Comments by Stanley Fischer on the IMF and the environment

The following is drawn largely from informal remarks made by IMF First Deputy Managing Director Stanley Fischer at a luncheon talk during the May 10–11, 1995, IMF seminar on "Macroeconomics and the Environment."

To a remarkable extent, the work of the IMF is still guided by its original mandate, as spelled out in the Articles of Agreement. In 1944, the founding fathers charged the IMF with, among other things, facilitating "the expansion and balanced growth of international trade, and to contribute thereby . . . to the development of . . . productive resources" and helping member countries with temporary balance of payments problems so that they do not have to adjust by "resorting to measures destructive of national or international prosperity." These goals are pursued primarily through balance of payments assistance and what has come to be called surveillance.

Although the environment is not referred to in the Articles of Agreement, it is clear that environmental issues must be taken into account in trying to attain what the Managing Director often refers to as "high-quality growth"—that is, growth that is sustainable, that brings improvements in living standards, and that does not mortgage the future for short-lived gain. For instance, natural resource degradation that threatens growth cannot be ignored by the IMF. Taking account of such environmental concerns is just good economics.

How might environmental issues show up in our dealings with member countries? Here are a few examples:

Developing countries. The economic growth strategy of a developing country that relies on depletable resources for current economic activity has to be different from that of other countries. Resources need to be used at an optimal rate, and provision needs to be made— through saving and investment—for the time when economic activity cannot rely to such an extent on raw materials. Most obviously, these considerations are paramount in the oil exporting countries, but they are also important in other natural resource exporting countries—for example, Kiribati built up a reserve fund as it used up its stock of guano.

Economies in transition. For countries switching to a market-oriented economy, the opportunities for efficiency gains—through realigning prices, removing subsidies, and ending soft budget constraints for state-owned-enterprises—are enormous. The IMF can encourage these countries to adopt policies that would serve both the economy and the environment. These might include, as a first step, adjusting energy prices to their market value, which the World Bank has estimated could reduce atmospheric emissions of sulfur by up to 60 percent in Central and Eastern Europe.

Industrial countries. In countries where our efforts focus largely on surveillance, we can draw on the work by national governments, international organizations, and academics on country-specific studies of the impact of environmental policies and conditions on the macroeconomy (e.g., proposed carbon taxes and common environmental policies in the European Union), and bring these to bear on our policy discussions.

There is no question, however, that environmental issues tend to be of a longer-term and sectoral nature. Thus, it is generally up to the World Bank—our sister organization—to take the lead on these issues. The Bank and the IMF cooperate in two key ways. First, in connection with some of the IMF's longer-term lending programs, we work closely with the Bank to help countries prepare policy framework papers, which often include medium-term plans for addressing environmental problems. Second, together we assist countries in designing public policy reforms that are supportive of the environment.

Finally, green accounting is expected to help policymakers fashion better environmental and economic policies. For that reason, the IMF has been supporting the work of the World Bank, the United Nations, and others to develop methodologies for environmental satellite accounts that augment conventional national accounts. This work is extremely useful and important in practice—indeed, improved measurement has already shown in some cases just how significant environmental factors are in long-term growth.

Peter Bartelmus, of the UN's Statistical Division, which is charged with developing the system of environmentally adjusted national accounts, argued at the seminar that what is important is ensuring that the use of environmental resources is measured in a way consistent with conventional economic aggregates. At this stage, many outstanding conceptual and methodological problems, especially on valuation issues, remain. Even so, seminar participants agreed that this should not prevent further efforts to develop satellite accounts, at least on an experimental basis.

Tackling economic problems

While Ecotopia's environmentalists address environmental problems, its macroeconomists must pursue policies aimed at avoiding macroeconomic instability. Instability can harm the environment, largely by distorting incentives to preserve environmental resources or undertake investments in environmental protection. For example, high and variable rates of inflation—which frequently distort intertemporal choices concerning the use of forests, mines, and other natural resources—reduce the incentive to preserve resources, as producers and consumers act as though they were facing high discount rates, thus ignoring the future. Macroeconomic instability may also hinder the effectiveness of environmental policies, as it may necessitate frequent adjustments to environmental taxes and subsidies.

