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A Critical Evaluation of IMF History and Policies

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Abstract
The International Monetary Fund (IMF) was originally mandated to maintain exchange rate stability and adjustment of external imbalances in member countries and to act as a lender for countries facing short-term balance-of-payment crises. With the breakdown of the fixed exchange rate system, the IMF had to adjust its role in exchange rate management. The international banking crisis in the 1980s required a recalibration of IMF policies. Most of the policies in the 1980s and 1990s were driven by “Washington Consensus,” a doctrinaire view of economic development that called for structural adjustment through market liberalization and privatizations. However, critics indicate that the IMF, by failing to consider the unique conditions in developing economies and lumping them under a “one size fits all,” category may have caused more damage than good. In addition, it was alleged that IMF loans imposed unrealistic conditions on borrowers. All these policies are under review now in a quest for appropriate policies that will address some of these concerns and aid economic development. This paper provides a brief review of IMF policies from a historical perspective and a critique of IMF policies over the last few decades.

Keywords: Capital control; conditionality; financial crisis; financial reform; global institution, reserve asset, structural adjustment.

1. INTRODUCTION

The establishment of the International Monetary Fund (IMF) at the conclusion of the Bretton Woods agreement heralded a new era in the international economic landscape after the stalemate of interwar years. The Bretton Woods agreement was the brainchild of two protagonists. Representing the British side was the world renowned economist, John Maynard Keynes, who revolutionized macroeconomics with his General Theory. Representing the US side was a Harvard economist, John Dexter White, then treasury secretary. These two prodigies had two different, sometimes, opposing visions about the emerging international monetary order. Keynes, being the reputed economist, wanted to maintain UK interests in the postwar era, whereas White wanted to ensure that the emergence of the United States as the mightiest economic power was recognized. Another complicating issue was that British and other European powers needed immediate financial aid to recover from their prewar losses.

Keynes envisioned a truly multilateral system, based on a single international central bank that would serve as an international clearing union (ICU). The ICU would be structured in a way so that no single currency and, therefore, no single country could dominate the system and also to prevent a crisis in the foreign exchange market similar to the one in 1928-1932 (D’Arista and Erturk, 2013). In Keynes’ vision, the ICU would create an international reserve currency, Bancour, which would supplement gold and dollar. Similar to Keynes, White also believed that a multilateral institution would be far more effective than a bilateral institution in helping countries ravaged by the war. He suggested the formation of an international credit cooperative, which would provide loans to banks, the size of the loan to be determined by the amounts paid by other member countries. At the end, neither of the two proposals saw the light of the day in their original forms, but the final deal incorporated parts of both proposals.

This paper provides a brief review of IMF policies from a historical perspective and a critique of IMF policies. Section 2 delineates the evolution of IMF from a historical perspective. Section 3 provides a critique of IMF governance and policies. Section 4 demonstrates some evidence between IMF loans and economic growth. Section 5 provides some concluding thoughts.
2. EVOLUTION OF IMF POLICIES—A HISTORICAL PERSPECTIVE

We can divide the evolving history of the IMF into three phases.

2.1. Phase I: IMF Policies during the Fixed Exchange Period, 1944-1971

The mandate of the IMF at its creation was to govern and support the new international economic order in the postwar world (Kenen, 2007). The IMF was created to maintain exchange rate stability and adjustment of external imbalances in member countries and act as a lender for countries facing short-term balance-of-payment crises (Minton-Beddoes, 1995). In the initial years, the overriding objective of the IMF was to support and maintain the multi-currency parity rate based on the fixed price of dollar in terms of gold. During the fixed exchange rate system, the US dollar was pegged to gold at $35 per ounce of gold and other major currencies were linked to the US dollar at a fixed rate. The IMF would advise a country to devalue its currency if it considered the currency to be overvalued, hurting its balance-of-payment position. Exchange rate misalignment and balance-of-payment difficulties were the main preoccupation of the IMF during the period from 1944 to 1971.

During the 1950s and 1960s, IMF lending mostly comprised short-term loans to advanced economies to facilitate moderate exchange rate adjustments (Reinhart and Trebesch, 2015). Western developed nations such as the United Kingdom, France, Iceland, Italy, Spain Portugal, and the United States borrowed from the IMF in the initial years after the formation of IMF. Later, the IMF assistance was provided mainly to developing economies of Asia, Africa, and Latin America and emerging market economies in Eastern Europe. Membership expanded from 28 in 1945 to 188 in 1990s. Membership experienced two growth spurts, one in the 1960s because of independence of former colonies of Africa and the other in the 1990s after the breakdown of the soviet empire and the independence of eastern European countries (Broughton, 2009).

