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# **Restrictive IMF Policies Undermine Efforts at Health Systems Strengthening (HSS)**

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## **Restrictive IMF Policies Undermine Efforts at Health Systems Strengthening (HSS)**

In recent years, health advocates and donors alike have increasingly recognized the need for “health systems strengthening (HSS)” in developing countries to undergird their other disease-specific efforts. Additionally, aid recipients are expected to devote greater domestic resources towards such HSS efforts, which will require scaled-up levels of public investment as a percent of GDP. There is reason for concern, however, that countries will be unable to do this now for the same reasons they have chronically underfunded public investment for much of the last 30 years: to stay in compliance with the conservative policy orthodoxy of the International Monetary Fund (IMF), which has been based on strict notions of fiscal balance and price stability (low inflation).

Although the IMF was originally designed to assist countries in managing their fixed exchange rates by providing funds and technical advice, its role changed when developed nations moved away from fixed exchange rates in the 1970s. With the inception of the debt crisis in 1982, the IMF was charged with crisis management in developing countries and conducting the surveillance, financial and technical assistance. That assistance was informed by the Reagan and Thatcher governments in the early 1980s and their strong belief in the school of monetarism within neoclassical economics. These policies have gained acceptance over time and go largely unchallenged, particularly among donors who look to IMF approval before giving aid. Central to the IMF’s policy approach was to condition future aid and debt-relief on achieving balanced budgets and price stability.

The requirement for fiscal balance compelled governments to cut expenditures, often with little regard for the composition of government expenditure. In most cases, the budget was brought to a balance or surplus by cutting public investment rather than by raising taxes. There have been precipitous declines in public investment since the early 1980s in both Latin America and Africa, the two regions which experienced growth slowdowns. Public investments have generally declined in Latin America since the debt crisis starting from around 1982, while the collapse in sub-Saharan Africa during the early and mid-1980s was reversed slightly before the decline continued, more gradually, in the 1990s (1). The situation was made worse by the fact that declines in public investment were not matched by increases in private investment, as had been hoped, largely because of the other IMF policy seeking price stability.

Focusing on price stability was supposed to have created favorable conditions for private investment, capital inflows and exports, which should have spurred growth. However, both public and private investment has been adversely affected by the orthodox macroeconomic policy framework of the past

three decades, which has been focused on achieving low single-digit inflation rates (about 5%), financial sector deregulation and the opening of the capital account, all of which usually involved raising real interest rates (2). This makes credit less affordable for domestic industries, which are then less able to generate higher levels of productive capacity, employment and GDP output, and thus, tax revenues, than otherwise could be the case under more expansionary fiscal and monetary policy options. This deprives governments of higher levels of tax revenues for both recurrent expenditures and crucially, for long-term public investment as a percent of GDP.

Consequently, recent decades have been characterized by fiscal and monetary policies that have prioritized fiscal balance and low inflation in the constant short-term to the neglect or subordination of the public investment necessary for longer-term developmental goals such as increased employment, tax-revenue generation and investments in the underlying health infrastructure. The IMF has succeeded in lowering fiscal deficits and inflation, but at the cost of a long-term trend of low-growth, low-employment and low-public investment that has been characterized by chronically insufficient health budgets and dilapidated health infrastructure.

This concern had been clearly articulated by a 2001 US Government Accountability Office (GAO) report on IMF loans when it cautioned: "Policies that are overly concerned with macroeconomic stability may turn out to be too austere, lowering economic growth from its optimal level and impeding progress on poverty reduction" (4). This concern was also raised in a major 2005 World Bank retrospective on economic growth which concluded the IMF's effort to lower inflation may well have come at the cost of unnecessarily lower growth and tax revenue generation, multiplied over many years (4).

It is important for readers to know that the IMF has very little empirical evidence in the economics literature to justify pushing inflation down to the 5–7% level, with the consequences of lower growth, lower taxes and lower spending that result. This is often considered surprising, given the widespread belief that the IMF is the expert on such matters. While everyone agrees that high inflation is harmful and must be brought down, there has developed a false, black-or-white dichotomy in which it is believed a country has either very low inflation or out-of-control hyperinflation, with a disregard for other reasonable rates of moderate inflation that have historically (before IMF structural adjustment programs in the 1980s) coexisted with higher GDP growth rates in developing countries (5).

Far more relevant questions are how low must inflation be brought down and at what level must it be maintained. There have been several major studies which have tried to find this 'kink' in the inflation–

growth relationship, or at what level inflation begins to hurt a country's long-term GDP growth rates, yet the estimates range across the board. Some studies find the danger point for inflation is between 15 and 30%, as high as 40% or as low as 8%, and with several in between (6). Health advocates should know that what these major studies collectively show is that not only are the estimates all over the place and further research is still needed, but, as one recent study notes, "There is no justification for inflation-targeting policies as they are currently being practiced throughout the middle- and low-income countries" (7).

The same literature was reviewed in a 2007 study by the Center for Global Development which similarly concluded: "Empirical evidence does not justify pushing inflation to these levels in low-income countries" (8) and by the House Financial Services Committee of the US Congress, which wrote to the IMF in 2007, "We are concerned by the IMF's adherence to overly-rigid macroeconomic targets" and "It is particularly troubling to us that the IMF's policy positions do not reflect any consensus view among economists on appropriate inflation targets" (9).

