increase social services. This switching of expenditure is generally recommended as part of a fiscal consolidation strategy. One of the main concerns of the report written for Cameroon is how to mobilise the revenue estimated in the 2010 budget—the report even has a section where it enumerates the reasons why " the budget framework is problematic." Against this background, the IMF recommends that the country revise the budget and replace fuel subsidies "by a more targeted social safety net" (IMF, 2010e).

Social policies are also mentioned in the sphere of fiscal policies in the report for Indonesia. The IMF recommends fiscal reforms and mentions policies considered as important to create fiscal space for infrastructure development: "improved budget execution"; "increasing non-commodity based revenues and phasing out energy subsidies, combined with expanding transfer programs and social services for the poor" (IMF, 2010l).

Recommendations to Malaysia are also given in a fiscal context. The report mentions the need to overhaul the "fragmented and ill-targeted" social safety nets and to undertake subsidy reform along with fiscal initiatives such as tax reduction (IMF, 2010n).

In the report written for El Salvador, the IMF clearly argues for a switch in spending: "the planned reform of energy subsidies should provide the space to increase spending on infrastructure, security, and social programs, including education." Also in the case of El Salvador, subsidies are considered "poorly targeted and a drain on government resources"—staff estimate their cost at 1.4 per cent of GDP in 2009. The authorities have agreed to reduce subsidies on liquefied gas and electricity and to redirect them to "other social policies" (IMF, 2010i).

The reference to subsidy reform in the report for Egypt also focuses on the fiscal aspects and the costs of the programmes. However, it adds the issue of ineffectiveness—for example: "products consumed by higher income families—such as diesel and regular gasoline—remain highly subsidized." The recommendation is clearly a change of policies: "Ongoing energy subsidy reform (...) would help reduce spending inefficiencies and provide more room for spending on priority social and infrastructure needs" (IMF, 2010b).

Similarly, the IMF recommended Moldova to pursue "growth-enhancing consolidation" while increasing funds for investment and social assistance. In this sense, IMF staff support the government's plan to implement a "new targeted social assistance system", and the new budget increases social assistance spending by 50 per cent and capital expenditure by 37 per cent (IMF, 2010t).

Unlike the last three cases, IMF recommendations to India to cut subsidies were not made to redirect these resources to other social services but rather to meet fiscal targets. The report highlights that substantial adjustment in current spending is required to meet the medium-term fiscal target and argues that much of this adjustment will depend on cutting subsidies, as these are expensive: "spending on subsidies, primarily on fuels and fertilizers, but also on food, accounts for a share of general government spending comparable to that of health and rural development combined" (IMF, 2011c).

Similarly but more directly than the recommendation made to India, the IMF advised Turkey to decrease social spending: "the mission urged continued implementation of measures to control healthcare, wage, and pension expenditure" (IMF, 2010x).

Apart from the fiscal motivation to cut subsidies or social spending, recommendations on social policies were also made with the objective of rebalancing the economy. This was the case of China and Malaysia.

The Chinese report recommends an expansion of the social safety net as a policy to "ensure a sustained rebalancing of growth toward private consumption". In more detail, the policy recommendations focus on increasing the basic pension, the quality and availability of health care and unemployment benefits. Interestingly, the IMF advises China to implement consumption subsidies, despite the position held in other reports that these generate inefficiency. The consumption subsidies would be used to purchase "autos, motorcycles, and home appliances", with the objective of increasing consumption (IMF, 2010g).

Social protection is also recommended as a policy to increase consumption in the case of Malaysia. Moreover, the IMF mentions that by curbing savings, social welfare will "offset the drag of fiscal consolidation" (IMF, 2010n).

5.2 EMPLOYMENT

As mentioned above, the IMF's former Managing Director has mentioned the importance of tackling unemployment and inequality to enhance stability, and how this should be the Fund's agenda. Specifically related to unemployment, Dominique Strauss-Kahn has also stated "Growth without jobs is not meaningful to the man in the street" (Strauss-Kahn, 2011a). Nevertheless, an analysis of IMF 2010 Article IV reports has shown that employment issues were not a concern of the Fund, and most of the reports had no reference to them. Unemployment rates, for instance, were only mentioned in nine out of the 26 reports analysed.