Since its inception, the Bretton Woods system suffered from problems of liquidity, confidence, and adjustment. In the post-World War II world economy, the dollar emerged as the key currency and a major reserve asset. Dollars held by the official institutions (mainly non-US central banks) were freely convertible into gold. However, the problem was, as Triffin (1960, 1968) indicated, the inherent unsustainability of the system. This is because a growing supply of world liquidity of reserve assets (US dollar) depended crucially on a growing US trade deficit. However, a large balance-of-payments deficit, relative to the supply of gold, undermines confidence in the reserve currency and could trigger a crisis. The pressure on the US dollar mounted, as the US trade balance worsened in the 1960s owing to Vietnam, a huge international aid program, and other commitments.

When some European central banks began to convert US dollars into gold, US gold reserves at Fort Knox began to fall at an alarming rate. President Nixon declared a moratorium on the convertibility of dollar into gold on August 15, 1971, ending the era of fixed exchange rate.

2.2. Phase II: Oil Price Shock and International Banking Crisis, 1972-2007

After a turmoil in the foreign exchange market upon the collapse of the Bretton Woods agreement in 1971, dust started to settle around 1973 when the Jamaica agreement was reached. The era of floating exchange rates began with the exchange rates of developed countries determined by free forces of demand and supply and exchange rates of most developing economies linked to major convertible currencies of the west.

The oil price shocks of 1973-1974 unleashed a new set of dynamics both on the demand and the supply side in the foreign exchange market, which also provided new challenges for the fund. On the demand side, oil-importing countries were in need of dire financial help for high costs of oil imports. On the supply side, oil-exporting countries ended up with a sudden bonanza of reserves from the oil price hike. Much of the oil revenues found their way into European financial markers as petrodollars. To meet the challenges of the oil price shock, the IMF created an oil facility (Broughton, 2009).

On the heel of the international banking crisis in the early 1980s, the IMF had to reinvent itself to meet new challenges and recalibrate its policies to deal with the crisis that unfolded with default on sovereign debt by some Latin American countries. The focus shifted from exchange rate management issues and balance-of-payment problems to sovereign default and international banking issues. The scope of IMF expanded to structural reform and financial stabilization management of member countries. The international institution
was expected to provide a new public good in the form of financial market stability (Bordo and James, 2000). In view of recurring banking crises, the IMF adopted a two-pronged policy of financial sector stability and prevention of liquidity crisis (Papi et al., 2015). These issues reemerged during the global financial crisis of 2008. Since the early 1980s, term loans were replaced with long-term loans on projects that would span over decades with precautionary credit lines provided to prequalified countries. Loans became more of developmental assistance. Following the lead of World Bank and based on the Washington consensus, IMF loans were also tied to structural reforms. Loans were made conditional upon implementation of structural adjustment policies and successful reforms in the economy. Close surveillance, constant monitoring, and policy recommendations became part of the new policy. Since 1990s, IMF loans have been tied to financial reform measures and capital account liberalization measures (Joyce and Noy, 2008). An important lesson learned from the financial crises of the 1990s in Mexico, Southeast Asian counties, Russia, and Turkey is that financial sector liberalization, without tight banking supervision in place, may lead to banking sector fragility.

2.3. Phase III: Global Financial Crisis and New Challenges, 2000
During the Asian financial crisis in 1997, many Southeast Asian countries could not get IMF loans because of highly stringent conditions attached to the loans. Consequently, the IMF reserves continued to grow. Countries such as Thailand, Hong Kong, Korea, and Singapore learned a valuable lesson from their experiences of financial crises. Not taking any more chances, some of these countries gathered over $100 billion war-chest funds to ride over any possible financial storm (Eraseder, 2015). Consequently, around 2003, income from the IMF loan portfolio shrunk alarmingly as countries started taking fewer loans from the IMF.

