International Monetary Fund (IMF)

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Overview

The International Monetary Fund (IMF), created at the Bretton Woods Conference in 1944, is a foremost international organization which has been intended to serve key functions related to the monitoring and management of the world monetary and financial system. These functions have evolved substantially over time but have included the provision of 'liquidity' to the world economy so as to permit the smooth and uninterrupted maintenance and growth of world trade and payments, 'surveillance' of national and world economies so as to provide timely information for use in policy decisions, and the provision of expert policy advice on macroeconomic and financial management so as to further national and international economic goals.

Originally conceived as the central institution supporting the maintenance of the fixed exchange rate system designed at Bretton Woods, the IMF came successively to be viewed as a potential 'world central bank', and as an agency with the dual tasks of supporting the management by countries of short-term economic crises and of longer term structural reform aiding their integration in the world economy. Along with the World Bank and the World Trade Organization (WTO), the IMF has become a pillar of the system of global governance supporting the process of economic and financial globalization. This enlarged role has occasioned substantial debate.

1 Origins

The IMF was born against the backdrop of war and the memory of a turbulent inter-war world trading and monetary system. The leading countries of the United Nations (the wartime alliance against the axis countries), and in particular the United States and the United Kingdom, sought to create a durable framework within which the inter-war problems of currency instability and competitive devaluation, defaults on international credit obligations, and the development of regional trading blocks tied to currency systems could be avoided, while furthering their own national interests. The solution to this problem, under the dominant intellectual influence of John Maynard Keynes of the United Kingdom and Harry Dexter White of the United States, was the 'gold exchange standard' or Bretton Woods system, in which countries other than the United States pegged their currencies at fixed exchange rates (or 'par values') to the United States dollar and the United States maintained a fixed rate of exchange between the US dollar and gold. Through this solution it was sought to establish a regime of substantial currency stability. However, countries with relatively low official reserves, net debtor positions and current account deficits (such as the United Kingdom) still risked the inability to maintain their declared par values. The primary goal of the IMF was to address this difficulty and thereby ensure the stability and durability of the Bretton Woods system.

The eventual shape of the IMF merged aspects of Keynes' plan for an international 'clearing union' (from which loans of a new international currency (the 'bancor') were to be made available up to a fixed quota to debtor countries, and to which creditor countries would be required to lend surpluses beyond a fixed level) with aspects of the White Plan in which a Stabilization Fund of national currencies available to be purchased by members would be created, and in which changes in exchange rates would be accepted only in the event of a 'fundamental disequilibrium' (see KEYNES, J.M.). In its final shape was embodied acceptance of the demand of the debtor coun-

tries (especially the UK) that surplus countries should in principle bear some of the 'burden of adjustment' and the demand of the surplus countries that debtor countries take appropriate responsibility for the maintenance of par values. The international currency envisioned by Keynes was not initially created.

Specifically, the Articles of Agreement of the IMF negotiated at Bretton Woods established a system of national 'quotas' based on negotiations and the assessment of a set of fundamental economic variables (such as the size of official reserves, national income, and the level of imports and exports). These quotas, although first established at Bretton Woods, have been repeatedly revised. A country's quota determines the amount of the subscription it must pay in to the fund, in the form of external reserve assets and its own currency. It also determines its voting strength (proportional to its quota beyond a common base level) and its access to IMF resources. In particular a portion of a country's quota (the 'gold tranche', later renamed the 'reserve tranche') could be drawn on with few (and later no) conditions. Borrowing from the Fund (essentially drawing on the resources provided to the IMF by other countries' subscriptions) beyond this amount would normally require the imposition of IMF 'conditionalities' (i.e. specific policy and performance requirements). The Fund's resources were to be extended to prevent countries having to depart from par values other than in conditions of 'fundamental disequilibrium'. Where it was deemed necessary by a country to depart widely from its par value, the IMF was authorized to judge whether a fundamental disequilibrium existed. The Articles of Agreement also required member countries to avoid imposing 'restrictions on the making of payments and transfers for current international transactions', other than for a transitional period, and to engage in periodic consultations with the Fund if they continued to do so. In this way the IMF's articles encapsulated its founders' vision of a conventionally liberal as well as stable world economic order. In accordance with its Articles of Agreement, the IMF headquarters was established in the territory of the member country with the largest quota, the United States.

