The IMF and Economic Policy

Unit 1 Macroeconomic Stabilisation and the Role of the IMF

Contents

Unit Overview

In this first unit, you will focus on the operations and structure of the International Monetary Fund. The IMF is the major international institution pursuing stabilisation policies and its model of stabilisation has become the most widely used among countries seeking to stabilise their economies. You will learn something of the history and the rationale behind the development of the IMF and its sister organisation, the World Bank, as well as the nature of the IMF's organisation and procedures. In short, this unit provides background to the IMF that you will need as you work through the rest of the module.

Learning outcomes

When you have completed your study of this unit and its readings, you will be able to:

- explain the mandate of the IMF
- outline how the IMF is organised
- explain how a country goes about arranging a financing facility with the IMF
- discuss the key financing facilities of the IMF
- define IMF conditionality, describe the types of conditions applied in IMF financing arrangements, and note recent policy changes and their rationale
- discuss some of the key internal governance challenges facing the IMF.

Reading for Unit 1

International Monetary Fund (nd) *About the IMF*. 'Organization & Finances'.

International Monetary Fund (nd) *About the IMF*. 'Our work'.

Devesh Kapur (2000) 'Who gets to run the world?'. *Foreign Policy*, 121 (November/December), 44–50.

International Monetary Fund (nd) *About the IMF*. 'Lending by the IMF'.

1.1 Introduction

The IMF was established in 1944 at a conference held at Bretton Woods, New Hampshire, in the USA. It was one of two organisations established at the conference, the other being its sister organisation, the International Bank for Reconstruction and Development, more popularly known as the World Bank. The two organisations, together known as the Bretton Woods Institutions, were formed for different purposes. The IMF was established to promote monetary stability; in particular, focusing on the stability of exchange rates among its member countries. The World Bank was established to provide a mechanism that would enable the international community to find the enormous resources needed to finance reconstruction after the Second World War.

In the early years following the establishment of the two institutions, their differing initial purposes resulted in the two institutions emphasising different aspects of their common desire to bring about stability and to promote longer-term economic growth. The IMF focused on macroeconomic stabilisation, particularly emphasising the need for stability in the current account of the balance of payments and currency stability among its members, while the World Bank focused on the structural impediments to long-term economic growth in its member countries.

Over time, this initial distinction has blurred. At present, for example, the IMF continues to provide financing to its members for short-term balance of payments stabilisation. But it also provides financing facilities to some of its members, particularly its low-income members, designed to help them correct some of the long-term constraints to economic growth. Similarly, while the World Bank provides long-term loans to its low-income members to promote economic growth, it also provides short-term, focused assistance, typically in the form of small grants, to some of its members to enable them to overcome immediate short-term obstacles that impede their ability to pursue longer-term strategies for economic growth.

Subsequent to the establishment of the IMF and the World Bank, several other multilateral organisations have also evolved in the post-war period. These included the Organisation for Economic Cooperation and Development (the OECD), as well as organisations and arrangements focused on the establishment of international rules regarding trade – initially, the General Agreement on Trade and Tariffs (GATT), which later evolved into the World Trade Organization (WTO).

While the range and number of international organisations vested with responsibility for international economic, finance and trade responsibilities, has grown in the period since the establishment of the Bretton Woods Institutions, the IMF has evolved as perhaps the single most important among the multilateral financial organisations. It has come to assume a dominant role over the process of macroeconomic stabilisation, establishing policies and practices that member countries applying to the IMF for financing facilities are required to pursue. As a consequence of this dominance, in practice other international multilateral institutions typically tend to follow the lead of the IMF, taking their cue as to whether or not to lend or engage with a member country on the basis of the status and the performance of that country in its dealings with the IMF.

Studying the operations and structure of the IMF is useful in several respects. Firstly, it will help you understand the background to the IMF's stabilisation approach, which you will examine in Unit 2; and it will assist in understanding how the key documentation, which is prepared whenever a country approaches the IMF for financial resources, is crafted. This will be particularly useful, for several of the case studies contained in this module are based on actual loan agreements between the IMF and some of its member countries. A deeper appreciation of the role, functions and financing instruments of the IMF is also useful, for it helps to distinguish between the different types of programmes that member countries can follow, when receiving financing from the IMF.

In this unit, I aim to comprehensively, though briefly, cover some of the major institutional elements of the IMF, including its mandate, role, functions, departmental structure, manner of financing, its facilities and a few additional issues of relevance to this module on macroeconomic policy and stabilisation.

The IMF produces a monthly online publication, the *IMF Survey.* It also produces an ongoing online overview of the organisation, its operations, functions and policy work. This section of the IMF website, entitled *About the IMF*, provides an excellent brief summary of the IMF's work. This section of the website reinforces much of the information that you will study in Unit 1, and it provides some additional details that will also be of relevance to this module, including information regarding some of the latest policy issues the IMF staff are engaged in.

I will ask you to read several parts of the IMF website section, *About the IMF*, as you progress through Unit 1, but you should find it useful and interesting to browse through the entire publication on your own as well.

Exercise 1.1

In reading through the module work for Unit 1, I would like you to make notes on a range of issues, which will assist you in answering the following questions:

1. What is the mandate of the IMF?
2. How is the IMF organised?
3. How does a country go about arranging a financing facility with the IMF?
4. What are the key financing facilities of the IMF?
5. What is IMF *conditionality* and what types of conditions are applied in IMF financing arrangements?
6. What are some of the key internal governance challenges in the IMF?

Please make a note of these key questions and keep them in mind as you progress through Unit 1. As you work through the unit's study material try to develop answers to them, for that will help you deepen your understanding and check your progress.

1.2 The Character of the International Monetary Fund

The IMF can be described as a cooperative multilateral, intergovernmental, monetary and financial institution. Its policies and activities are guided by its Charter, known as the Articles of Agreement (the Articles). Forty-five members founded the institution at Bretton Woods in 1944. Today, 188 countries are members of the organisation. The IMF is located at the centre of the international financial system and, indeed, throughout its history, the institution has played a central role in the evolution of that system. Today, for many countries, the IMF is the single most important global international financial institution, for a programme agreed with the IMF is often a necessary condition for that country to attract additional international financial resources.

As you have already seen, the IMF was established in the closing years of the Second World War. Initial discussions were held over a period of nearly four years – in fact, from almost immediately after the war commenced – on the need for a new international monetary order, which could bring about stability in the international monetary system.

The initial dialogue took place between the USA and Britain, with two key individuals leading the discussion: Harry Dexter White, who at the time was the Deputy Secretary of State in the US and John Maynard Keynes, who led the discussions for Great Britain. Both individuals, as well as the teams they led, were concerned to establish an institution and a system that could mark a fresh start from the situation of collapse in international monetary relations that had characterised much of the period since the First World War. They looked back to the 1920s, which had witnessed hyperinflation in Germany, and to the collapse, in 1929, of the stock market in the US; and they sought to take account of the need for an international system of monetary cooperation which would help avoid the profound economic recession that had prevailed through the early- and mid-1930s.

1.2.1 Differing British and American interests

The US and Britain approached the dialogue with several common interests, but also several specific national interests. Because the two countries and their negotiators would prove to be the decisive voices once the Bretton Woods conference took place, it is important to understand what some of these differences and similarities comprised, for they influenced the character of the institution, the IMF, which would emerge in 1944.

The US, led by Harry Dexter White, sought to promote a global monetary system in which exchange rates were closely managed by an international authority, which would have the power to determine the extent to which countries were able to adjust their exchange rates in response to short-term balance of payments disequilibria. The intention was to avoid large, short-term fluctuations in exchange rates, particularly among the large trading nations at the time, to promote stability and to avoid the deflationary policies and competitive devaluations that had occurred in the inter-war period. The

US also sought to promote trade liberalisation and thought the best method of doing so would be to secure international monetary stability. US authorities were also concerned, in approaching the issue of establishing a new international monetary institution, that in the post-war reconstruction period the US would not be called upon to finance global economic reconstruction, and that the burden of financing could be spread among several countries.

The British authorities also sought international monetary stability. Yet they were concerned about the challenge of financing reconstruction in the post-Second-World-War period. Prior to the war, Britain had ranked as one of the leading creditor nations, offering loans to a large number of countries for their development. With the war, these loans, known as the Sterling Balances, had been frozen, at least until economic stability returned. During the war, Britain had been called upon to finance enormous wartime expenditures, and had needed to borrow for this purpose. As a consequence, the war had shifted Britain from its status as a large pre-war creditor, to a large post-war debtor.

British negotiators therefore had to ensure that a new post-war international monetary institution would be capable of financing post-war reconstruction on favourable terms. With the presence of very large sterling balances, Britain was concerned that a new monetary order would insist on the dissolution of the thus-far frozen sterling balances, as such a step would provide immediate liquidity to a very large number of countries and would thereby help the process of stabilising exchange rates in the immediate post-war period. Consequently, Lord Keynes and his team argued strongly for capital account policies to be excluded as a responsibility of the new international institution, enabling Britain to exercise its sovereign decision-making in regard to its sterling balances.