The global financial crisis of 2007-2008 changed the international financial landscape for the IMF again, as it regained its status as international lender of last resort (Ban and Gallagher, 2014). The IMF started providing more loans to countries that suffered financial crises, opening the spigot of money to distressed countries. During the global financial crisis, the IMF provided loan arrangements of $225 billion as of October 31, 2009, whereas it had provided only $36 billion in loans to distressed countries in Southeast Asia in 1997-1998. Thus, according to Rose (2010), the IMF emerged as the lead international financial institution in charge of dealing with financial crises. The IMF received additional resources in the form of Special Drawing Right (SDRs) worth $250 billion. Its lending capacity increased to $750 billion through an expansion of “New Arrangements to Borrow” (Rose, 2010). Within 18 months of the unfolding of the crisis, 18 countries received loans as part of the crisis management. After the global financial crisis, the IMF loan exceeded any previous record in terms of sheer volume of loan provided to Greece and other PIIGS (Portugal, Italy, Iceland, Greece, and Spain) countries (Eraseder, 2015). According to Rose (2010), the IMF rose to the occasion in the aftermath of the global financial crisis, as leaders of developed countries stood by their IMF commitments. As a result, the IMF was not criticized as badly about handling the global crisis as it was in the aftermath of the Asian financial crisis.

Since the financial crisis of 2008, the IMF started emphasizing the importance of fiscal balance and consolidation to borrower countries with reduced emphasis on structural reforms that characterized the IMF policies in the 1980s and 1990s (Broome, 2014).

3. REVIEW OF IMF POLICIES
The original framework of the Bretton Woods system had international development content and was formulated in consultation with developing countries. The Bretton Woods discussion generated many innovative proposals to create a development-friendly international financial order, some of which found their way into the agreement (Helliner, 2014). The content was dramatically watered down when many of the original architects of the system lost influence and those who assumed power were skeptical about the development goals and urged free trade and the acceptance of foreign investment in the region (Helliner, 2017).

Countries of Latin America and India expressed strong frustration with the lack of international development content in the existing system and together with Africa and other developing countries demanded a “New International Economic Order” (NIEO) that would support their development goals. They demanded greater access to financial resources in the North to meet development needs and an increase in the overall participation in the decision-making process of the fund.
In early 1970s when interest rates were low, developing countries borrowed heavily to invest in infrastructure and other large-scale development projects. When interest rates increased sharply in 1980s, heavy debt loads seriously affected their ability to repay and forced them to borrow more to finance their debt. As a result of this, the push for the NIEO order collapsed, developing countries lost their voice in the decision making, state-level development policies were dismantled, and multilateral governance became mainly centered around G7 (Helliner, 2017).

As mentioned above, the World Bank and IMF introduced structural adjustment programs (SAP)—long-term loans to countries experiencing recurrent balance-of-payment problems. These loans emerged with a variety of conditions based on what is termed as “Washington Consensus.” The Washington consensus maintained that market liberalization, privatization, and fiscal responsibility would spur economic growth in less-developed economies as it did in developed economies. Restructuring comprised reducing public expenditure, liberalizing trade, investment, and capital controls; deregulation; and privatization of state-owned enterprises. Frequently, the terms of conditionality were attached with IMF loans without due consideration for borrower countries’ individual circumstances and their perspectives.

According to critics, the IMF imposed the Washington consensus upon developing economies with considerably many restrictions. Stiglitz (2002) contends that requirements of conditionality imposed by international institutions such as the IMF or World Bank have been used as policy tools frequently without considering the best interests of the economics concerned. In some cases, the IMF may have provided wrong recommendations to developing economies in terms of monetary and fiscal policies. For example, Stiglitz provided an example of Korea where during the Asian financial crisis, the IMF urged the central bank of Korea to focus on inflation although monetary policy did not cause any problem there. Stiglitz also suggested that the “one size fits all” approach did not recognize the distinct characteristics and dynamics of different countries and the policies might have caused more harm than good.

Critics argue that the IMF policies were applied all at once than sequentially—for example, careful regard was not taken to determine whether appropriate Institutional framework was present for implementation of such policies. For example, privatization of utility companies was recommended without consideration for the impact on unemployment. Large-scale privatization was conducted without creating an appropriate institutional framework to deal with unemployment problems that would result from the massive layoffs by the newly created private firms who took over public companies, leading to immense economic and social problems.