In the 13 country reports where the unemployment rate is quoted, this was rarely done in the context of a deep analysis. In six of these countries, the unemployment rate was only quoted in a box dedicated to indicators, without any reference in the main text—these are: Colombia, India, Indonesia, Paraguay, Peru and Thailand. In the case of Malaysia, unemployment rates were presented as an indicator of the economic situation only. The report written for Botswana went further by citing that the country's high unemployment rate (17.5 per cent in 2005/6) as a "social challenge" and presenting a reason behind this problem, but no recommendation was given. Therefore, only five of the 26 reports analysed presented the country's unemployment rate and a policy recommendation: those for South Africa, China, Turkey, Jordan and Egypt. The reports for South Africa, China and Turkey were the only ones that presented the unemployment rate and a somewhat deeper discussion on unemployment issues.

South Africa's report contains a section on unemployment issues where it discusses the authorities' views and policies. It also provides recommendations on how to better implement policies and how to better tackle unemployment (IMF, 2010v). Unemployment issues were also a concern in China's report. When arguing for an exchange rate appreciation, the IMF analysed the impact this would have on unemployment. The report also advised the country to increase its unemployment benefits in line with the strategies to boost domestic consumption and to increase labour market flexibility (IMF, 2010g). In the report written for Turkey, the IMF recommends "sustained rapid GDP growth and better training" as key to lowering unemployment (IMF, 2010x).

Apart from these reports, others have shown some concern with employment issues by mentioning the government's plan to decrease unemployment—although not presenting the unemployment rate. These were the reports written for Peru, Malaysia, Egypt, Nepal, Guinea-Bissau and Benin.

However, even in cases where the unemployment analysis was deeper, recommendations were not always consisent with analysis done or with some statements made by the Fund. Together with Dominique Strauss-Kahn's quotes mentioned above on the importance of tackling unemployment and on the IMF's role in doing so, the former Director has also indicated directions in terms of policy recommendations. As he declared:

> *"But growth alone is not enough. We need direct labour market policies. The crisis taught us that well-designed labour market policies can save jobs. (...) We must get past the binary and unhelpful contrast between 'flexibility' and 'rigidity' in labour markets and ask instead if policies are effective in creating and sustaining jobs. Few would disagree that decent unemployment benefits are foundational. And when combined with education and training, they can help the unemployed adapt to a changing economy."* (Strauss-Kahn, 2011b)

However, IMF policy recommendations were not in accordance with these statements. In fact, few policy recommendations mentioned training and education, and most of them were focused on increasing labour market flexibility.

In the South African report, the analysis indicates that neither labour market flexibility nor 'sound policies' are problems. In fact, the report mentions that structural unemployment is still very high despite "strong overall performance" since the mid-1990s. It also shows that South Africa is placed fourth in a rank of labour market flexibility among G20 economies in the volume dimension. Despite these conclusions, the IMF recommends more labour market flexibility: "the severity of the unemployment problem, in particular, calls for bolder action to enhance the efficacy of labour and product markets." The report also highlights the importance of high growth: "It is only with growth in the region of 5½–6 percent that employment levels would revert to the level last seen in 2008 by 2013" (IMF, 2010v).

The IMF agenda for China also included "reducing labour market rigidities". This topic is also raised in the Fund's analysis of the impact of an exchange rate appreciation. As mentioned in the report, "There are considerable geographical disparities in growth responses to a movement in the real exchange rate. (...) across provinces, those with a large service sector or greater labour market flexibility appear to be less affected by currency appreciation" (IMF, 2010g).

The agenda of liberalisation is also present in Cape Verde's report. It mentions that staff and the country authorities have agreed upon policies to encourage competitiveness, highlighting that wage flexibility is "useful to preserve growth and employment against any negative demand shocks", and "existing labour market restrictions may hinder a competitive business environment and deter formal employment growth" (IMF, 2010f).

In the report written for Senegal, labour market efficiency is mentioned as one of the country's main weakness in terms of competitiveness (IMF, 2010u). In Jordan's report, the IMF welcomes the introduction of unemployment insurance, as it "should enhance labour market flexibility" (IMF, 2010m).

Apart from these recommendations to increase labour market flexibility, some reports briefly recommend tackling unemployment through training. In China's report the Fund recommends "skill training for the unemployed and migrant workers" as a way to boost household and income consumption (IMF, 2010g). The importance of skill training is also mentioned in the report written for South Africa, but rather as a government policy which is welcomed. As mentioned above, the country's government is considering "more direct interventions in the labour market, such as a wage subsidy aimed at younger workers". The IMF welcomes this policy and adds that "the wage subsidy, if introduced, would make it cheaper for firms to employ young unskilled workers, helping to build skills and enhance the productivity" (IMF, 2010v). Turkey's report mentions "better tailoring education to employers' needs" as key to reducing unemployment (IMF, 2010x).