Different initial proposals were put forward by the US and British teams. Lord Keynes, for example, initially suggested that the new institution be vested with the authority to issue its own currency, which he termed the 'bancor'. This would, in his view, enable the new institution to finance the very large post-war expenditures that would be needed for post-war reconstruction. The US authorities, by contrast, saw dangers in the ability of the new international monetary authority to issue its own currency, for this could generate a new source of international inflationary pressure.

Moreover, the currency issuance would require ultimately to be backed by the financing assurances of the members of the new institution. With the US expected to be by far the largest member, this would ultimately place the underwriting responsibility for large post-war financing on the US. The US was reluctant to assume this responsibility, as it would divert financial resources that it required for its own post-war development. Consequently, in subsequent drafts of the US and UK proposals, the idea of the establishment of an international currency, the *bancor*, was progressively diluted.

Initially, the US proposed an alternative currency, called the 'unitas', which was meant to represent not a currency but rather a unit of account comprising a basket of existing currencies. Eventually, even the unitas was abandoned in the final outcome at Bretton Woods. A consequence of this US/British dialogue was that when the IMF finally emerged in 1944, it was decided that the financing of its lending operations would be sourced from among the members, in a form of credit union arrangement. Consequently, no recourse would be made to external sources – for example, to commercial banks. This principle has remained a central practice in IMF financing, with far-reaching consequences for the terms of lending by the IMF. For when the IMF lends to its members for balance of payments support, its insistence that the facilities be repaid on the terms on which it is lent is underpinned by the fact that the funding provided is from among the IMF's members themselves.

1.2.2 The Bank

The US/British dialogue that preceded the Bretton Woods Conference in 1944 also settled a range of additional issues, which would subsequently be endorsed at the 1994 conference. Particularly important among these was the decision to establish an international bank, which would be responsible for providing longer-term financial resources for reconstruction. By 1944, it was apparent that the Second World War was beginning to draw to a close; and it was clear that several countries, including France and later Germany and Japan, as well as other European countries that had been devastated by the war, would not be able to acquire the financial resources, either from within their own economies, or from within Europe alone, to finance the process of reconstruction. An international bank would be required.

The concept of such a bank had initially been put forward by Harry Dexter White for a pan-American bank. As the dialogue between the US and Britain evolved, White switched strategy and presented a re-worked version of his proposed pan-American development bank, to an international bank for reconstruction and development. The concept was quickly grasped by the British authorities, who saw the initiative as a further mechanism to spread the responsibility for post-war reconstruction away from one or two countries (including Britain) to a broader range of countries.

Lord Keynes also identified in the US proposal elements of his earlier proposal for a *bancor*, or an international currency. Although the concept was eventually never carried through, Lord Keynes and his team ensured that the soon-to-be-established International Bank for Reconstruction and Development would acquire significant power to borrow externally, in order to secure the financial resources for large-scale long-term lending both to countries emerging from the war and to developing countries.

Initially, these proposals were shared and refined between the British and US authorities and not with the rest of the international community. When it became apparent that close consensus was emerging, the Bretton Woods conference was convened. The conference brought together delegations from 44 countries. It lasted nearly three weeks and focused, in two separate commissions, on the structure, responsibilities, mandates and related issues associated with what were to emerge as the World Bank and the IMF. The entry into the discussions of other countries aside from the US and Britain brought about some significant and unexpected developments. In part, these focused, on the one hand, on the strong desire of the British authorities to ensure that in the post-war era, Britain would emerge with much of its pre-war influence over global economic affairs intact; and on the other, the determination of the US to exert a much stronger influence over global economic relations and decision-making than had been the case in the pre-war period.

1.2.3 Tensions at Bretton Woods

Tensions emerged between the two countries during the conference, around several issues. These included the relative voting strength among the members of the new institutions. The US, for example, favoured granting a large voting share to countries such as Russia and China, in anticipation that US foreign policy in the post-war period would focus on shifting away from the pre-war focus on US/British relations. The US saw this as a method of expanding its economic, trade and political influence far further than had been the case prior to the war.

The British, by contrast, feared that the broader foreign policy approach of the US would dilute British influence in global affairs; Britain accordingly supported much smaller voting shares for countries such as the (then) USSR. Such tensions usually resolved themselves in favour of US interests. In the case of the negotiation regarding the Soviet voting share, for example, the Russian authorities quickly recognised the opportunity presented by the emerging new approach of the US and hardened its stance at Bretton Woods, demanding a larger share of voting power and insisting on the need for a very large initial line of credit from the new IMF, in order to finance post-war reconstruction. The US approach prevailed and the USSR became the third largest member by voting share in the IMF. In the event, having secured a substantial concession, the Russian authorities opted not to formalise its membership of the IMF until several years later.

1.2.4 Consensus and idealism

The Bretton Woods institutions were therefore the product of negotiation, founded on a very strong and generally prevailing consensus between the US and Britain. Where the two major powers disagreed, the US view typically prevailed. Despite some areas of disagreement, there were significant areas of consensus, particularly between the US and Britain. Both initially viewed the two institutions somewhat idealistically: the IMF and World Bank would serve as the pillars of a post-war era of stable, sustained reconstruction and growth, by acting as collaborative, consensus-based decision-making institutions which would approach significant global economic challenges with impartiality.

According to this vision, the new Bretton Woods institutions would bring about exchange rate stability, which had been absent in the inter-war years after 1918, by establishing a new framework for setting, maintaining and adjusting exchange rates, regulated and supported by international agreement. Moreover, the new institutions would spread the underwriting costs of financing post-war recovery across the international community, and would act in a generally impartial manner. To achieve this last objective, Keynes and White proposed that the staff of the new organisations would be drawn from across the member countries, be impartial in their approach and would come to represent a highly skilled international civil service.

The post-war IMF and World Bank came to be perceived in very different terms to those set out in the vision of the two major architects of the two institutions. In particular, the IMF has often come to be perceived as being dominated by US interests, lacking in impartiality, and pursuing institutional objectives far removed from the interests of its developing country membership. But it is important to recall that at its creation, the institution was crafted in the context of a strong vision of a multilateral, collaborative and consensus-based decision-making forum, which had as its core vision a global economic environment characterised by stability and a decision-making process which, while recognising the relative strengths of its various members, nevertheless functioned in the absence of rancour and with the maximum degree of common purpose.

As noted above, the IMF currently has a near-global membership of 188 countries. To become a member, a country must apply and then be accepted by a majority of the existing members. Upon joining, each member of the IMF is assigned a quota, based broadly on its relative size in the world economy. The quota system will be discussed below.

1.3 The Articles of Agreement

The IMF operates in accordance with the provisions of its founding constitution, known as the Articles of Agreement. The Articles were originally adopted in July 1944. While these Articles have subsequently been amended on four occasions, in most respects they remain as valid in defining the character and in establishing the functions and organisational structure of the Fund as when they were first adopted. In this module, I will refer constantly to the IMF's Articles of Agreement. This is because the Articles contain important provisions, concerning the mandate, role, scope of financing and many other issues of relevance to the consideration of macroeconomic policy and stabilisation.

1.3.1 What is the IMF and what does it do?

The primary purposes of the Fund are set out in Article I of the Articles. These key purposes have remained essentially unchanged over the past seventy years although both their interpretation and the means of implementing them have changed as the world economy, financial markets and their political context have changed. The aims in Article I include the following:

- *To promote international monetary cooperation* through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

- *To facilitate the expansion and balanced growth of international trade,* and to contribute thereby to the promotion and maintenance of high levels of employment and real income.
- *To promote exchange stability,* to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
- *To assist in the establishment of a multilateral system of payments* in respect of current transactions and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- *To give confidence to members by making the general resources of the Fund temporarily available to them* under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- *To shorten the duration and lessen the degree of disequilibria* in the international balance of payments of members.

One of the greatest changes since 1944 in the world economy, affecting the way in which the IMF tries to achieve its Article I purposes, has been a change in the world's system of exchange rates.

In 1944 it was agreed that countries should maintain exchange rates against the US dollar and gold that were almost fixed. Governments should intervene to prevent exchange rates diverging significantly from the 'par value' agreed between IMF members, and should only engineer changes in the par value if changes in countries' relative economic conditions made those exchange rates fundamentally inappropriate (or, in other words, if they experienced fundamental deficits – or surpluses – in their balance of payments). For nearly 30 years that system was at the heart of the IMF's operations. The Article I requirement to maintain exchange rate stability was interpreted in those terms, and the objective of making the Fund's resources temporarily available to member states was interpreted as lending member states foreign exchange to stabilise their exchange rate if there was a temporary (not fundamental) balance of payments deficit.