2 Changing role and structure

In its first two decades, the IMF's role was largely within the framework of its original conception, although this conception was tested by and adapted to changing circumstances (see ECONOMIC INTEGRATION, INTERNATIONAL). In its very early years, the IMF's role was limited and overshadowed by bilateral agreements (such as the Marshall Plan) and other multilateral institutions (in particular the short-lived European Payments Union). However, by the early 1950s it had come into its own, playing a key role in maintaining the stability of a number of European currencies. In this period it developed a number of its critical operational doctrines and instruments. However, while the IMF's success in fostering exchange rate stability was high, its success in its second goal of fostering a regime of unrestricted current account convertibility was very limited.

Among the instruments first developed in this period was that of the 'Stand-by Arrangement', which subsequently became a standard aspect of IMF operational procedure. The first 'Stand-by Arrangement' was negotiated with Belgium in 1952. In effect, stand-by arrangements provide for a line of credit to be made available to a member country for a specified period and up to a specified value in return for its accepting specific economic 'conditionalities' relating to monetary and fiscal conduct. The widening role of the Fund and its capacity to impose conditionalities in return for its assistance also required it to develop specific doctrines regarding the approach to economic management best suited to the achievement of stability. Accordingly, in this period the Fund substantially strengthened its research capacity and developed a variety of specific operational methodologies. Foremost among these was the 'flow of funds' methodology known as 'financial programming', associated with Jacques Polak of the Fund, which continues to be its central tool for policy analysis. The financial programming approach involves 'a recognition of basic accounting identities supplemented with a small number of behavioural relationships and forecasts of key economic variables' (Mussa and Savastano 1999), which are said to permit determination of the requirements for attaining balance of payments equilibrium and low inflation. The specific content of favoured IMF conditionalities (and in particular the often 'contractionary' approach to the restoration of external and internal balance, through restrictive monetary and fiscal policy) was also developed in this period.

As the IMF's role increased toward the late 1950s it became apparent that its subscriptions by member countries might not be enough for it to deal with all possible contingencies. Accordingly, in 1962 the General Arrangements to Borrow through which the Fund arranged for a line of credit with which to borrow specified amounts from 11 industrial countries were created. The GAB has been activated periodically to help finance particularly large drawings from the Fund (in 1997 the GAB was supplemented by the New Arrangements to Borrow, which provide for an additional line of credit from 25 countries and institutions).

In its first two decades, although the IMF became an increasingly important institution, its success was overshadowed by the fraying of the Bretton Woods system caused by the weakening position of the US dollar associated with the shift of the United States balance of payments from a surplus to a deficit position and with the so-called 'Triffin dilemma'. The latter related to the tension (deriving from the pivotal role of the US dollar in the Bretton Woods system) between the need for an enlarged supply of dollars to provide liquidity for a growing global economy and the inability of the United States to provide this without the supply of dollars exceeding the quantity of US reserve assets to a degree that would jeopardize the convertibility of the dollar into gold, in turn undermining the value of the dollar as a source of liquidity (and therefore the basis of the system as a whole).

An early response to this unease, and indeed a growing sense of crisis, was the 'special drawing right' or SDR, which was born through the first amendment to the Articles of Agreement in 1969. The SDR was envisioned as a new source of liquidity and potential reserve asset that would be free from the structural weakness of the dollar. It was also in effect a new international currency in embryonic form, partially realizing Keynes' vision of the 'bancor'. The SDRs are monetary units (defined currently as a composite of national currencies), which do not have any actual reserve backing. They may be used for payments between official institutions, but generally not for private transactions. SDRs may be exchanged between holders in return for an ordinary reserve currency or other asset, and bear interest at market rates while maintained with the Fund. A fixed quantity of SDRs was initially (and in subsequent rounds) allocated to all member countries in proportion to their quota. The SDR was not able to play the role envisioned for it (in which the IMF would have become akin to a world central bank with the SDR its currency) effectively. Even today, total allocations of SDRs compose less than two per cent of non-gold official reserves. This small quantity of SDRs combined with their restricted role outside of official transactions has undermined its ability to become a new reserve asset. New allocations of SDRs, of special interest to debtor and less developed countries, have often been resisted by reserve currency countries on the ground that there is no requirement for increased global liquidity (and attendant danger that new allocations will undermine the value of existing reserves and generate inflationary pressures). Repeated negotiation on the development of a 'substitution account', through which existing reserves (particularly the US dollar) would be exchanged for new SDRs, has also been unsuccessful due to inability to agree on the sharing of the burden of the decreasing value of non-SDR official reserves such a procedure would entail.

