WHY IS THE FISCAL POLICY IMPOSED BY IMF PRO-CYCLIC?

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The economies which appealed to the IMF loan faced difficulties related to financing the public and the private foreign debt. IMF imposed the promoting of a restrictive fiscal policy to the beneficiary countries, in order to decrease the budget deficit, even though they have already been in an economic recession and they would need to promote a new expansionary fiscal policy, which allows implementing the measures mentioned in the national anti-crisis plans. As a result, imposing new pro-cyclic fiscal policies will emphasize the recession within these economies, and this will contribute to decreasing the individuals’ available incomes and, as a consequence, to the occurrence of social discontents (as in Latvia, Hungary, Ukraine and Serbia).

Keywords: fiscal policy stance, structural budget balance, IMF agreement, economic recession
JEL Classification: E32; H30; H50.

Fiscal policy stance

In order to catch the restrictive/expansionary character of a fiscal policy, the structural budget balance has to be calculated. This variable represents the current budget balance, out of which the cyclic component of the budget was eliminated (meaning, the cyclically adjusted current budget balance). The calculation of this variable is necessary because the budget balance reflects the influence of both some cyclic (transitory) factors, and of some structural (permanent) ones. The transitory component refers to the variations generated by the GDP’s cyclic evolutions, and the structural component takes into consideration the modification of the budget balance, if the economy would produce at the level of the potential GDP. The cyclic part of the budget is determined depending on the budget balance’s sensitivity to the economic cycle, because the returns from taxes are influenced by the evolution of the national revenue (within the Euro zone, approximately 90% of the budget revenues come from taxes). With regard to the public expenses, only those referring to the unemployment assistance are sensitive to the evolution of the GDP, and their share is only of 5%. The result is that the cyclic variation of the budget balance is mostly explained by the modifications of the budget returns.

The output gap is calculated as the difference between the current GDP ($Y_a$) and the potential GDP ($Y_p$):

$$\Delta Y = Y_a - Y_p \Rightarrow Y_a = Y_p + \Delta Y.$$  

The current output is composed of the potential one to which a cyclic component is added. According to this relation, the decomposition of the current budget balance can be obtained as it follows:

$$SBA = SBS + SBC,$$

where:

$SBA$ – the current budget balance;  
$SBS$ – the structural budget balance (at the level of $Y_p$);  
$SBC$ – the cyclic budget balance (which corresponds to the output gap).

$SBA$ is obtained as the difference between the budget returns (from taxes $T$) and the budget expenses (including transfers), as it follows: $SBA = T - (G + TR)$. The function of the taxes takes into consideration both the taxes which are independent of the revenue level (the autonomous taxes – $n$), and those directly influenced by its evolution ($t \cdot Y$, where $t$ represents the marginal rate of taxation).

If a restrictive fiscal policy is promoted (for example, the increase of taxation or the decrease of transfers), then the structural budget balance will get increased ($\Delta SBS > 0$). If it records a decrease, then the promoted fiscal policy becomes expansionary. It is considered pro-cyclic if it is restrictive under the terms of a recessionary output gap and expansionary in the case of an...
inflationary output gap. An *anti-cyclic* fiscal policy is that which aims to stopping the recession or to impede the economic expansion.

**Why Did IMF Intervene?**
IMF Managing Director Dominique Strauss-Kahn considers that the solution to the global problems consists in promoting an expansionary fiscal policy and not a restrictive one, but not each economy can promote such expansionary measures. The economies facing difficulties in financing the budget deficit/the public debt service must promote a restrictive fiscal policy, even though it passes through a recession period.

IMF's main criterion to give the financial help is the situation of the public finances, but it also gives loans for financing the short-term payable debt (both public and private). According to IMF's logic, not only the state has to promote austerity, but also the private economic agents (companies, consumers). Under the terms of going through the economic recession, the states beneficiary of the IMF loan will record a decrease in the budget returns and they will have to decrease their budget deficit either by limiting the public expenses, or by increasing taxation, the both measures generating an emphasis of the economy's decline. These have been the evolutions in the European countries which benefited by the IMF loan – Latvia, Hungary, Serbia, Ukraine and Romania. The next sections I make analyses by comparing the macro-economical situations in Latvia and Hungary with Romania's macro-economical evolution.