That exchange rate system had lasted – with severe breaches and problems – until 1973. Since then, the US dollar has not had a fixed exchange rate against other major currencies (in 1973, these comprised the West German deutschmark, the Japanese yen and the British pound sterling – now the deutschmark has been replaced by the euro and the pound sterling is not so significant). Their exchange rates are largely determined by demand and supply on foreign exchange markets operating without governments buying or selling such currencies to affect their value. Therefore, the IMF no longer sees itself as being responsible for coordinating and supporting a generalised system of 'fixed' exchange rates. It is able to interpret its Article I obligation of maintaining exchange rate stability in a more subtle manner. For example the IMF does not seek to maintain fixity for the major currencies and in respect of other countries it has, in practice, supported a variety of arrangements, ranging in the 1990s from Argentina's rigid fixity against the US dollar to South Korea's floating rate against the dollar after 1997.

IMF (nd) *About the IMF*. 'Organization & finances' and 'Our work' on the IMF website.

Readings 1.1 and 1.2

For your first readings, go to the section *About the IMF* on the IMF website, and study two articles, 'Organization & finances', which focuses on the institution's management, international staff, its unit of currency or Special Drawing Rights and its borrowing arrangements, and 'Our work', which looks at economic surveillance, lending and technical assistance amongst its member countries. These readings should both reinforce the text of the unit and prepare you for the next section.

Make notes on the key points in the articles, and see if you can begin to answer some of the questions I set at the start of the unit – particularly, these:

1. What is the mandate of the IMF?
2. How is the IMF organised?
3. How does a country go about arranging a financing facility with the IMF?
4. What are the key financing facilities of the IMF?

1.4 Three Key Functions Performed by the IMF

In the changed modern world, the Fund performs essentially three sets of tasks with its member countries in order to fulfil the various purposes set out in the Articles of Agreement. These three functions,

- surveillance
- financing
- technical assistance

are examined in greater detail below. It is important to note, however, that not all member countries of the IMF utilise all three functions. For example, countries with advanced capitalist economies are subject to surveillance by the IMF, as are all member countries. But generally they no longer use the financing facilities of the IMF, although a country such as Britain did borrow from the fund as recently as 1976; and more recently, the global financial crisis prompted a number of smaller European countries to borrow from the IMF.

Consequently, in November 2008, Iceland borrowed $2.1 billion from the IMF in terms of a two-year Standby Arrangement; and in May 2010, Greece entered into a three-year Standby Arrangement, borrowing €30 billion from the IMF, as part of a broader package of joint support, together with the European Union, to Greece. The Standby Arrangement was intended to help Greece avoid having to approach international capital markets for the three year period to April 2013, while the country addressed its very large fiscal and balance of payments deficits. But this proved unachievable and in 2012 Greece again approached the IMF for an Extended Arrangement, borrowing a further €28 billion. In July 2015 Greece proved unable to fulfil its repayment obligations to the IMF under both the Standby Arrangement and the Extended Fund Arrangement.

In addition, only in some instances do such countries make use of IMF technical assistance. Some emerging market economies, as well as many transition economies, call on all three functions of the IMF. When they borrow from the Fund, they make use of a specific set of financing instruments, which you will examine further below. Similarly, the low-income members of the IMF also utilise all three functions. In the case of low-income members, however, they use a different type of financing arrangement.

1.4.1 Surveillance

The Articles of Agreement provide the IMF's international staff with a mandate to oversee the exchange rate policies of its member countries in order to ensure the effective operation of the international monetary system. To this end, the IMF assesses whether members' economic developments and policies are consistent with the achievement of sustainable growth and macroeconomic stability. This review and assessment process has come to be known as the process of IMF 'surveillance' over the economic policies of its member countries.

The IMF conducts its surveillance of members' economic policies by holding regular discussions with member countries about their economic and financial policies. The IMF fulfils its country surveillance responsibilities through a process of annual bilateral consultations with individual countries. Because this responsibility is mandated by Article IV of the IMF's founding constitution, the annual surveillance exercise in each member country has come to be known as the Article IV process.

It is often thought that only the IMF's smallest and weakest members undergo an annual surveillance exercise in terms of Article IV. In fact, however, because all members who join the IMF are signatories to the Articles of Agreement, the process is in fact voluntary, and all member countries have an Article IV surveillance exercise conducted in respect of their economies. Consequently, each year the institution's staff travel to each of the member countries to conduct their review and assessment of that member's economic policies. And in fact some of the most detailed Article IV assessments occur in the case of the largest members, such as the US. This is because these members exert a comparatively strong influence over global economic affairs and if their policies are weak or if they are not consistent with the common overall objective of global economic stability and growth, these countries can have the greatest capacity to destabilise the global economy.

The Article IV surveillance exercise focuses on an examination of the following issues in each member country:

- exchange-rate, fiscal and monetary policies
- balance of payments and external debt developments
- the influence of its policies on its external accounts
- the international and regional implications of its policies
- the identification of potential vulnerabilities
- capital-account, financial and banking-sector issues

and, where relevant to macroeconomic stability,

- such issues as labour markets, governance and the environment.

In recent years, IMF surveillance has broadened to include a substantial focus on financial-sector issues. This strengthened focus arose after the 1997 East Asian crisis, when several countries whose economic performance had been strong for several years – and for whom the IMF had consistently written strongly favourable Article IV annual surveillance reports – suddenly experienced unforeseen and very significant economic and financial difficulties. Many of the problems that had precipitated these crises were identified as stemming from financial-sector weaknesses in these countries; and it was decided to substantially strengthen the IMF's efforts to identify and to assess financial-sector weaknesses and vulnerabilities among member countries. As a result, while the Article IV reports continue to focus attention on the full range of exchange-rate, economic, monetary, fiscal and financial issues, a substantial new set of surveillance activities has emerged in the form of Financial Sector Assessment Programmes (FSAPs), which are very detailed assessments of the financial health of the IMF's member countries. You will study the FSAP process in much greater depth later in this module, when you examine the IMF's strengthened role in financial-sector surveillance.

Once the Article IV review has been completed, the IMF staff prepare a detailed report which is discussed by the IMF Executive Board. Article IV reports contain a wide variety of recommendations for policy improvements. But the recommendations contained in the Article IV reports are themselves not compulsory. They are intended as a compendium of policy analysis and recommendations that can be useful to country authorities as they conduct their policies.

In addition to the Article IV surveillance mission, the IMF also conducts other forms of surveillance, including surveillance of regional groups of member countries, on a voluntary basis; and multilateral surveillance of the global economy, in terms of the IMF's World Economic Outlook exercise.

The IMF's surveillance function has typically evolved over time, to take account of specific new developments in the global economy. From 2006, for example, three further important developments have taken place regarding IMF surveillance:

- Firstly, a decision in June 2006 to conduct simultaneous consultations, among several member countries: the focus of these consultations has been on addressing the challenges posed by global imbalances, in particular the large US current account deficit and growing current account surpluses elsewhere. Members participating in this multilateral consultation exercise have included the US, China, the Euro area, Japan and Saudi Arabia.
- A second recent modification to IMF surveillance is the decision of the IMF Executive Board in June 2007 that bilateral surveillance should cover all policies that can affect a country's external stability, including surveillance over member countries' exchange rates. Previously, IMF

staff had been reluctant to comment in detail on members' exchange rate policies. The new approach provides guidance to member countries on the conduct of their exchange rate policies and allows IMF staff to examine whether or not members are manipulating their currencies to gain an unfair competitive advantage over other members.

- Thirdly, the 2007–08 global financial crisis highlighted the strong interconnections between the financial systems of many advanced economies, including those of the USA, several Western European countries, China and Japan. Consequently the IMF has deepened, extended and made more frequent both its regional surveillance and its surveillance of the world's systemically most important economies, taking a number of particularly important steps in 2012, including a decision to conduct surveillance of the world's major economies on an integrated basis, developing a formal strategy to pursue financial sector surveillance and the development of pilot External Sector Reports that examine the external positions of these economies, going beyond consideration of exchange rate policies and including an examination of current accounts, reserves, capital accounts and the external balance sheets of these countries.

1.4.2 Financing

The IMF is probably best known for the financial assistance it provides to member countries. The Fund provides this assistance by means of credits and loans. Financing is provided to members who request such financing. Members make these requests for a variety of reasons. Later in this unit, you will study in more detail the variety of financing facilities provided by the IMF, and you will also observe that when the IMF lends to a member country, it imposes a variety of conditions on that lending.

The IMF's approach in attaching conditions to its lending has been the subject of very considerable criticism since the Fund's establishment. The imposition of 'conditionality' has been criticised as being too severe, inappropriate, resulting in debilitating limitations on the sovereign decision-making of member countries, ineffective, based on erroneous policy advice and partial to the interests of some sections of the IMF's members, broadly the creditor members of the IMF. You will study in more detail some of the controversies that have raged around the IMF's policy on conditionality later in this unit.

1.4.3 Technical assistance

The third major function performed by the IMF is the provision of technical assistance to its members, which includes several broad areas:

- design and implementation of fiscal and monetary policy
- institution-building (such as the development of central banks or treasuries)

- handling and accounting of transactions with the IMF
- collection and refinement of statistical data
- training officials.

The IMF's approach to stabilisation policy is also promoted through the provision of technical assistance. For in providing such assistance, the IMF promotes its view as to how stabilisation can be best achieved in countries receiving its financial support.