The collapse of the Bretton Woods system between 1970 and 1973, due to the abandonment of the parity of the US dollar with gold, and the subsequent emergence of a flexible exchange rate system (or 'non-system'), created significant challenges for the IMF. The abandonment of fixed parities required the Fund to reform its role in fundamental ways. In particular a rising role for non-gold (i.e. currency) reserves, increased monetary instability, and a sharp rise in private international banking activity (related to heightened cross-border speculation, hedging, and real investment) increased the demand for the IMF's sur-

veillance and balance of payments support activities. In the 1970s the IMF began to refine the economic doctrines that it would apply in a more comprehensive form in the subsequent decade. In particular, in 1975 it initiated the Extended Fund Facility (EFF) in order to enable the implementation of longer term conditionalities and programmes than were feasible under stand-by arrangements. Under the EFF a repayment horizon of up to eleven years was envisioned, during which fundamental reforms of trade and fiscal policy could be pursued. This innovation was born in part of a recognition that the IMF's concerns for currency stability required attention to underlying structural conditions, and in part of a renewed focus on the still unrealized Bretton Woods vision of the development of a conventionally conceived liberal international order.

By the late 1970s, the role of the IMF in relation to developing and middle income countries had taken on a heightened significance, as its role in relation to high income countries waned, due to the long-term improvement in the structural positions of many of them. Indeed, the Fund introduced specific facilities with which to address risks faced especially by developing countries (the Compensatory Financing Facility, introduced in 1963 to enable developing countries – especially producers of primary commodities – to cope with precipitate declines in export receipts, and the 'Oil Facility', established in 1974 to enable countries to manage sharp increases in oil prices). In the 1970s, calls from developing countries for a 'New International Economic Order' gave an added dimension to the ongoing debate over the international monetary system. In particular demands were made (all unrealized) for the IMF to create and finance stabilization and support funds for raw materials prices, and for the voting structure of the Fund to be reformed along more democratic lines.

The debate over the role of the IMF in the developing countries came to a head in the 1980s, with the onset of the debt crisis and the era of 'structural adjustment'. High levels of debt accumulated in the 1970s proved unsustainable for a large number of developing countries in the context of falling primary commodities prices and high world interest rates driven by conditions in industrial countries. The possibility of default on debt, especially by major borrowers such as Brazil, Mexico and Poland, threatened in turn the interests of creditors and the stability of the financial system in the industrial countries. This situation led to a heightened role for the IMF as a source of information, as a coordinator of public and private debt rescheduling efforts, and as a source of supplementary capital and policy advice. The IMF approach to stabilization and to the achievement of longer term viability of the balance of payments relied on its accustomed short-term instruments – devaluation and monetary and fiscal contraction – combined with longer term market-oriented reforms – increased openness to trade and, increasingly, internal deregulation and privatization. In this respect, IMF policy was increasingly influenced by the prevailing currents in the industrial world.

In 1986, the IMF created the Structural Adjustment Facility (SAF) followed in 1987 by the Enhanced Structural Adjustment Facility (ESAF). These new facilities marked the IMFs new focus on supporting medium and long-term market oriented policy reorientation. Sustained balance of payments crises in a variety of developing countries led to substantial reliance on these instruments and mounting criticism that the Fund's approach was both unsuccessful at attaining its economic goals and generated social costs of an unacceptable order (a trenchant example of such criticism is Cornia, Jolly and Stewart [1987]).