**Hungary's vulnerabilities. The constraints imposed by IMF**
Hungary's current problems represent the consequence of the populist measures promoted in 2002, namely giving a supplementary pension to the retirees (the 13th pension), the increase with 50% of the wages for all the public employees and giving some advantages (exemptions from taxation) to the political clients. From a macro-economical point of view, in 2008 Hungary has been characterized by non-fulfilling any criterion of nominal convergence, while Romania fulfilled only the public debt criterion. The comparison with Romania (table 1) emphasizes the relatively faster adjustment of inflation and of the current account deficit.

**Table 1. Comparison between Romania's and Hungary's macro-economical evolutions**

<table>
<thead>
<tr>
<th>Resemblances with Romania</th>
<th>Differences from Romania</th>
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<tbody>
<tr>
<td>Budget deficit over 3% in 2008 – <em>minus for Romania</em></td>
<td>The public debt increased from 52% in 2001 to 67% in 2008, thus reflecting average annual budget deficits over 7% between 2002-2007; <em>plus for Romania</em></td>
</tr>
<tr>
<td>The average inflation rate was over 6% in 2008 (6.1% in the case of Hungary)</td>
<td>Hungary is going through a recession period (the 3rd and the 4th quarters recorded an economic decline) <em>plus for Romania</em></td>
</tr>
<tr>
<td>The vulnerability in the banking sector at the Hungarian forint’s depreciation (more than half of the banking credits given to the private sector are in a foreign currency)</td>
<td>In January, the inflation rate decreased to 3.1% <em>minus for Romania (6.7%)</em></td>
</tr>
<tr>
<td>The approximately 15% depreciation of the national currency at present, compared to the beginning of 2008.</td>
<td>The foreign debt is approximately 100% of the GDP <em>plus for Romania</em></td>
</tr>
<tr>
<td>The average inflation rate was over 6% in 2008 (6.1% in the case of Hungary)</td>
<td>The current account deficit was 6.1% of the GDP in 2008 – <em>minus for Romania (approx. 12.5%)</em></td>
</tr>
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<td></td>
<td>Foreign currency reserves of approx. 16 billions Euro – <em>plus for Romania</em></td>
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Hungary obtained almost 20 billions Euro (26.5 billions dollars) not to go into payment default, but the receiving of the installments is conditioned by promoting some restrictive and pro-cyclic fiscal policy measures, such as:
- decreasing the public expenses in order to improve the long-term fiscal sustainability;
- reduction the share of the public sector in economy (in 2008 it was 49%, a level which is superior to the EU-15 average of 46%);
- wage freezing in the budgetary sector in 2009;
- limiting the 13th pension to a level of 260 Euro (80,000 HUF) and eliminating it for those retired - with anticipation.

_Latvia's vulnerabilities. The constraints imposed by IMF_
In 2008, Latvia was characterized by a unique cocktail of three factors of risk:
- the economy's overheating based on a crediting advance of approximately 70% of the GDP
- during the last 5 years;
- the monetary council, because of which the promoted monetary policy could not by anti-cyclic;
- a very high share of the short-term foreign debt (over 50%), the highest among the new EU member countries.

Latvia recorded a hard landing of economy, after which, during the 2003-2007 period, it recorded an economic growth average rate of 8% and an increase of the private crediting in the GDP with approximately 70 percents. Latvia fulfilled three of the nominal convergence criteria – the budget deficit, the public debt and the stability of the rate of exchange (under the terms of a fixed rate of exchange). The comparison with Romania emphasizes a relatively less favorable macro-economical situation, the resemblances mainly referring to the share in the GDP of the public debt and at the rate of unemployment level (table 2).