While the IMF's three major functions – surveillance, financing and technical assistance – are distinct activities of the institution, they are all nevertheless closely related. For example, the Article IV surveillance report for a member country may reveal inherent weaknesses in that country's financial system, which need corrective action by strengthening financial institutions or making more effective the financial regulatory system in the country. This in turn informs the IMF's policy on technical assistance to the country, with technical assistance provided to help the country correct the various perceived regulatory weaknesses. In addition, the process of deciding whether the IMF will lend resources to a member country – a process that you will study in considerable detail in Unit 2 – also often reveals institutional and other weaknesses that may need addressing. This information is also used to help the IMF assemble a package of technical assistance for the country concerned.

There are many further linkages between IMF financing, surveillance and technical assistance. For example, the progress a country makes with its financial programme is reported in the annual Article IV report, and updated surveillance exercises help both the country and the IMF decide whether any modifications are needed to the technical assistance being provided.

1.5 Organisational Structure of the IMF

In addition to describing the intended objectives of the institution, the IMF's Articles of Agreement also set out its organisational structure. The Articles provide for four key organs of the Fund. These are:

- a Board of Governors
- an Executive Board
- a Managing Director and three Deputy Managing Directors
- the Staff of the IMF.

In the simplest descriptive framework, it could be said that the first two of these, the Board of Governors and the Executive Board, comprise officials from the member countries. The latter two, the Managing Director, Deputy Managing Directors and staff of the institution, represent the institution. However, as you will see, this is in fact merely a convenient simplification for descriptive purposes. Indeed, when the IMF was established, the overarching vision of Keynes, White and its other founders was that it would actively seek to minimise differences that might emerge among members, and that its operations would be conducted impartially.

Consequently, Keynes and others strongly emphasised the imperative that the IMF's staff would represent an international, independent expert group of individuals, whose mandate would be to impartially assess the economic and financial wellbeing of the institution's members and to offer impartial, expert advice on how to remedy any distortions or policy failures which threaten global economic and financial stability. The international, impartial character of the IMF's staff has been strongly emphasised since the IMF was established, with its management consistently insisting that no single country or set of countries should exert influence over the appointment of IMF staff members; that such decisions are the prerogative of management; and that the staff should not come under pressure from any country member to have their judgement compromised by specific national interests. The challenge is a significant one and despite strong efforts by management and by the staff themselves, over the years the institution has repeatedly been accused of favouring in particular the interests of the larger and more powerful members of the institution.

1.5.1 The Board of Governors

The highest decision-making body of the IMF is the Board of Governors. The Articles of Agreement provide that all powers of the Fund shall be vested in the Board of Governors. The Board of Governors consists of one Governor (and in his or her absence, one Alternate Governor) for each of the 188 member countries. For this reason, it can be said that the ultimate decision-making power in the Fund is located in the member countries, which are the shareholders of the Fund.

The country's Governor to the IMF is appointed by the member country and is usually the Minister of Finance or the Governor of the central bank. All powers of the IMF are vested in the Board of Governors. The Board of Governors may delegate to an Executive Board (see below) all, except certain reserved, powers. In practice, this is in fact the case, with most of the responsibilities of the Board of Governors having been delegated by the Governors to the Executive Board. The Board of Governors has, however, retained several very important powers, including the power to admit and suspend country members and to increase or decrease the authorised quota or shareholding of the Fund. The Board of Governors is also responsible for approving amendments to the Articles of Agreement and endorsing the institution's financial statements and budgets.

The Boards of Governors of the IMF and the Bank meet in joint session at Annual Meetings. There the Governors decide on key IMF policy issues for the coming year. The views of individual governments, however, are represented throughout the year by the members of the Executive Board.

1.5.2 The Executive Board

As noted above, the conduct of the general operations of the IMF is delegated by the Fund's Governors to an Executive Board, or Board of Executive Directors. That Board is composed of 24 Directors, who are appointed or elected by member countries or by groups of countries, as well as a Managing Director, who serves as its Chairperson. Executive Directors are based at the IMF's headquarters in Washington DC. The Board of Executive Directors is the policymaking organ of the Fund and is accordingly responsible for policy decisions affecting the Fund's operations and for the approval of all facilities provided by the IMF.

The Executive Board conducts the day-to-day business. It acts on the basis of the powers assigned to it under the Articles of Agreement and delegated to it by the Board of Governors. Meetings of the Executive Board are usually called by the Chairperson or Acting Chairperson. However, any Executive Director can request that a meeting be called. A quorum exists when a majority of Executive Directors having not less than 50 percent of the total voting power is present. The practice is, in fact, for all chairs to be occupied at all times.

The Board functions in continuous session and meets as often as Fund business dictates. Generally, meetings are held at least three times a week.

1.5.3 Major Executive Board responsibilities

The major responsibilities of the Board are to:

- conduct surveillance of the economies of member countries
- discuss, approve and review adjustment and reform programmes under the various facilities of the Fund, which includes the facility most frequently used by low-income member countries, known as the Poverty Reduction and Growth Facility (PRGF)
- decide on general Fund policies and initiatives, such as the Heavily Indebted Poor Country (HIPC) debt initiative and the Multilateral Debt Relief Initiative, the role of the Fund in governance issues, guidelines on data dissemination and international codes of conduct – for example, on transparency and on the conduct of monetary policy
- conduct general surveillance of the global economy.

The Executive Board also does the background work for the International Financial and Monetary Committee (IMFC), which meets twice a year.

Several Board committees also exist, including those for the Budget, Personnel, Evaluation and Administrative Matters. However, unlike the Board committee system in other multilateral organisations, such as the World Bank Group, for example, the Fund's Board conducts the overwhelming bulk of its work in the formal sessions of the Board.

The Executive Board carries out its work largely on the basis of papers prepared by IMF management and staff. Typically, the Board spends about 60 percent of its time on member country matters and most of its remaining time on policy issues, such as an evaluation of the world's economic outlook, developments in international capital markets, the IMF's financial resources, surveillance, data issues, the debt situation and issues related to IMF facilities and programme design.

1.5.4 The Managing Director and Deputy Managing Directors

The Managing Director is both the chairperson of the Executive Board, which appoints the Managing Director, as well as the chief of the operating staff of the Fund. He or she is ultimately responsible for all aspects of the internal management and working of the institution and its relations and communications with the outside world. The Managing Director is also directly responsible for relations with the Board of Governors and the Executive Board. The Managing Director serves a five-year term and may be re-elected to successive terms. The Managing Director is seconded by three Deputy Managing Directors, one of whom comprises a First Deputy Managing Director.

The First Deputy Managing Director maintains general oversight on all issues facing the institution. Each of the three Deputy Managing Directors chairs selected Executive Board meetings, oversees staff work in specific areas and maintains contacts with member governments, Board members, the media and other institutions. In discharging these functions, each Deputy Managing Director speaks with equal authority for the Fund. Each Deputy Managing Director is available, as needed, to deal with all aspects of the management of the institution.

Reading 1.3

Devesh Kapur (2000) 'Who gets to run the world?' *Foreign Policy,* 121 (November/December), 44–50.

For your next reading, please study the article by Devesh Kapur, an economist based at the University of Pennsylvania and formerly at the Harvard Business School. Kapur's article highlights the fact that the process of selection of the head of the IMF is controversial, for by tradition the individual is selected from only one among the several groups of countries that comprise the IMF's membership. The article is challenging and illustrates several of the controversies associated with the operations and practices of the IMF, which you will study in more detail as you progress through this module.

As you progress through the article, write notes on the following key issues:

- How is the Managing Director of the IMF selected?
- What difficulties does this present in achieving the original objectives of the founders of the IMF, such as Keynes and White, for the IMF to serve as an impartial, consensus-based multilateral organisation?
- What, if any, changes would you propose for the process of selecting the Managing Director of the IMF? Describe these and explain why you consider them to be necessary.

1.5.5 The Chief Economist and other officers

During various periods in the IMF's history, a variety of other individuals have come to play an important role in shaping the institution's policies. Most significant among these has been the role of the IMF's Chief Economist. Depending on the individual concerned, the position of Chief Economist has often assumed very significant status. During the period of the East Asian crisis, for example, when the position was occupied by the economist Michael Mussa, the position assumed very significant weight in the overall policy decision-making framework of the IMF, with Mussa providing guidance on a wide range of issues of crucial policy importance. These included:

- assessing the reasons for the problems that emerged during the East Asian crisis – and pointing to the nature of the IMF's response
- influencing the extent to which the IMF would provide financial support to members confronting very large scale balance of payments crises
- determining the IMF's stance as to the reasons for global economic imbalances
- taking responsibility for providing projections about the future direction of the global economy.

At other times during the IMF's history, other individuals have also exercised particularly important influence. Some department heads, for example, have come to be identified as having exerted significant influence over IMF policies. In the 1990s, the head of the Policy Development and Review Department of the IMF came to be associated with the new focus on very large-scale financial packages for emerging market economies, and also came to be identified as one of the main architects of the IMF's new thrust into lending to very small, low-income countries.