Frequently, policy recommendations to tackle unemployment are focused on medium- or long-term reforms. The report written for Jordan mentions the country's high unemployment rate (13 per cent) as a policy challenge and states that "structural reforms" would "entrench stability and sustain medium-term employment". These policies are fiscal consolidation, due to risks related to the "already-high public debt", and monetary policies that would "resuscitate credit growth" (IMF, 2010m).

In the case of Egypt, the report indicates the importance of growth in decreasing the unemployment rate: "A return to sustainable rapid growth of 6–7 per cent—supported by raising total factor productivity—is needed to address Egypt's persistent high unemployment rate." To achieve growth, the report recommends a reform based on two pillars: addressing fiscal vulnerability and ensuring macroeconomic stability (IMF, 2010b).

Apart from being medium- or long-term solutions only, these recommendations are in line with other IMF recommendations which have different goals rather than tackling unemployment. This indicates the Fund's undisclosed assumption that macroeconomic stability is enough to tackle unemployment and the absence of labour market policies.

Another common feature of the analysis carried out in the reports was to indicate an increase in public-sector salaries as the reason behind unemployment.

South Africa's report has the deepest analysis of unemployment issues among the reports analysed. It provides a rather broad discussion, but its main focus is on the country's wage stickiness and the recent increase in labour costs. The conclusion is that a pre-crisis increase in public-sector wages increased labour costs, leading to a hike in unemployment. The report, however, makes it clear that unemployment is not cyclically, but rather structurally, high—it has been above 20 per cent at least since 2000 (IMF, 2010v).

The report written for Turkey points to the following reasons for the high unemployment rate and the high shares of unofficial and semi-official employment: "a minimum wage that was increased substantially", "Turkey's severance pay scheme" and restrictive regulations on short-term contracts (IMF, 2010x).

In the case of Benin, the argument is the same, although the report does not discuss unemployment issues. IMF researchers argue against an increase in civil servants' wages, as this could have knock-on effects in the private sector and increase unemployment (IMF, 2010c).

The argument that high wages will increase unemployment is based on the view of wages as a price in a perfect market, rather than an important determinant of aggregate demand. Following the first view, high wages will prevent firms from hiring, leading to unemployment. The second view sees wage as a determinant of consumption and, therefore, demand. In this case, if demand is higher, firms will hire more, decreasing unemployment.

This duality can be seen in the report written for Botswana. The report argues for causality between higher public-sector wages and unemployment, but when analysing the soundness of the banking industry, it indicates that this has suffered from the public-sector salary freeze and the squeeze on household incomes—a clear consideration of the impacts of salaries in the aggregate demand (IMF, 2010d).

However, this consideration of salaries in household incomes is not the IMF's usual practice. Its focus when analysing unemployment is on the flexibility of the labour market: the greater the flexibility, the easier the wage adjustments and the less persistent unemployment is (see IMF, 2003).

The United Nations Conference on Trade and Development (UNCTAD) (2010) analyses the argument that high real wages or rapidly rising real wages lead to unemployment and finds it inconsistent theoretically and empirically. As the report indicates, the theoretical inconsistency was already shown by Marshall (1890) and Schumpeter (1976) and lies in the fact that supply and demand functions would have to be independent for the resulting price to balance supply and demand. However, this is not valid at the macroeconomic level, given the importance of labour on the economic system. UNCTAD, therefore, concludes that "employment growth critically depends on an expansion of aggregate demand, and much less—if at all—on the price of labour relative to that of capital."

5.3 CONCLUSION

Only half of the 2010 reports provide any reference to social protection programmes. As seen above, these references were rarely made in the form of a deep analysis—to only two or three major developing countries.

The impact of social protection programmes on the well-being of the most vulnerable, especially after the economic slowdown with the crisis, was only mentioned in the report written for El Salvador. Apart from that, almost none of the references to social protection programmes were made for its 'per se' value. Indeed, most of the references were made regarding the fiscal sphere and especially in the context of switching subsidies by better targeting transfers. Subsidies, in turn, were often classified as ill-targeted and expensive.

As a reflection of the post-crisis concerns with global imbalances, some of the recommendations to increase social protection were made with the aim of increasing consumption in export-led Asian economies. Additionally, the improvement of social protection programmes was recommended as a way to curb the negative effects of fiscal consolidation.

Most of the 2010 IMF reports analysed lack a discussion on unemployment issues, which are discussed in more detail in only a few reports written for emerging economies, such as South Africa, Turkey and China. References to unemployment are mainly made as an indication of the country's economic situation, and the unemployment rate is absent from many country reports, even for those where unemployment is an important issue. This contradicts the position held by the Fund's former Managing Director on the importance of tackling unemployment and the Fund's important role in doing so.