The report of the high-level 2008 Spence Commission on Growth and Development also pointed to this specific concern: "...Very high inflation is clearly damaging to investment and growth. Bringing inflation down is also very costly in terms of lost output and employment. But how high is very high? Some countries have grown for long periods with persistent inflation of 15–30%" (10). Commission member Montek Singh Ahluwalia added, "The international financial institutions, the IMF in particular, have tended to see public investment as a short-term stabilization issue, and failed to grasp its long-term growth consequences. If low-income countries are stuck in a low-level equilibrium, then putting constraints on their infrastructure spending may ensure they never take off."

In its responses to critics thus far, the IMF has not addressed this major criticism. The key point to bear in mind for advocates of health system strengthening (HSS) is that, while the IMF and monetarists within neoliberal theory believe strongly that it is "prudent" to drive inflation so low, there are actually very real consequences and very important trade-offs being made behind closed doors when the IMF and finance ministries regularly agree to such low targets—and when other donors go along with this. Because the policy usually calls for raising interest rates to get inflation down, economists refer to the trade-off as the "sacrifice ratio" – or the amount of GDP growth that is forgone or sacrificed in order to get inflation rates down to lower levels (11).

HSS advocates should look closely at what is being "sacrificed" when these targets are agreed behind closed doors: the higher interest rates often mean lower growth rates, fewer taxes collected, thus less

public expenditure and public investment is possible. This carries huge social costs over time, and yet these costs, or the possible benefits of alternative policy options for higher spending, are not subject to public debate, analysis or consideration by any wider groups of stakeholders in developing countries. Yet health advocates and others have a right to know how much higher GDP output, employment, future tax revenues, future public expenditure and public investment in health infrastructure is being "sacrificed" before signing on to such IMF loan program targets, year after year. They also have an obligation to ensure alternatives are considered.

As global aid donors take steps to assist with financing for HSS, it is expected that developing countries must also increase their own domestic contributions to increased health spending and investment. Yet, countries will not be able to generate significantly more domestic resources under the current IMF fiscal and monetary policies. Health advocates, particularly those in the richest and most powerful G7 countries, must call on their finance ministries (such as the US Treasury Department) to take immediate steps at the IMF Executive Board to revisit and change these unnecessarily-restrictive IMF policies so that developing countries can better generate higher GDP output, employment and tax revenues for increased long-term public investment in rebuilding their health systems.

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- (6) The major studies and their estimates for the danger point for inflation are: Pollin and Zhu (2005) "Inflation and Economic Growth: A Cross-Country Non-linear Analysis," by Robert Pollin, Department of Economics, University of Massachusetts-Amherst and Andong Zhu, Tsinghua University, Beijing, China. October 2005. PERI Working Paper Series 109. The Political Economy Research Institute, University of Massachusetts Amherst (Between 14-16% for MICs & LICs); Fischer, Stanley, 1993, "The Role of Macroeconomic Factors in Growth," *Journal of Monetary Economics*, Vol. 32, pp. 485-512 (15-30%); Bruno, M. "Does Inflation Really Lower Growth?," *Finance & Development*. Vol. 32, no. 3. September 1995. pp. 35-38 (cites a then-recent major World Bank study of the link between inflation and economic growth in 127 countries from 1960 to 1992 found that inflation rates below 20% had no obvious negative impacts for long-term economic growth rates.) (Below 20%); Barro, Robert J. 1996, "Inflation and Economic Growth," *Federal Reserve Bank of St. Louis Review*, Vol. 78, pp. 153-169 (Finds that an increase by 10 percentage points in the annual inflation rate is associated on impact with a decline by only 0.24 percentage points in the annual growth rate of GDP); Sarel, Michael, 1996, "Nonlinear Effects of Inflation on Economic Growth," *IMF Staff Papers*, Vol. 43, pp. 199-215. (8%); Bruno, Michael and William Easterly, 1998, "Inflation Crises and Long-Run Growth," *Journal of Monetary Economics*, Vol. 41, pp. 3-26. (40%); Ghosh, Atish and Stephen Phillips, 1998, "Warning: Inflation May be Harmful to Your Growth," *IMF Staff Papers*, Vol. 45, pp. 672-710 (Finds inflation-growth relationship is convex, so that the decline in growth associated with an increase from 10% to 20% inflation is much larger than that associated with moving from 40% to 50% inflation); Khan, Mohsin S., and Abdelhak S. Senhadji, 2001, "Threshold effects in the Relation Between Inflation and Growth," *IMF Staff Papers*, Vol. 48, pp. 1-21. (Between 11% -12% for developing countries; 1-3% for rich countries); and Gylfason, Thorvaldur, and Tryggvi T. Herbertsson, 2001, "Does Inflation Matter for Growth?" *Japan and the World Economy*, Vol. 13, pp. 405-428. (Between 10-20%). It should be noted that the IMF has



pointed to a November 2009 study on this issue by the US Government Accountability Office (GAO) concluded "empirical evidence generally suggests inflation is detrimental to economic growth after it exceeds a critical threshold, which is broadly consistent with the inflation targets included in the IMF-supported programs reviewed." However this judgement is based on comparing IMF targets to only six studies. Despite listing 16 papers in the bibliography, the GAO only analyzed nine studies published since 1999 in the text of the report. To judge the IMF targets as consistent, they simply dropped three of the nine studies "since two of the three estimates outside the 5 to 12% range are likely due to methodological issues and the remaining estimate (17%) is from a June 2009 study that addresses a number of the methodological issues in the existing literature but has not been peer reviewed." Buried in a footnote is the admission that "this exercise is not meant to imply that literature is conclusive."

(7) Pollin and Zhu, Ibid.

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