In the article you have just read, Kapur explains that the most senior management figure in the IMF is the Managing Director, who is vested with very significant powers. Given the desire by the founders of the IMF to ensure that the institution and its staff remain impartial at all times, the responsibilities of the IMF Managing Director are significant indeed.

Because the IMF's membership spans not only the industrial countries, but also emerging markets and low-income countries, the challenge of maintaining impartiality is particularly difficult. The character, personality and also the nationality of the Managing Director are often viewed as a proxy for assessing the degree to which the IMF will act as an independent arbiter of global economic policies. Kapur's article shows, however, that the selection process for the IMF Managing Director fails to address this challenge. Instead, it perpetuates the common perception that the IMF serves the interests of a narrow group of the overall country membership, focusing on the interests of the large industrial countries, particularly the USA, Western Europe and Japan.

To a large extent this results from the fact that the nationality of the Managing Director of the IMF has, by convention since its establishment, always been European, while the President of the World Bank has always been a citizen of the USA.

1.5.6 Staff of the IMF

The IMF has a staff of about 2,600, headed by the Managing Director. As noted earlier, the staff is intended to be independent, expert, impartial and capable of resisting pressure from country authorities to favour the interests of any single country or group of countries.

At present, members of the international staff come from over 145 countries and comprise mainly economists, but also statisticians, research scholars, experts in public finance and taxation and in financial systems and central banking, linguists, writers and editors, and support personnel.

Most staff members work at IMF headquarters in Washington, though a few are assigned to small offices in Paris, Geneva, Tokyo, and at the United Nations in New York, or represent the IMF on temporary assignment in member countries. At present, there are 67 resident representatives assigned to 89 member countries.

1.6 The Executive Board, Constituency System and Advisory Organs

Built around the four major organs of the Fund is an intricate array of relationships, both internal to the IMF and with other institutions participating in the realm of international finance. Chief among these are the constituency system, or the system through which the 188 member countries of the IMF arrange their participation in the institution, the major international committees whose work is closely linked to that of the IMF and a series of international financial institutions with which the IMF has regular dealings as it carries out its work.

1.6.1 The Executive Board and the Constituency System

According to the Articles of Agreement, the five largest shareholders – France, Germany, Japan, the United Kingdom and the United States – are each entitled to appoint one Executive Director. All other countries are grouped into constituencies, each represented by an Executive Director elected by a country or group of countries. The member country decides which group to join.

1.6.2 Progressive expansion of the Executive Board

When the IMF started functioning in May 1946, there were 12 Executive Directors on its Board: five of them represented the largest shareholders of the Fund, and the remaining seven represented the 40 other members. As more countries joined the IMF, the number of countries requiring representation on the Board of Executive Directors grew, from the original 45 members to today's 188. To accommodate the increased membership, the number of Directors has progressively expanded. As a result there are at present 24 Executive Directors, or double the number at the establishment of the Fund.

The five largest shareholders remain entitled under the Articles of Agreement to appoint their own Executive Director. In addition, three other countries – China, the Russian Federation and Saudi Arabia – comprise single-country constituencies in the Executive Board. The remaining 16 Executive Directors are elected by groups of countries, or constituencies.

Constituencies are generally formed more or less along geographic lines, with political and cultural factors playing some part in the groupings. A four-per-cent minimum voting power, excluding the combined votes of the five members that appoint their individual Executive Directors, is required before a constituency can be formed. However, a lower threshold can be considered if the Board of Governors, through the recommendation of the Executive Board, so decides.

1.6.3 The International Monetary and Financial Committee (IMFC)

The International Monetary and Financial Committee (IMFC) came into being on September 30, 1999, as the Advisory Committee of the Board of Governors, replacing the Interim Committee, which operated since October 1974. The IMFC advises and reports to the Board of Governors on managing and adapting the international monetary and financial system. This includes the continuing operation of the adjustment process and the transfer of resources to developing countries. The IMFC also considers proposals by the Executive Board to amend the Articles of Agreement and deals with disturbances that might threaten the system.

The IMFC members are Governors of the IMF. Each member country that appoints and each group that elects an Executive Director appoints a member of the IMFC, which, like the Executive Board, has 24 members.

1.6.4 The Development Committee

The Development Committee, established in 1974, is known formally as the joint Ministerial Committee of the Boards of Governors of the World Bank and the International Monetary Fund on the Transfer of Real Resources to Developing Countries. The Committee has 24 members, typically comprising Finance Ministers or other officials of comparable rank. Members represent all the shareholders that elect an Executive Director to the Boards of the two institutions.

The Committee generally meets at the same time as the IMFC. The Committee advises and reports to the Board of Governors of the Fund and the Bank on all aspects of the transfer of real resources to developing countries. It also sets guidelines to be followed by the Executive Directors of both institutions in implementing the conclusions reached by the Boards of Governors. The committee meets usually twice a year, in the spring (April–May) and in conjunction with the Annual Meetings in the autumn. The Chairperson of the Development Committee is usually from a developing member country – from Africa, Asia or Latin America – by rotation. The Chairperson generally holds office for two consecutive years.

1.7 The Departmental Structure of the IMF

The IMF is organised primarily on a departmental basis and there are essentially three types of departments in the Fund: area departments, functional departments and information/liaison departments. At any time in a member country's relationship with the Fund, more than one of these can be of central importance to the relationship, and for this reason a brief outline of the functions performed by each department is provided below. Each department is headed by a Director, who reports to the Managing Director.

1.7.1 Area Departments

The Fund divides its operations into five area departments. These comprise:

- Africa
- Asia and Pacific
- Europe
- Middle East and Central Asia
- Western Hemisphere.

In addition, 67 area department staff members are assigned to member countries as IMF resident representatives. These posts, typically filled by a single staff member, are intended to enhance the provision of IMF policy advice and are often set up in conjunction with an IMF-supported adjustment programme.

1.7.2 Functional and Special Services Departments

There is a range of functional departments that are central to the quality of resources provided to the member countries of the IMF. There are currently eight major functional departments. These comprise:

- Fiscal Affairs Department
- Monetary and Capital Markets Department
- Strategy, Policy and Review Department
- Research Department
- Statistics Department
- Finance Department
- Legal Department
- the Institute for Capacity Development.

In addition, the IMF has a Communications Department, which serves as a mechanism for disseminating information about the Fund to its members, and an Independent Evaluation Office (IEO).

The following sections briefly outline the roles and functions of each of these major functional departments.

The Fiscal Affairs Department

This is responsible for activities involving public finance in IMF member countries. It participates in area department 'missions', or visits to IMF member countries on fiscal issues, reviews the fiscal content of IMF policy advice and IMF-supported adjustment programmes, contributes to fiscal policy design in member countries and provides technical assistance in public finance. It also conducts research and policy studies on fiscal issues, as well as on social sector issues, public expenditure policy and the environment.

The Monetary and Capital Markets Department

This department works closely with the relevant area departments, to conduct financial sector surveillance. It provides technical assistance to member countries in such areas as monetary and exchange-rate policies, financial sector policies and capital-market development. This includes assessments of financial sector soundness and stability, the assessment of anti-money laundering and anti-terrorism financing regimes and offshore financial centres. The department also assists in the development of internationally recognised standards and codes in the financial sector. It assigns experts to central banks where long-term technical assistance is sought. In addition, the department monitors trends and developments in international capital markets, assesses systemic risks and related policy issues. It also contributes to the exercise of IMF jurisdiction on exchange practices and restrictions. This is the department that prepares the IMF's semi-annual *Global Financial Stability Report*.

The Strategy, Policy and Review Department

This plays a central role in the design and implementation of IMF financial facilities and operations, in surveillance policies and in other areas. It advises management and prepares Board papers on the development and review of IMF policies and facilities, including surveillance and Article IV consultation policies. It plays a key role in the IMF's participation in the IMFC and Development Committee and its relationships with the World Bank, the UN and other international and bilateral institutions and agencies.

The Research Department

This department conducts policy analysis and research in areas relating to the IMF's work. It coordinates multilateral surveillance work and such bilateral surveillance activities as the monitoring of exchange rates, commodities and energy markets. It plays a prominent role in the development of IMF policy concerning the international monetary system and exchange rates issues for the Board. It prepares the semi-annual World Economic Outlook report for the IMFC and periodic reports on World Economic and Market Developments (WEMD) for the Board. The Research Department also prepares surveillance notes for regional groupings, including the G-7 and G-20, and conducts a multilateral assessment of exchange rates for a number of advanced and emerging market economies. The department also maintains contacts with the academic community and with other research organisations.

The Statistics Department

The Statistics Department maintains databases of country, regional and global economic and financial statistics and reviews country data in support of the IMF's surveillance role. It is responsible for developing statistical concepts in balance of payments, government finance, and money and financial statistics, as well as producing methodological manuals. The department provides technical assistance and training to help members develop statistical systems and produces the IMF's statistical publications. In addition, it is responsible for developing and maintaining standards for the dissemination of data by member countries.

