At issue: Too much, too soon: IMF conditionality and inflation targeting

Gerald Epstein, co-director of the Political Economy Research Institute at the University of Massachusetts, finds that despite little evidence of the success of inflation targeting in promoting economic growth, employment creation or poverty reduction, the IMF is increasingly pushing its use. There is an urgent need for viable alternatives that focus on employment generation, poverty reduction, export promotion and investment enhancement to be given more attention.

Ironically, employment creation has dropped off the agenda of most central banks just as the problems of global unemployment, underemployment and poverty are taking centre stage as critical world issues. The ILO estimates that in 2003, approximately 186 million people were jobless, the highest level ever recorded. IMF economists estimate that economic growth needs to be sustained at seven per cent per year or more to reach the millennium development goal of reducing poverty by half by 2015.

Yet the so-called 'global best practice' approach to central banking has not focused on economic growth or employment generation; instead, the IMF promotes formal or informal inflation targeting, in which keeping a low rate of inflation - in the low single digits - has been proposed as the dominant and often exclusive target of monetary policy. According to this orthodox approach to monetary policy, the focus of policy is on stabilisation, rather than growth or development, with an implicit assumption that once stabilisation is achieved, economic growth, employment creation, and poverty reduction will follow.

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This orthodox view not only specifies the appropriate target of monetary policy, but also the appropriate tools or instruments. The orthodox approach has emphasised indirect, market-based instruments of policy, such as short-term interest rates, as the primary and often exclusive tool of monetary policy. This is in contrast to the direct, quantitative tools often used by central banks which have involved credit allocation methods, interest rate ceilings, and other ways to direct credit to priority economic sectors and goals. In short, the IMF-sponsored orthodox approach has narrowed both the goals and the tools of monetary policy.

After several decades of experience with this inflation-focused market-based approach, the record has been disappointing. In a number of countries, inflation has come down, to be sure, but it is questionable to what extent the drop in inflation is due to changes in domestic monetary policy, rather than the overall global fall in inflation. But even if domestic monetary policy has reduced inflation, the hoped for gains in employment have generally not materialised; and, for many countries following this orthodox approach, economic growth has not significantly increased. The key point, then, is this: despite what the orthodox approach maintains, employment generation and economic growth are not automatic by-products of stabilisation-focused central bank policy.

Surprisingly, despite a disappointing record, this almost single-minded focus on inflation is gaining a more secure foothold in monetary policy circles and the circles are widening to include an increasing number of developing countries. According to a recent report by the IMF, an increasing number of central banks in emerging markets are planning to adopt inflation targeting as their operating framework. An IMF staff survey of 88 non-industrial countries found that more than half expressed a desire to move to explicit or implicit quantitative inflation targets. Nearly three-quarters of these countries expressed an interest in moving to full-fledged inflation targeting by 2010.

Importantly, to support and encourage this movement, the IMF is providing technical assistance to many of these countries. In addition, the IMF is considering altering its conditionality and monitoring structures to include inflation targets. In short, 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, a substantial momentum is building up for fully-fledged inflation targeting in developing countries.

While it might seem obvious that stabilisation-focused central bank policy represents the only proper role for central banks, in fact, looking at history casts serious doubt on this claim. Far from being the historical norm, this focus by central banks on stabilisation to the exclusion of development represents a sharp break from historical practice, not just in the developing world but also in the now developed countries as well. In many of the successful developed and developing countries, development was seen as a crucial part of the central bank's tasks. Now, by contrast, development has dropped off the 'to-do list' of central banks.

The promotion of inflation targeting has implications for the type of conditionality that the IMF imposes. As the IMF states: "Conditionality in Fund-supported programmes is intended primarily to ensure that Fund resources are used to support adjustment toward sustained external viability, and thereby to safeguard the capacity to repay the Fund. Traditionally, monetary conditionality consists of limits on monetary aggregates...".

The IMF is concerned, however, that this approach could allow for higher inflation than they might like if, for example, larger than necessary increases in net international reserves result from inflows of capital. As a result, inflation targeting might require a further tightening of monetary conditions for countries undergoing IMF programmes in order to maintain inflation rates in the low single digits. To the extent that such tightening slows employment growth even further, inflation targeting as part of IMF conditionality could have more severe impacts on employment and poverty impacts for developing countries than current conditionality.

A Ghana case study

In a recent report with my colleague at the Political Economy Research Institute, James Heintz, we studied the evolution of this

conditionality and its impact in Ghana. In Ghana, monetary policy has been strictly limited by macroeconomic stabilisation agreements made with the IMF and World Bank in conjunction with IMF loans, the Heavily Indebted Poor Countries (HIPC) initiative and the Poverty Reduction Strategy Paper (PRSP) process. In addition to the typical IMF requirements to limit credit to the government and increase foreign reserves, the Bank of Ghana has also been encouraged to focus on reducing inflation into the "low single digits." This focus on inflation fighting and the other limitations imposed by IMF conditionality has reduced the prospects for rapid economic growth and broad-based employment generation.