<table>
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<th>Table 2. Comparison between Romania's and Latvia's macro-economical evolutions</th>
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<td><strong>Resemblances with Romania</strong></td>
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<tr>
<td>The decreasing of the demand was reflected in the current deficit’s adjustment beginning with the 3rd quarter of 2008, approx. 12.5%, a level which is similar to that in Romania</td>
</tr>
<tr>
<td>A low share of the public debt in the GDP, near to 13% in 2008 (12.3% for Latvia and 13.5% for Romania)</td>
</tr>
<tr>
<td>The biggest banks in Latvia ensured the Government that they would continue to guarantee the financing necessary for the economy’s functioning (resemblance with Isărescu’s statement).</td>
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<tr>
<td>Almost a third of the employed population works in the public sector.</td>
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<td>The wages in the public sector were raised over the economic growth rate, and those from the private sector rose over the growth rate of labour productivity.</td>
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<td>The rate of unemployment was approximately 6.7-7%, according to the Eurostat methodology in 2008.</td>
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Latvia obtained a loan from IMF of 7.5 billions EUR, approximately 45% of the GDP recorded in 2008. The fiscal objectives fixed by IMF for Latvia refer to:

- decreasing the wages in the public sector with 15%, as well as the decreasing of the budgetary personnel, eliminating the bonuses/incentives given to the public employees;
- decreasing the subsidies, except the social security benefits;
- introducing a 10% tax on dividends, interests, rent, starting with 2010;
- the three percents increase from 21% of the normal VAT rate and the increase from 5% to 10% of
  - the decreased VAT rate which has a much more restraint basis of taxation (mainly the medicines);
  - the increase of the fuel excise (achieving the communitarian acquis), as well as a partial compensation by decreasing the rate of taxation of the natural persons’ revenues with 2 percents;
- freezing the pensions and their indexation on the inflation rate only starting with 2010.

Receiving the future installments is conditioned, first of all, by the compliance with the target of the budget deficit; even though the level settled for 2009 is 5%, the Government considered that the unfavorable evolution of the economy generates the deficit's automatic increase to a level which is superior to the value of 10%. As a consequence, the compliance with the established budgetary threshold will involve the emphasizing of the fiscal policy's and economic recession's restrictiveness.

The provisions in the IMF’s agreement with Romania

The main objective of the loan consists of diminishing the effects of the strong decrease in the private capital entries and of properly financing the disequilibrium in the Romanian economy. The intermediary objectives refer to the medium-term promotion of a fiscal strengthening policy (by decreasing the public expenses) and of a restrictive monetary policy (in order to comply with the NBR's inflation target). The budget deficit which must be complied with by Romania in 2009 is inferior to that in 2008, under the terms in which the economy will record an approximate 11% decline compared to the previous year, and the budgetary returns will get decreased, this automatically leading to the increase of the budget deficit. As a consequence, Romania has to promote a restrictive and pro-cyclic fiscal policy, the main measures for decreasing the budgetary expenses aiming to:

- significantly decreasing the expenses with the wages in the public sector, by decreasing the bonuses and the other benefits;
- eliminating 137,000 vacant jobs;
- continuously decreasing the subsidies intended for the public entities;
- eliminating the increases in wages for the public sector (a total of 5%) planned for 2009 or the corresponding decreasing of the personnel number;
- unifying the wage grid in the budgetary sector, so that the bonuses could peg at 25% of the total expenses with the personnel;
- indexation of the public pensions at the prices index and not at the evolution of the revenues from the average gross wage in economy; also, there will occurs the raise of the retiring age (especially for women) according to the average expectation of life.

Conclusions

The agreement with the IMF does not automatically generate a decrease of the macro-economical risks for an economy, under the terms in which a restrictive fiscal policy is promoted. Thus:
- the national currency is not appreciating (the national currencies from Hungary, Ukraine, Serbia recorded depreciations even though these countries have signed agreements with the IMF);
- the country rating is not getting improved as a consequence of the agreements with the IMF (Ukraine’s and Latvia’s ratings were low);
- the domestic economic agents’ confidence in the economy’s evolution is not getting improved. According to the Economic Sentiment Index (ESI), calculated by the European Commission, ESI decreased in Latvia from 77 in November 2008 to 53.4 in February 2009, and ESI in Hungary decreased from 75 in October 2008 to 39 in February 2009.
- an agreement with the IMF is not increasing the stability of the banking system; on the contrary, the recession is getting deeper and the incapacity to repay the credits is getting increased through the promoted restrictive policy.

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