The Finance Department

This department formulates the IMF's financial policies and practices, and conducts and controls financial operations and transactions in a variety of financial accounts. It advises management and the Board on the IMF's liquidity and its income. It invests assets held in trust, develops policies and advises on the financial aspects of access to IMF facilities. The Finance Department also assess the financial risks to the IMF of large lending arrangements. Many developing country members in the IMF are very familiar with the Finance Department, as it is this department that coordinates members' regular payments of obligations due to the Fund.

The Legal Department

The Legal Department advises management, the Board and the staff on the applicable rules of law. It prepares most of the decisions and other legal instruments necessary for the IMF's activities. The department serves as counsel to the IMF in litigation and arbitration cases, provides technical assistance on legislative reform and responds to inquiries from national authorities and international organisations on the law of the IMF.

The Institute for Capacity Development

The Institute for Capacity Development, formerly known as the IMF Institute, provides training for officials of member countries, particularly developing countries, in such topics as financial programming and policy, external sector policies, balance of payments methodology, national accounts and government finance statistics and public finance.

The Communications Department

The Communications Department edits, produces and distributes the IMF's non-statistical publications, provides information services to the press and general public, maintains contacts with non-governmental organisations and parliamentary bodies and manages the IMF's website. The IMF maintains four offices in Asia and the Pacific, in Europe, in Geneva and at the United Nations Headquarters in New York to foster close contacts with other international and regional institutions.

The Independent Evaluation Office (IEO)

As part of its ongoing measures to improve transparency, governance and accountability in the Fund, the Executive Board approved the establishment of an Independent Evaluation Office, which became operational in August 2001. The office, which reports to the Board, conducts independent evaluations of Fund policy and operations with the full cooperation of Fund Management. Since its establishment, the IEO has initiated work on a variety of projects, including an evaluation of the prolonged use of IMF financial resources and the implications of long use of IMF resources by its members, for the institution.

1.8 The Process Followed in Negotiating a Financing Arrangement with the IMF

A set of key steps is taken by the IMF whenever a financing programme is arranged between the Fund and one of its member countries.

The first step in the overall process commences when a member country requests a financing facility. Upon receiving the request, the IMF's staff in Washington, as well as any staff who may be located in the requesting country, seek to obtain comprehensive data on the member country, prior to travelling on a mission to that country. Requests for updated data on a host of variables are sent to the member country authorities.

Once sufficient data have been obtained by the IMF staff, they integrate this information, in the context of a common methodology, to determine the broad parameters of any potential financial support that the IMF may consider providing the member country. This common methodology is known as *financial programming*.

In Unit 2, you will see that financial programming represents the key framework used by the IMF in developing stabilisation programmes for its member countries. During this process of integrating data received from the country authorities, a mission brief is prepared, on the basis of internal agreement among the staff and management of the IMF. The brief contains the parameters of the negotiating mandate that the IMF staff will be guided by once the mission visits the member country.

Thereafter, the mission travels to the member country and conducts detailed negotiations on a variety of issues, including:

- the amount (from all sources) of financing which the member country intends to raise
- the type of facility which the IMF will consider providing
- the schedule of actions, including an associated timeframe, on the basis of which the IMF will conduct one or more reviews of progress in terms of the facility being negotiated

- the content of the programme conditionality that is to be included in the terms of the financing agreement.

As I shall note later in this unit, there is a wide range of 'conditionalities', which are negotiated in a typical financing arrangement with the IMF, including quantitative and structural performance criteria, prior actions, benchmarks and indicative targets.

Once the details of the programme have been agreed between the IMF staff and the member country authorities, a Letter of Intent (LOI) and a Memorandum of Economic and Financial Policies (MEFP) are prepared. In the past, these documents were often prepared by the IMF staff and simply signed by the member countries in whose names the documents were issued. More recently, some IMF member countries have developed the technical acumen to enable them to prepare these documents themselves, in a manner which is internally consistent and which makes commitments that the member country authorities are capable of achieving, within the timeframes indicated. In several units of this module, you will examine some of the actual LOI and MEFP documents that countries have prepared and signed with the IMF.

Once the documentation has been prepared, these are forwarded to the IMF Managing Director. For the process to continue, the Managing Director is required to accept the content of the documentation. Thereafter, the package of documentation is brought to the IMF's Executive Board for a decision. If the Executive Board approves the arrangement, the first tranche of the facility is disbursed. Thereafter, the country is expected to follow the terms of the programme, implementing the reforms and other measures specified in the arrangement. The duration of individual programmes differs, depending on the type of programme and the nature of the financing provided by the IMF. You will examine later this unit the various types of financing arrangement provided by the IMF to its members.

After approval, the arrangement becomes subject to continuous monitoring, both during the course of specific country review missions and in the context of the regular Article IV staff missions.

1.8.1 Instances of unsatisfactory progress

On a number of occasions, the programme arranged between the member country and the IMF has proceeded smoothly and the periodic reviews of the programme are completed as scheduled, enabling further disbursements of financial resources. In some cases, however, problems emerge which can precipitate a breach in the conditions the member has negotiated with the IMF.

Where, in such cases, the IMF Executive Board is not willing to grant a waiver of the relevant conditionality or conditionalities, the review of the programme is not completed by the Executive Board. In such instances, scheduled disbursements are delayed. The IMF staff notify management of the issues which have emerged. Where management concur, the matter is brought to the Executive Board for a decision.

1.9 Types of IMF Lending

You have seen that the IMF's approach to stabilisation is most clearly expressed through its lending operations. Yet the IMF lends in different ways to different types of countries and indeed you will see this clearly when you come to examine the different types of case studies of IMF lending, in Units 4–8 of the module. Because the range of circumstances as well as the range of financial products differs, it is useful to understand more closely how and why the IMF lends.

When the IMF was founded in 1944, the only expected reason for the IMF to lend to any of its members was to help the country overcome a temporary balance of payments problem. And in the first few years of the IMF's operations, this form of lending, for short-term balance of payments problems, was indeed the only type of lending provided by the organisation.

With the expansion of the number of countries joining the IMF and becoming members, however, the types of needs for IMF financing began to change. In particular, over time it became increasingly recognised that while some countries might only need balance of payments support for a short period of time, other countries might require such support for a greater period. This is particularly the case for countries with structural impediments to improving their ability to expand exports, and for countries that have little or no access to international capital markets from which to borrow to finance their development. As the needs of the IMF's membership changed, so the types of financial products offered to the members also began to change.

Before discussing the specific types of financing facilities that the organisation provides, however, one other preliminary remark is important. Unlike development and other banks – including, for example, the World Bank – the IMF does not provide project finance lending, such as for the construction of a school or bridge. Instead, it lends directly to the governments that are the IMF's members for balance of payments or, in some instances, for budgetary support. When members borrow from the IMF, they borrow in the currency of the IMF, known as the Special Drawing Rights (SDRs), or in one or more of the more freely tradable international currencies, such as US dollars. These currencies are known as *reserve assets*. These reserve assets are borrowed and are usually deposited in the borrowing country's central bank. These borrowings are then freely available for use by the member country in the same manner as all other international reserves. For this reason, the financial assistance provided by the IMF enables the member to rebuild its reserves, or to make larger payments for imports and other external purposes than would have been possible without its assistance.

Except in the case of a few facilities, including particularly the Poverty Reduction and Growth Facility (PRGF), which you will study in more detail in Unit 7, the IMF lends to a borrowing member country by providing it with reserve assets, which are obtained from other members. The borrower uses its own currency to 'purchase' reserve assets from the IMF. In turn, these reserve assets are obtained from shareholder subscriptions, known in

IMF language as 'quotas'. The borrower repays the loan by 'repurchasing' its own currency from the IMF with international reserve assets. This purchase–repurchase mechanism explains why, from an accounting perspective, the IMF's total resources do not vary as a result of the Fund's financial assistance; only the composition of its assets changes.

Financial assistance is typically made available in instalments, which are linked to the borrowing country's observance of specific economic and financial policy conditions ('performance criteria' or 'benchmarks') that must be satisfied before the next instalment is released. The IMF makes two kinds of loan: non-concessional and concessional. It makes its non-concessional loans to member countries under a number of facilities, the terms of which reflect the nature of the balance of payments problem the country is experiencing. The global financial crisis brought about a major modernisation of the IMF's non-concessional facilities, reducing conditionalities and making existing facilities more easily accessible to members facing economic and financial crises; increasing the amounts members are able to borrow – or in IMF terminology, increasing members' 'access limits'; and introducing new types of non-concessional lending to take account of the needs for emergency financing during periods of crisis, when countries face large, volatile and unpredictable capital flows. Consequently, there are various types of non-concessional facilities and these include:

- Stand-By Arrangements (SBA)
- Flexible Credit Line (FCL)
- Precautionary and Liquidity Line (PLL)
- Extended Fund Facility (EFF)
- Rapid Financing Instrument (RFI).

Details of these facilities are provided below, while in Unit 7 you will study the various concessional lending facilities provided to low-income country members of the IMF, including the Extended Credit Facility (ECF), the Standby Credit Facility (SCF) and the Rapid Credit Facility (RCF).