The rejection of the centrally planned economic model which commenced in 1989 added another important dimension to the Fund's activities. The Fund was called upon to provide financial and policy support of a new kind, in many cases to new members. A new 'Systemic Transformation Facility' allowing large drawings from quotas was created to support the efforts of a number of these countries to develop private market economies. Over the course of the 1990s the Fund has however been extensively criticized for pursuing a policy approach and priorities argued to be inappropriate to the requirements of the 'transition' countries, and in particular for favouring fiscal retrenchment and a contractionary monetary approach to stabilization in a context in which fundamental microeconomic reorganization and the establishment of robust fiscal and political institutions required due consideration, as did the unusually dramatic distributional and social consequences linked by critics to the Fund approach.

3 Recent developments and current debates

In the 1990s, debate over the IMFs current and future role became more acute than ever. The immediate sources of this debate lay in the mixed record of the Fund in fostering prosperity and stability in the 'transition' countries, the continued controversial record of structural adjustment programmes in developing countries (and in particular the ongoing economic and social crisis in the highly indebted poor countries), and the perception that the Fund has limited and possibly inappropriate tools at its disposal to address the causes and consequences of recent high levels of instability in international financial markets. A growing popular awareness of the lack of direct democratic oversight over international markets and economic institutions has also influenced perceptions of the IMF.

As the IMF's approach to structural adjustment and reform has proved to be insufficiently effective, it has unprecedentedly and increasingly turned to conditionalities linked to institutional reform and 'governance'. These have been controversial as they have been perceived by some as an illegitimate challenge to national sovereignty (jealously guarded under the original interpretation of the Articles of Agreement). The Fund has also been accused of husbanding its resources excessively, especially in relation to debt relief in highly indebted poor countries (for which debt to the IMF itself has become an increasing burden) and meeting the requirements of a successful 'transition' from central planning. Finally it has been accused of promoting, at considerable economic and social cost, a lagging and inflexible economic paradigm.

In the context of countries in structural adjustment programmes, the focus of critics has been on their limited and slow success in fostering sustained and high growth and in safeguarding social achievements (as against the traditional Fund objectives of current account balance and low inflation). In the context of recent financial crises (especially those of East Asian and Latin American countries in 1997–8) the Fund has been accused of applying its traditional contractionary 'medicine' in a circumstance in which more focused microeconomic tools (such as financial sector restructuring) and alternative macroeconomic policies (such as short-term capital controls) may have been more effective. These criticisms have gained force in a global environment in which the sharply increased scale of the private flows of funds has arguably increased the likelihood of financial crises linked to self-fulfilling expectations, and to speculative attacks unlinked to 'fundamental' economic variables, and reduced the ability of official actors (including the IMF) to influence market behaviour. The ability of the IMF to significantly influence the level of global liquidity, or even to act as an effective 'lender of last resort' has accordingly come into question.

New issues regarding the appropriate role of the IMF have also arisen. In particular, whether the Fund generates 'moral hazard' (i.e. increased risk-taking behaviour) by providing finance that indirectly benefits private interests in the event of crisis, has been hotly discussed. As with other points of contention, some have called on the Fund accordingly to limit its role further (or indeed to be abolished) while others have called for it to expand its application of resources and ideas. Fundamental questions as to whether the IMF has – just past the mark of half a century – outlived its usefulness, at least in its current form, and whether its primary purpose has been, or ought to be, to enforce conformity in the rules and institutions which govern and link national economies, continue to give rise to vigorous debate.

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Further reading

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See also: EAST ASIAN ECONOMIES; ECONOMIC INTEGRATION, INTERNATIONAL; ECONOMIES OF CENTRAL AND EASTERN EUROPE; EUROPEAN CENTRAL BANK; GLOBALIZATION; INTERNATIONAL FINANCIAL STABILITY; KEYNES, J.M.; MONEY AND CAPITAL MARKETS, INTERNATIONAL; RUSSIAN TRANSITION; WORLD BANK; WORLD TRADE ORGANIZATION