Critics of IMF were also apprehensive about the role of the Bretton Woods institutions in shaping the development discourse through their research, publishing activities. Many of the top positions of the IMF were held by University of Chicago graduates who were strong supporters of free market economy and advocated privatization, deregulation, and cuts on social spending (Klein, 2007). As the World Bank and the IMF staff were regarded as experts in the field of financial regulations and economic development, their view and prescriptions undermined or eliminated alternative perspectives on development. Even within the Chicago boys, those who tried to introduce these ideas with democratic debate were overwhelmingly rejected (Klein, 2007).

There is a slew of critical literature on the conditionality with a general focus on the distributional aspect of the reform. Criticisms of IMF policies include the failure of reforms to take social and environmental issues into account and the failure to ensure sustained growth. Another point of criticism of the IMF was that the conditionality impinged upon the sovereignty of borrowers. Thus, there were not only economic repercussions of conditionality but the inflexibility in negotiations alienated governments from the measures they were supposed to implement. The overlap of IMF and the World Bank policies also swamped governments of borrowing countries with policy conditions (Kellick, 1993). In response to the critique, the IMF became more flexible in ways it engaged with countries in issues related to structural reform. In 1999, it replaced SAP with poverty reduction and growth facility (PRGF). The PRGF was intended to be based more on participation and country ownership, be more selective in the use of terms of conditionality, and include stronger analysis of social issues (Bull et al., 2006).

The guidelines on the conditionality were revised in 2000. The new guidelines state the key principles of conditionality are to ensure that fund resources are used to assist members in solving their balance of payments, which is consistent with the original intent of the fund (IMF, 2002). The new guidelines emphasize five interrelated principles that the fund believes are relevant for the success of fund-supported programs: 1)
National ownership of reform program, 2) Parsimony in the application of program-related conditions, 3) Tailoring programs to members circumstances, 4) Effective coordination of policies with other multilateral institutions, and 5) Clarity in specific conditions (IMF, 2002).

Cooperation among governments of member countries is of paramount importance to address a global economic crisis. The IMF is criticized for not being adequately equipped to ensure such cooperation (Woods, 2006). It is a global institution, but it is dominated by a few major industrialized countries who pay little heed to the views of developing countries. Advanced economies provide the bulk of IMF resources but do not use the facilities while developing countries provide a small share but draw upon the fund’s resources for financial assistance, which makes them subject to conditionality. This situation created tension around governance issues. Developing countries make up 85% of the total membership and believe they have an inappropriately small voice within the organization (Bloomberg and Broz, 2006). Jha and Saggar (2000) mentioned that the Bretton Woods agreement did not provide a clear raison d’être for the quota system. Moreover, the quota system is inherently biased against developing economies. According to them, despite impressive growth, some non-oil-exporting countries experienced a decline in their quota shares. Under the existing quota structure, members should vote to approve or disapprove policy proposals before they are implemented. In most cases, a majority of 70% votes are required to make a decision. In certain cases, such as admitting a new member, it would require 85% of the votes (Woods, 2006). Because of the way the governance of the IMF is structured, few industrialized countries dominate their votes. For many years, there has been an effort to reform the IMF through changing vote. In December 2010, the board of governors of the IMF approved a package of the fund’s quotas and governance, and the reform became effective only in January 26, 2016 (IMF, 2017). The reform reflects the increasing importance of emerging market countries. The voting shares of China, Russia, Brazil, and India were increased. The United States is the largest member of the IMF currently accounting for 17.46% of the quota and 16.52% of voting shares (IMF, 2017). With such a big chunk of the quota, the United States along with other G7 countries dominates decisions in the IMF. The fifteenth review of quotas, scheduled for 2019, is expected to show further increased share of dynamic economies of emerging markets. Reforms also envisage an increase in permanent capital resources. In fact, the IMF resources doubled to SDR $477 billion (approximately US$659 billion) in recent years.

The IMF was created with limited lending ability, because it was overtly reliant on the US dollar. It did not develop an effective method for dealing with trade imbalances. Consequently, imbalances among countries continued to grow. “Lack of an effective mechanism to deal with trade imbalances ultimately undermined the system’s ability to provide flexible monetary reserves and simultaneously safeguard its integrity” (D’Arista and Erturk, 2013, 235). Currently, Germany, Japan, and China are sitting atop a huge amount of international reserves, whereas, the United States is running with a huge trade deficit with no automatic adjustment in place.