Moreover, in most of the cases where unemployment is mentioned, it is said to be a consequence of rigid labour markets or an increase in civil servants' wages. This argument is consistent with past IMF publications but not with more recent statements from its former Managing Director that unemployment policies should go beyond these policies. These statements have not seen growth and other innovative policies as the main driver for employment, as has been discussed in academic and policymaking circles, but argue for well-designed labour market policies. These latter policies were discussed in only a few reports though.

6 FINAL REMARKS

This paper has analysed IMF policy recommendations to several developing countries. Problems found can be grouped as follows: i) recommendations do not reflect the current thinking that has being taking place in economics; ii) the revision of the IMF's position as stated by its main directors and in the research department was not reflected in the policy recommendations; iii) there are several cases where the policy advised does not seem to be the most appropriate due to the country's specific circumstances; and iv) middle-income countries received deeper analysis, and their reports presented a debate between the IMF and country authorities.

Regarding the policies themselves, those that were not the traditional IMF view but were praised as positive by the Fund's research department or one of the Fund's main directors after the crisis were not incorporated in the recommendations. This was very evident in the case of capital controls, which were not only absent from the recommendations but were also said to be ineffective. Automatic stabilisers, which were mentioned in IMF papers as adequate to protect countries in case of crisis, were also absent from the policy recommendations.

Social policies, including employment policies, which Dominique Strauss-Kahn said were very important for stability and growth, were rarely mentioned in the reports. When they were mentioned, it was more as a quote of the government's policies but without any recommendation or suggestion. In particular, almost no policy recommendation was given on how to decrease unemployment. Unemployment numbers, for instance, were mostly mentioned as an indication of the economic situation and were even absent from many reports. When a policy to decrease unemployment was mentioned, the analysis used did not reflect the economic rethinking in place. On the contrary, analyses of unemployment were mainly focused on real wage issues and civil servants' salaries. Demand or structural aspects were not touched on. Decent work was also not considered as an issue. The importance of training was mentioned in a few reports.

Regarding social policies, the main focus was on switching expenditure from subsidies to targeted interventions. This was mostly mentioned in the fiscal context and only rarely involved issues of efficiency. In several cases it was argued that this shift could save government funds.

Regarding the differences in the reports according to the country's income level, the analyses done for middle-income countries were better tailored to the countries' circumstances and needs. One can argue that it makes sense that the IMF pays more attention to bigger economies that have more knock-on effects on other economies. However, from the perspective of the smaller countries, the fact that the IMF makes a poor analysis of the domestic fundamentals results in recommending inappropriate policies, which can have important implications locally.

Another important fact is that reports for middle-income countries more often present a discussion on the policy recommendations between IMF staff and country authorities. Such a debate is not the rule for all the reports, but they were only presented in those for middle-income countries. Reports for low-income countries do not usually present the authorities' opinion, and when they do it is often to show disagreement without presenting any comment on or justification for such a position.

Finally, we can also summarise some policies that the IMF recommended to several countries regardless of their circumstances: i) aiming at very low inflation levels, if possible moving towards explicit inflation targeting; ii) reducing government spending and government revenues; iii) allowing the exchange rate to flow freely; iv) free capital account convertibility; v) phasing out subsidies; and vi) analysing unemployment as a problem of high civil servants' wages.

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NOTES

1. This follows the World Bank's 2010 classification.

2. For some countries, such as China, India, Malaysia and Turkey, the conclusion is drawn without presenting the results themselves, which might be justified by the IMF's publication policy, which allows for the deletion of market-sensitive information.

3. Here, it is important to highlight the conditionalities Guinea-Bissau would have to implement to be eligible for debt relief: a six-fold increase of government tax revenues in three quarters; downsizing civil services; and having zero public external short-term borrowing.

4. Estimations according to different approaches: ES, 20 per cent overvaluation; MB, 8 per cent overvaluation; ERER, close to equilibrium.

5. Although it recognises that "a large deviation of the current account from its medium-term norm remains to be corrected."

6. The authors refer to the Euro Area, the United States and Japan.

7. The calculation of the average pass-through by different country groups was done by Ho and McCauley (2003) based on the values estimated in the original papers— Choudhri and Hakura (2001) and Hausmann et al. (2001).

8. Organisation for Economic Co-operation and Development.

9. See Baqueiro et al. (2002).

10. As Eichengreen (1994) shows, sudden stops of capital flows were the reasons behind the loss of international reserves which 'forced' several countries to change their exchange rate regime in the late-1990s.