1.9.1 Stand-By Arrangements (SBA)

These are designed to deal with any temporary balance of payments problem. The typical SBA is for 12 to 18 months but may be as long as three years, and disbursement of financing is usually conditional on the borrower meeting specified performance requirements. There are two types of Stand-by Arrangements:

- firstly, an arrangement in which the member actually borrows from the IMF
- secondly, a 'precautionary' arrangement, where the member enters into an arrangement to borrow from the IMF, but in fact refrains from doing so unless it eventually requires the finance. The arrangement then serves as a form of insurance facility for the borrower, which can be drawn upon at any time during the facility, as long as the borrower has complied with the conditions attached to the loan.

SBA loans must be repaid within three-and-one-quarter to five years. The expected repayment period is shortened to two-and-one-quarter to four years if the country's external position allows it to repay earlier. When they have been used in the past, SBA arrangements have typically been issued to large emerging market economies, such as Korea, Brazil, Turkey and Argentina, when these countries have approached the IMF for financial assistance for balance-of-payments support. SBAs were used extensively during the emerging market economy crises from 1997–2002. Between 2002–2006, demand for SBA's declined, as many of these countries built large foreign exchange reserves and refrained from approaching the IMF for financing. But since late 2006 and the emergence of a global financial crisis, demand for SBAs has increased significantly.

To help members access SBA facilities more easily during periods of crisis, the IMF increased the flexibility of the SBA from 2009. The amount available for borrowing by members was doubled, providing confidence to countries that, in crises, they would be able to access sufficient resources. The IMF increased levels of access on a precautionary basis, allowed the frontloading of access, and reduced the frequency of Board reviews of members' compliance with the conditionalities attached to these facilities.

1.9.2 The Flexible Credit Line (FCL)

The IMF introduced a new FCL in March 2009. The facility is available to countries with very strong economic and financial policies and strong track records of policy implementation, and its key purpose is to help these countries prevent crises from occurring in their domestic financial systems. The IMF approves FCL arrangements for countries meeting pre-set qualification criteria, giving these countries certainty that they will have access to the resources if they meet these criteria. In addition, unlike other IMF arrangements, which require conditions to be met before disbursements are made, the FCL is disbursed without conditionality, either at the time of disbursement or on an ongoing basis.

The FCL is a renewable facility, which lasts for either six or twelve months, based on the member's choice. Its repayment period is between three-and-a-quarter years and five years, allowing a country experiencing major problems to have a reasonable period to work through the crisis before repaying. There are also no limits on the level of access to these facilities for eligible countries; and there is flexibility to either utilise the resources by drawing down on the facility, or to treat the facility as a precautionary arrangement, in case a crisis occurs.

The FCL is a highly flexible arrangement, suited to the needs of many types of countries facing external crises. However, there are qualification criteria. Before a member country is considered eligible to access an FCL, the IMF conducts an assessment to confirm that the country has strong economic fundamentals and institutional policy frameworks, is implementing – and has a sustained record of implementing – very strong policies and remains committed to maintaining these policies. To conduct this assessment, the IMF relies on a number of criteria.

These include whether or not the country has the following:

- a sustainable external position and a capital account position dominated by private flows
- a track record of access to international capital markets at favourable terms
- a reserve position that is relatively comfortable
- sound public finances and a sustainable public debt position
- low and stable inflation and a sound monetary and exchange rate position
- no bank solvency problems posing systemic threats to banking system stability
- effective financial sector supervision and data integrity and transparency.

Where countries can convince the IMF that these criteria have been satisfied, they are able to access FCL facilities. Since the commencement of the FCL, three countries have accessed the FCL – Poland, Mexico and Colombia. In all three cases, the countries have chosen not to draw down on the facilities, but rather to use the FCL as a precaution, in the event of a future crisis.

The overhaul and modernisation of the IMF's lending has led to the closure of a number of facilities that were either previously unused or have been replaced. For example, a previous facility known as the Compensatory Financing Facility (CCF), which provided financing for members experiencing temporary export shortfalls or excesses in cereal import costs, was closed in January 2010, as was the Supplementary Reserve Facility (SRF). The SRF was introduced in 1997 to supplement resources made available under SBAs in order to provide financial assistance for exceptional balance of payments difficulties owing to a large short-term financing need resulting from a sudden and disruptive loss of market confidence, such as occurred in the Mexican and Asian financial crises of 1995 and 1997. The SRF was used in the past by such countries as Brazil, Russia and Korea, each of which borrowed very substantial amounts under this facility. For example, the IMF first activated the SRF in December 1997, committing SDR 9.95 billion to Korea as part of its overall financing arrangements with the IMF. In July 1998, SDR four billion were committed to Russia under the SRF as part of the augmentation of Russia's Extended Arrangement by SDR 6.3 billion. However, the new FCL, which provides large-scale financing during periods of financial crisis, has now effectively replaced the SRF.

1.9.3 The Precautionary and Liquidity Line (PLL)

The Precautionary and Liquidity Line (PLL) was established in 2011. It provides financing to meet actual or potential balance of payments needs of IMF member countries with sound economic fundamentals but with some remaining vulnerabilities that preclude them from using the Flexible Credit

Line (FCL). Similar to the FCL, the PLL is also a highly flexible arrangement and the circumstances in which the PLL is provided are broad. These include instances in which countries are affected by regional or global economic and financial stress, with the PLL providing rapid short-term liquidity to help to bolster market confidence, limit contagion, and reduce the overall cost of the crisis.

To qualify, countries need to have sound economic fundamentals and institutional policy frameworks; need to be implementing – and have an established track record of implementing – sound policies; and require to be committed to maintaining sound policies in the future. The IMF assesses a country's qualification for the PLL in five broad areas including its external position and market access; its fiscal policy; its monetary policy; the soundness of the financial sector and its supervision; and data adequacy. While the arrangement requires strong performance in most of these areas, the PLL provides liquidity to member countries that may still have moderate vulnerabilities in one or two of these areas. Conditionalities are set once the facilities are utilised.

1.9.4 The Extended Fund Facility (EFF)

The EFF was established in 1974 to provide medium term assistance in particular to members with

a) an economy suffering serious payments imbalances relating to structural maladjustments in production and trade and where price and cost distortions had become widespread; or
b) an economy characterised by slow growth and an inherently weak balance of payments position that prevents pursuit of an active development policy.

The length of an EFF arrangement is typically three years and disbursement is conditional on the borrower meeting specified performance requirements, including structural reforms. The facility has longer repayment periods than other facilities, four-and-one-half to 10 years, to allow time for reforms to take effect. The expected repayment period may be shortened to four-and-one-half to seven years if the country's external position allows it to repay earlier. An example of a country that has used this facility in recent years is Albania, which undertook an EFF arrangement in 2006.

1.9.5 Rapid Financing Instrument

The IMF has for many years provided emergency financial assistance to member countries facing balance-of-payments difficulties. Initially these facilities were provided for countries experiencing natural disasters. In 1995, the IMF policy on emergency assistance was expanded to cover countries in post-conflict situations. And in 2011 the policy was broadened further, with a new facility – the Rapid Financing Instrument (RFI) – established to provide support to address several types of urgent need including those arising from commodity price shocks, natural disasters, conflict and post-conflict situations, and emergencies resulting from fragility. Countries requesting FRI assistance must cooperate with the IMF to make efforts to solve their balance-of-payment difficulties and to describe the general economic policies they propose to follow. They can access the RFI without the need for a full-fledged programme or reviews. Financial assistance is provided subject to the same financing terms as the SBA, FCL and PPL arrangements and the RFI is expected to be repaid within three and one-quarter to five years. While these facilities are not provided on a concessional financing basis, the RFI is in fact similar to the Rapid Credit Facility (RCF), which is provided to the IMF's low-income country members, and in practice these countries are more likely to utilise the RCF, which is provided on concessional terms.

Since the RFI was established, two countries – Iraq and St. Vincent and the Grenadines – have used the facility.

1.9.6 Concessional lending

In addition to its non-concessional lending, the IMF also provides concessional or low-interest loans to low-income member countries. Until January 2010, these concessional facilities were provided through the Poverty Reduction and Growth Facility (PRGF) and the Exogenous Shocks Facility (*ESF*). From January 2010, however, these facilities have been modernised and strengthened, to address the needs of the IMF's low-income country members for short-term and emergency support in the context of the current global financial crisis. The PRGF arrangements has been replaced by the Extended Credit Facility (ECF), which provides medium-term support to low-income countries. A new Standby Credit Facility (SCF) has been introduced to address low-income countries' short-term and precautionary needs. The SCF replaces the former ESF. Finally, a new facility, the Rapid Credit Facility (RCF), has been created to provide for urgent financing needs with limited conditionality.

The IMF also provides grants to qualifying members under the Initiative for Heavily Indebted Poor Countries (HIPCs) and the Multilateral Debt Relief Initiative (MDRI), to help reduce external debt burdens. You will examine these facilities in greater detail in Unit 7, when you consider more closely the work of the IMF on stabilisation in low-income countries.