Monetary policy has been strongly influenced by the IMF Poverty Reduction and Growth Facility agreements and commitments undertaken by Ghana as well as commitments made in conjunction with the development of the Ghana Poverty Reduction Strategy, as part of the HIPC debt-relief initiative, and the Multi-Donor Budgetary Support initiative. According to documents associated with these initiatives: "The focus of macro-stability in the medium term is to ensure prudent fiscal and monetary policy management to achieve price stability, maintain interest rate levels that are conducive to both savings and investments, and to ensure stable yet competitive exchange rates and a fiscally sustainable debt burden."

Financial programming has been used since the 1970's as part of the IMF's lending programmes to least developed countries. This programming has now been folded into the PRSP and HIPC processes without much alteration. The programming uses extremely simple models (at best, a set of assumptions about the structure of the economy) to establish a set of targets that the IMF will monitor and the government will have to meet in order to receive the next installments of IMF loans, or qualify for HIPC relief and other donor support.

The typical programme connects balance of payments constraints, the government fiscal deficit, and central bank policy in order to attempt to reduce indebtedness to a sustainable level, primarily by keeping economic growth in line with likely available foreign resources from export receipts, aid and capital inflows. Increasingly, reducing inflation into the low single-digits has become a central focus. Therefore, two key assumptions of these programmes are (1) that inflation rates between 10 and 20 per cent are bad for economic growth and reducing inflation below that level will not reduce economic growth; and (2) that reducing government spending is good for the economy, because more government spending crowds out private investment.

Under the standard financial programming methods implemented by the IMF, target ceilings are set for central bank monetary and credit expansion and floors are established on net foreign reserves. The original motivation for these restrictions was to ensure the ability of countries to reduce their foreign debt and remain solvent, including protecting the ability of the IMF to get repaid. Recently, other goals, such as reducing inflation, increasing foreign exchange reserves and "creating room for private investment," have been emphasised.

A troubling implication of this approach is that there is no clear set of conditions under which expansionary monetary policies are called for, even in a situation of slow growth and high unemployment. This is because there is no explicit operational target for economic growth, employment creation, or poverty reduction. The bias of financial programming is therefore highly contractionary. Traditional financial programming did not incorporate explicit inflation targets. Now, however, there are new commitments made by central banks to the IMF and associated organisations to reduce inflation. This adds an additional restriction on central bank policy along with the traditional commitments with respect to domestic credit ceilings and reserve floors.

Alternatives do exist

Alternatives to this destructive approach to central bank policy do exist. Erinc Yeldan from Bilkent University in Ankara, Turkey and I directed a series of country studies undertaken by a team of researchers working on a project on alternatives to inflation targeting. The countries covered in this project are Argentina, Brazil, Mexico, India, The Philippines, South Africa, Turkey, and Vietnam. I also worked with a UNDP-sponsored study of economic policy which targets employment for South Africa.

A range of alternatives were developed in these papers, all the way from modest changes in the inflation targeting framework to allow for more focus on exchange rates and a change in the index of inflation used, to a much broader change in the overall mandate of the central bank to a focus on employment targeting, rather than inflation targeting. Some of the alternative policies focus exclusively on changes in central bank policy, while for other countries, changes in the broad policy framework and in the interactions of monetary, financial and fiscal policy are proposed. Some incorporate explicit goals and targets, while others prefer more flexibility and somewhat less transparency. But all of the studies agreed that the responsibilities of central banks, particularly in developing countries, while including maintaining a moderate rate of inflation, must be broader than that, and should include other crucial real variables that have a direct impact on employment, poverty and economic growth, such as the real exchange rate, employment, or investment. They also agree that in many cases, central banks must broaden their available policy tools to allow them to reach multiple goals, including, if necessary, the implementation of capital management techniques.

The major lesson of these case studies and auxiliary materials is that there are well thought out and plausibly viable alternatives to inflation targeting that can focus more on important social, real sector outcomes such as employment generation, poverty reduction, export promotion and investment enhancement. If inflation targeting is resilient as the 'big idea' of modern central bank policy because many perceive that there is no alternative, these case studies can provide an antidote by showing that viable alternatives are plausible and can be further developed and put into practice. In fact, doing so would be consistent with long-standing historical practice.

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Gerald Epstein is professor of economics at the University of Massachusetts

A longer, fully-referenced version of this article is available at: www.brettonwoodsproject.org/inflationatissue52

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Hamlyn House, Macdonald Road, London N19 5PG, UK
Tel +44 (0)20 **7561 7546**/7
Fax+44 (0)20 **7272 0899**
info@brettonwoodsproject.org
www.brettonwoodsproject.org/subscribe
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