11. See Neely (1999) for a summary of the types of controls, their objectives and their different uses in the past.

12. It has also been argued that capital controls only treat the symptoms of inconsistent policies or distortions (Neely, 1999). This argument has lost importance, though, as capital flows have been driven by changes in the economic situation of developed countries and capital flows cycles are the same in several different countries.

13. On the problem of circumvention, see Carvalho and Garcia (2006). As they stated, the effectiveness of controls depends on incentives and costs of circumvention, which, in turn, depend on "the development of domestic financial market and alternatives in overseas derivatives markets (...); the ability of authorities to monitor inflows; the penalties for avoidance; and, the most difficult to prevent, regulation loopholes". Another point determining circumvention, although not mentioned in the text, is the broadness of controls.

14. Some studies based on econometric evidence also support the effectiveness of capital controls. Magud and Reinhart (2006) present a summary of 30 different papers, weighing their results according to their econometric rigour and concluding that capital controls are effective: to change the composition of inflows towards longer maturities; to make monetary policy more independent; and to reduce exchange rate pressures.

15. Ostry et al. (2010) was published in February 2010, before the publication of all the reports mentioned.

16. As shown in the IMF report, reserves in Egypt as of 2008/09 covered 5.8 months of imports and 661 per cent of short-term external debt.

17. One important exception here is the United States of America, where the monetary policy has two objectives: fighting inflation and maintaining a stable output gap.

18. Cecchetti (2001) also finds an increase in policymakers' preference for lower inflation variability as opposed to lower output variability in the 1900s.

19. Countries where the IT regime was in place as of 2011 (Berganza and Broto, 2011) are: Brazil, Chile, Colombia, Czech Republic, Ghana, Hungary, Indonesia, Israel, Mexico, Peru, Philippines, Poland, Romania, Slovak Republic, South Africa, South Korea, Thailand, and Turkey. Countries which had received technical assistance on the IT regime from the IMF in 2005 and had not implemented it as of 2011 (Berganza and Broto, 2011) are: Albania, Armenia, Belarus, Costa Rica, Guatemala, Kazakhstan, Poland, Ukraine (Batini et al., 2006).

20. Some of these ideas were previously published in another IMF paper (Claessens et al., 2010).

21. One interesting point raised by Epstein (2007) is that "thousands of hours of the time of highly scarce, skilled economists are spent pouring over complex models designed to show how to get inflation down from 8 to 4 per cent, but not on how to create more and better jobs."

22. These studies have different methodologies and look at different country groups.

23. Among these countries, 11 follow a crawling or fixed pegged exchange rate regime or are fully dollarised economies— Nepal, Cape Verde, Botswana, Benin, Guinea-Bissau, Senegal, Cameroon, Cape Verde, El Salvador, Ecuador, and Panama. In this case, the need to pursue *the* inflation rate targeted by the country that your currency is pegged to is clear.

24. “The implicit assumption was that stable inflation would deliver economic stability in the larger sense, in the sense of a stable output gap. This was the case in many formal academic models, in particular in the benchmark —New Keynesian model, which displayed a property Jordi Gali and I called the —divine coincidence. In these models, if you maintained stable inflation you would also maintain a stable output gap. The two went together, so there was really no reason to look at the output gap separately” (Blanchard, 2011).

25. Ethiopian authorities disagree with the need for exchange rate liberalisation, but the executive summary states only that this reform is still to be embraced.

26. Indeed, the supply responds to the monetary policy, as this changes the costs of investments. Through this channel, a monetary tightening could even worsen inflation, as an increase in production capacity will be more costly.

27. Epstein (2007) shows that “monetary policy is often more likely to be too tight than too loose.” Frenkel (2006) argues that “the inflation targeting sets a bias towards exchange rate appreciation, with negative effects on employment and growth.” And Libânio (2010) presents the Brazilian experience and concludes that “the way monetary policy has been conducted under the inflation targeting (IT) regime in Brazil brings about an upward bias in interest rates, which harms aggregate demand through different channels and, as a consequence, negatively affects economic growth— at least in the short run.”

28. In Chile’s Public Information Notice (PIN) No. 01/73 and its 2001 Article IV report.

29. Some of these ideas were previously published in another IMF paper (Claessens et al., 2010).

International Policy Centre for Inclusive Growth (IPC - IG)
Poverty Practice, Bureau for Development Policy, UNDP
Esplanada dos Ministérios, Bloco O, 7º andar
70052-900 Brasilia, DF - Brazil
Telephone: +55 61 2105 5000

E-mail: ipc@ipc-undp.org ▪ URL: www.ipc-undp.org