Thus, to the extent macroeconomic reforms help control inflation, lower discount rates, and create stable macroeconomic conditions, they encourage decision makers to take a longer-term view and ensure that the right price incentives work to preserve environmental resources.

If Ecotopia's policymakers were working in a "first-best" world, where environmental resources were priced to reflect social costs and private decisions were based on social costs, they would need to worry little about the environmental impact of macroeconomic policies. But our policymakers are working in a "second-best" world characterized by pervasive market, policy, and institutional failures. In such a world—as pointed out by IMF economists Ved Gandhi and Ronald McMorran—macroeconomic policy reforms can have an adverse impact on the environment, albeit only indirectly. However, it is the lack of sound environmental policies—not of sound macroeconomic policies—that leads to environmental degradation.

Two World Bank economists, Mohan Munasinghe and Wilfrido Cruz, reported that studies carried out by the World Bank and others supported this conclusion. A study of Morocco showed that trade liberalization led to increased GDP, as exports became more competitive, resources were allocated more efficiently, and household incomes and consumption grew. But the expansionary effects of liberalization would also lead to increased use of scarce supplies of water in sugarcane production, as the relative price of water was held artificially low because of a prevailing policy distortion.

The good news, however, is that there are "win-win" policies that can benefit both the economy and the environment. A World Bank study of Sri Lanka shows, for example, that increasing the price of electricity to its long-run supply cost would encourage more efficient use of electricity—an economic benefit that would also have favorable environmental impacts (e.g., improved air quality, reduced biodiversity loss, and lower greenhouse gas emissions).

Thoughts for policymakers

What should the Ecotopian government do to ensure that the standard of living of Ecotopians is sustained or improved as it will have to weigh the macroeconomic and financial implications of various policies? A few helpful hints can be culled from the seminar:

Ensure coordination. There is no substitute for coordination between environmentalists and macroeconomists to ensure that policies are consistent with sustaining and improving living standards. Moreover, there may well be a need for such cooperation on a regional or international level, especially to address transboundary environmental problems.

Pursue macroeconomic stability. This is a minimum and necessary condition for preserving the environment, because it ensures that the right price incentives work to improve both economic growth prospects and the environment. Indeed, macroeconomic instability is bound to hinder any strategy for preserving the environment.

Exploit "win-win" opportunities. Policies that promote allocative and productive efficiency should be adopted to enhance both economic growth and the environment. The IMF and the World Bank can help countries in designing and implementing such policies (see box on p. 48).

Adopt sound environmental policies. If environmental policymakers ever hope to tackle the root causes of environmental degradation, they must—working with the finance ministry—introduce and enforce sound environmental policies so that households and businesses recognize the environmental costs of their actions. Moreover, this internalization of environmental costs, if complete, would ensure that the necessary conditions were met for the sustainable management of the macroeconomy, as noted by seminar discussant Andrew Steer, Director of the World Bank's Environment Department.

Consider computable general equilibrium (CGE) models. These models offer both a framework for a dialogue between macroeconomists and environmentalists, and a tool for unraveling the complex links between the environment and the macroeconomy. But, while CGE simulation results may provide an indication of directions and, possibly, magnitudes of change, they are based on imprecise assumptions and thus cannot provide precise forecasts.

Search for better environmental indicators. Developing national accounts that incorporate the effects of environmental degradation and depletion can go a long way toward providing basic data for asssessing the links between the macroeconomy and the environment. However, environmentally adjusted accounts can provide only a piece of the puzzle. To evaluate whether countries are on sustainable development paths, policymakers must develop a more complete set of indicators (e.g., on equity, health, and culture)—indeed, efforts to do so are under way at the World Bank and the United Nations. F&D

The proceedings of the May 10–11, 1995, IMF seminar on "Macroeconomics and the Environment" will be available in a forthcoming IMF volume.