Another concern is the role of unrestricted movement of capital across national boundaries in financial crises including the ones in Mexico in 1994, East Asian financial crisis in 1997, and the global financial crisis in 2007-2008. The IMF stance on capital control has changed drastically over the years. In the initial years after its inception, the IMF supported capital control, consistent with the views of the academic circles then, namely, Keynes and White. Capital control allows a country to pursue an independent macroeconomic policy and maintain financial and currency stability. However, this view changed with the onset of the liberal era in the 1980s. The IMF started supporting capital account liberalization and, for example, did not, in particular, support Malaysia imposing capital control in the wake of the financial crisis in 1994. However, in the aftermath of the Asian financial crisis in the late 1990s, the IMF started supporting a limited capital control. However, there was considerable ambivalence about capital control. The pendulum swung to capital control as all doubts about it evaporated after the global financial crisis of 2008.

The IMF has made a significant progress over the years including adaptation of lending facilities, streamlining reforms, and helping countries to have control over their own reform (Helliner, 2017). The changes, however, have been very slow and considerably little to have any significant impact on IMF decision making. Dissatisfied with the decision-making process and policies of the IMF, the developing countries started to look for alternative sources of funding. In particular, China’s influence in developing countries has been increasing. Moreover, it has become an important source of both development funds and foreign exchange. New institutions such as New Development Bank and Asian Infrastructure Investment Fund pose
further challenges to the IMF. Unless, the fund reforms its quota system to reflect the changing economic dynamics of the world, its credibility and influence will be further eroded.

4. EVIDENCE ON ASSOCIATION BETWEEN IMF LOAN AND ECONOMIC GROWTH

The evidence on the impact of IMF loans on the economic growth of developing economies is mixed. The IMF reviews typically report a positive relationship between IMF loans and economic growth. For example, in a study of 36 countries that received support under structural adjustment facility (SAF) and enhanced structural adjustment facility (ESAF), the IMF study finds that most of them became more market oriented and economically stronger after receiving IMF loans (IMF, 1997). The living standards of the people in these countries improved, and substantial progress was made toward external viability. The IMF study also recognized that the progress was uneven, thereby reflecting policy weakness, and a number of ESAF countries are still poor. Easterly (2003) finds no systematic effect of adjustment lending on growth. Papi et al. (2015) covered 113 low- and medium-income countries from 1970 to 2010 and found that countries who participated in the IMF-supported programs were less likely to have banking crises. Eichengreen et al. (2008) also found that countries with strong fundamentals who take IMF loans are less likely to have financial crises.

Dreher and Walter (2010), in a study of IMF programs in 68 developing countries that spanned five years, found that the IMF aid reduced probability of a currency crisis. They also indicated that it was the terms of the lending agreement that made a difference. Since 1990s, IMF loans have been tied to financial reform measures and capital account liberalization measures (Joyce and Noy, 2008). An important lesson learned from those days is financial sector liberalization without tight banking supervision may lead to banking sector fragility. Przeworsky and Vreeland (2000) and Barro and Lee (2003) found that the IMF loan participation had a negative effect on economic growth.

5. CONCLUSION

Since the inception of the IMF in 1944, it has come a long way in meeting new challenges of international finance and international monetary order. During the first few decades of the IMF’s formation, major clients of the IMF were advanced economies of the west. Since the 1980, banking crises and sovereign default problems in Latin American and African economies dominated the IMF agenda and focus shifted from balance-of-payment problems of advanced economies to debt sustainability problems of developing economies.

In recent years, the IMF has conducted major reforms in terms of quota and governance of loans. The IMF’s fourteenth general quota review, which was conducted in 2010, reflected a major shift in quota governance policy. The reforms entailed a major shift in quota share toward dynamic emerging market economies. Another remarkable development is the elevation of four emerging market economies, Brazil, India, China, and Russia, to the group of 10 largest members of IMF. According to some quarters, the changes, however, have been very slow and considerably little to have any significant impact on IMF decision making. Dissatisfied with the decision-making process and policies of IMF, developing countries started looking for alternative sources of funds (Ocampo, 2013). In particular, China’s influence in developing countries has been increasing. Moreover, it has become an important source of both development funds and foreign exchange. New institutions such as New Development Bank and Asian Infrastructure Investment Fund pose further challenges to the IMF. Unless, the fund reforms its quota system to reflect the changing economic dynamics of the world, its credibility and influence will be further eroded.

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