Reading 1.4

IMF (nd) *About the IMF.* 'Lending by the IMF' on the IMF website.

Now visit the *About the IMF* section of the IMF website and study the article, 'Lending', for an account of how lending is arranged and provided. This article also touches on the issue of 'conditionality', which is discussed in the section below.

Your notes should cover the main issues raised in this section of the unit.

1.10 Types of IMF Conditionality

You have seen that the IMF adopts a particular approach to stabilisation policy. But how is this approach actually applied? In practice, the IMF applies its approach to stabilisation policy by attaching conditions to the use of its financing facilities. Consequently, member countries that apply for and accept IMF financing are obliged to fulfil these conditions. This approach is known as the IMF's 'conditionality' policy. In this section, you will consider two sets of issues pertaining to conditionality. Firstly, in which specific ways does the IMF apply its conditionality policy? And secondly, how stringently is conditionality applied?

1.10.1 Instruments of IMF conditionality

Conditionality is applied in four key ways in Fund-supported financing programmes:

- Performance Criteria (PCs)
- Programme Reviews
- Prior Actions (PAs)
- Structural Benchmarks (SBs).

Performance Criteria

The most basic monitoring tool comprises Performance Criteria (PCs). PCs are conditions that are formally specified in the country's financing arrangement with the IMF. These are set when the arrangement commences. At that time, the country receives a first tranche, or disbursement, of financial resources, with the remaining disbursements made conditional on the fulfilment of a variety of conditions, including PCs.

PCs are the strongest form of conditionality, and they must be observed if the country is to be allowed to obtain the next tranche of financing. Where PCs are not achieved as stipulated in the relevant IMF arrangement, this constitutes a serious breach of the arrangement. In many cases, the programme can be suspended, unless the IMF Executive Board grants the country a waiver of the relevant performance criterion. Applications for waivers are considered during the periodic Executive Board reviews of the country's financing arrangement. Waivers can be granted by the Executive Board in instances where the non-observance of the conditionality is minor or temporary, or where the member is shown to be prepared to take corrective action.

IMF arrangements include various PCs. These are known as *quantitative* performance criteria, as they described in precise quantitative terms: examples include:

- setting a floor or minimum level of net international reserves
- limiting the size of a member's budget deficit, usually by setting a ceiling or maximum on the level of net domestic credit extension to the government by the banking sector

- setting a maximum level of non-concessional external borrowing permissible in terms of the financing arrangement.

Quantitative PCs are specified on actions or measures that can be monitored by staff and are subject to the control of the authorities. These criteria are derived directly from the financial programming model that the IMF uses to derive quantitative assessments of the various measures in the financial programme. In Unit 2, you will see more clearly which types of PCs are most often used in IMF financial programmes, and why these PCs are important to the IMF's approach to stabilisation.

Indicative targets

Often quantitative performance criteria are supplemented with indicative targets, which are usually included in the later stages of a programme. Indicative targets are appropriate where a PC would normally be used, but cannot be established due to uncertainty about economic trends. Indicative Targets do not require a Board waiver if they are not met.

Programme Reviews

Another major tool of conditionality is the Programme Review. These represent the formal condition that all financial programmes with the IMF must be reviewed at set intervals. After the initial financial disbursement is made, subsequent tranches are conditional on the successful completion of a Programme Review and endorsement by the Executive Board.

In 1979, the IMF Executive Board developed guidelines for the staff members of the IMF. These guidelines were intended to assist IMF staff during their missions to member countries by illustrating in what circumstances certain types of conditionalities would be appropriate. The 1979 Conditionality Guidelines envisaged that the Programme Reviews would be used for the purpose of setting PCs in cases where it was impossible to set them sufficiently far ahead at the outset of the programme, and in cases where an essential feature of a programme could not be formulated as a PC at the beginning of a programme year because of substantial uncertainty regarding major economic trends.

The main advantage of the Programme Review is that it provides an opportunity to update the information on which both the IMF and the recipient country rely when assessing the progress of the programme. Programme Reviews enable both the IMF and the member country to modify a programme as it progresses. Programme Reviews are also used to establish conditions for future drawings, and to assess progress toward structural policy objectives that may take time to come to fruition. For that reason, they have become more prevalent with the growing structural content of Fund-supported programmes.

Prior Actions

Prior Actions (PAs) are additional tools of IMF conditionality that affect the country's access to the Fund's resources. PAs are steps that the authorities agree to take before a Board decision on the use of Fund's resources. The use of PAs has expanded considerably in recent years. In some cases, they are viewed as a way of signalling the authorities' commitment to the programme. In general, PAs are negotiated between the authorities and the staff but they are not specified in advance and only affect the Board decision on the programme after they have been implemented.

PAs generally comprise structural measures, which tend to be relied on where the member country's past track record is poor. PAs were previously not considered a formal conditionality, but have recently become a much more integral part of formal IMF conditionality.

Structural Benchmarks

A further major method of applying IMF conditionality is through Structural Benchmarks (SBs). These have become increasingly prevalent since their introduction in the context of IMF structural adjustment programmes in the 1980s. They have also subsequently been adopted in the more recent IMF programmes in low-income countries.

Because the key structural reforms take considerable time to implement, SBs map out a series of steps towards a desired policy outcome, such as central bank independence or a broader tax base. Measures that start out as structural benchmarks, or merely measures listed in a matrix, may become performance criteria or prior actions for subsequent reviews; other measures may be downgraded or dropped from the programme. Such shifts often reflect the changing economic situation as well as the experience with programme implementation, which may alter the priority attached by the IMF to different measures.

1.10.2 The importance of fulfilling IMF conditionality

If these are the major tools through which IMF conditionality is applied, how stringently are these conditions applied? In practice, the IMF attaches significant weight to the application of its conditions. For each of the various types of financing arrangement, the IMF provides its financial support in tranches. Disbursements of each tranche hinge upon the fulfilment of the conditions that were set at the point of disbursement of the previous tranche. When conditions are judged not to have been met, IMF staff inform the Executive Board.

The Executive Board is empowered to take one of two broad sets of decisions. Either it can refuse to complete the programme review, pending the completion of the specified conditions; or it can grant one or more waivers of conditions that have not been fulfilled. In practice, in each programme there are a host of conditions. And it is often the case that one or more conditions may not have been completely fulfilled at the time of a programme review. In the bulk of cases, the IMF Executive Board grants waivers, the review is completed and the overall financial arrangement moves to the next stage – the disbursement of a further tranche and the imposition of a further set of conditions.

In some cases, however, where there have been fundamental breaches of conditions, or substantial non-achievement of conditions, the Executive Board decides not to proceed with the review. In such instances, financing programmes are stalled. In IMF language, these programmes 'go off-track'. Sometimes, corrective action by the country authorities results in the programme coming back on-track and proceeding. In some cases, however, programmes remain off-track for long periods of time. Often in these cases, it is decided to abandon the original programme and, when appropriate, to commence a new programme.

For countries seeking to stabilise their economies, this can represent a very difficult set of circumstances. For once the IMF indicates that its programme with a member country has gone off-track, other multilateral and bilateral creditors, including private-sector creditors, invariably also decide to cease new lending and in some instances call for early repayment of their loans to the country. You will see later in this module, in Units 4 and 5, that these decisions can in turn precipitate a serious outflow of capital, causing further adverse consequences for the economy. For these reasons, member countries that have taken IMF financing facilities typically ensure that they are fully compliant with the conditionalities they accepted at the start of the programme.

1.10.3 Reform of IMF conditionality policies

IMF conditionality policy has undergone continuous change in the past three decades. A particularly important review of conditionality took place in 2000, leading to revised guidelines, which were implemented in 2002. In 2007, the IMF's Independent Evaluation Office conducted an assessment of structural conditionality, which found that several structural conditions were not critical for achieving programme goals.

In March 2009, a new conditionality framework was adopted, creating greater flexibility and streamlining, and focusing IMF conditionality more closely on core areas of Fund expertise than previously. In addition, all structural performance criteria have been discontinued, in all IMF arrangements, including those for low-income countries; and all structural reforms are monitored in the context of programme reviews. In addition, conditionality in the new FCL arrangements is applied using pre-set qualification criteria.

1.11 Conclusion

We hope that this unit's introduction to the structure, functions and history of the International Monetary Fund has given you new insights into the institution that looms so large in discussions of economic policy. Now that you have studied the unit it would be useful for you to check your understanding. What answers can you give to the key questions posed at the beginning? Have you been able to refine your answers as you studied the readings? Here they are again, to remind you:

- What is the mandate of the IMF?

- How is the IMF organised?
- How does a country go about arranging a financing facility with the IMF?
- What are the key financing facilities of the IMF?
- What is IMF conditionality and what types of conditions are applied in IMF financing arrangements?
- What are some of the key internal governance challenges in the IMF?

If you have had any difficulty in answering them, you might find it useful to return to the *About the IMF* section of the IMF website, and read the remaining articles.

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