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Empowering the IMF:

Should Reform be a Requirement for Increasing the Fund's Resources?

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Executive Summary

This paper briefly reviews the IMF's current practices and policy-making in the context of a proposed quadrupling of IMF resources to $1 trillion dollars, and a consequent increase in the Fund's influence over economic policy-making in developing countries.

In the last major set of economic crises of the 1990s, the Fund made serious mistakes that adversely affected the economies of Argentina, Indonesia, South Korea, Thailand, Russia, Brazil, and other countries. At the time, these mistakes drew widespread criticism, including from prominent economists such as Nobel Laureate Joseph Stiglitz and Columbia University's Jeffrey Sachs.

In those crises the Fund failed to act as a lender of last resort, when it was most urgently needed in Asia, as countries such as South Korea, Indonesia, Thailand, the Philippines, and Malaysia fell victim to a severe shortage of foreign exchange. It then imposed procyclical policies and in some cases, such as South Korea, set unrealistic inflation targets that would be impossible to achieve, given the currency depreciation, without a severe economic contraction. The IMF's own Independent Evaluation Office later conceded that "[I]n Indonesia… the depth of the collapse makes it difficult to argue that things would have been worse without the IMF…" [1]

In Argentina, the Fund lent tens of billions of dollars to support an overvalued exchange rate that inevitably collapsed, while attempting to adjust the economy to this unsustainable exchange rate through contractionary macroeconomic policies. When the inevitable sovereign debt default and exchange rate collapse occurred at the end of 2001, the Fund again failed to act as a lender of last resort. Instead, it (together with the World Bank) drained a net 4 percent of GDP out of the country in 2002, while pressuring Argentina to pay more to its foreign creditors, and opposing some of the most important economic policies that facilitated Argentina's recovery and ensuing six-years of rapid economic growth.

This paper finds that the IMF is still prescribing inappropriate policies that could unnecessarily exacerbate economic downturns in a number of countries. In El Salvador, for example, the country has signed an agreement that precludes the use of expansionary fiscal policy. This is especially problematic because the country cannot use exchange rate policy and is very limited in monetary policy since it has adopted the dollar as its currency. The IMF agreement thus cuts off practically the only policy tool for a country that is heavily dependent on a contracting U.S. economy – El Salvador gets remittances amounting to 18 percent of GDP from the United States and exports about 9.6 percent of GDP there.

In Pakistan, the IMF agreement signed last December provides for tightening both fiscal and monetary policy, including a sharp reduction in the fiscal deficit from 7.4 percent of GDP last year to 4.2 percent of GDP for the current fiscal year. It is questionable whether such policies are necessary, especially given that the country's current account deficit has largely disappeared, and inflation has fallen considerably since last October. Furthermore, the

[1] IMF Independent Evaluation Office. (2003). "The IMF and Recent Capital Account Crisis: Indonesia, Korea, Brazil," p. 38. Washington, D.C: International Monetary Fund. Accessed online on April 20, 2009 <http://www.ieo-imf.org/eval/complete/pdf/07282003/main.pdf>

country is facing a number of external shocks, including declining exports and capital inflows.

The Fund has also prescribed fiscal tightening for Ukraine, where GDP is now projected to decline by 9 percent in 2009. The IMF Standby Arrangement approved in October 2008 provided for a zero fiscal balance. At the time, the country was undergoing a number of severe negative external shocks: the price of Ukraine's steel exports, which amount to 15 percent of GDP, had fallen by 65 percent; Russia had decided to phase out natural gas subsidies, implying a price increase of up to 80 percent in gas imports, which amounts to 6 percent of GDP; and a slowdown in capital inflows due to the international financial crisis. It was also suffering from liquidity strains and falling confidence in the banking system. Given these conditions, and the fact that Ukraine's gross public debt is a very low 10.6 percent of GDP, the agreed upon fiscal tightening would appear to be inappropriate.

Hungary, Georgia, Latvia, Serbia, and Belarus all have signed IMF agreements that provide for fiscal tightening that could unnecessarily exacerbate these countries' economic downturns.

The Fund may also have contributed to the vulnerability of countries in the current crisis, as it did in the run-up to the Asian crisis a decade ago. For example, the Fund has supported the liberalization of capital flows, as well as inflation targeting. Central banks that have targeted a specific inflation rate tend to let the currency appreciate, which encourages the private sector to borrow in foreign currency. This foreign borrowing has made many countries more vulnerable to the current crisis, because households and firms are hit especially hard when the currency depreciates. This also limits the ability of countries to ameliorate the crisis by allowing the currency to depreciate. The IMF has also generally opposed capital controls, which can help governments stem the loss of reserves, currency crashes, and other problems associated with large capital outflows. This cuts off an important policy tool and makes governments more dependent on tightening fiscal and monetary policy to resolve balance of payments difficulties.

The main purpose of having international institutions to provide hard currency lending, especially in a time of world recession, is to allow countries that would otherwise be prevented by balance of payments problems from pursuing expansionary (counter-cyclical) policies to do so. China, for example, is able to implement one of the largest stimulus packages in the world because it has $1.95 trillion in reserves. The resources of the IMF should be used to allow and encourage counter-cyclical policies wherever possible, not procyclical policies.

The IMF's current lending practices have implications for the immediate future of the affected countries, because procyclical policies can exacerbate the world economic downturn. But more importantly, the proposed quadrupling of IMF resources will have implications for many years to come, even after the world economy recovers. Although the new resources are unlikely to reverse the trend of governments avoiding, whenever possible, the Fund's lending and influence, they will help to re-establish an unreformed IMF as a major power in economic and decision-making in low-and-middle income countries, with little or no voice for these countries in the IMF's decision-making. This could have long-term implications for growth, development, and social indicators in many countries.

Governments that are contributing to this increase in funding should think carefully about these implications and the possibilities of making such increases contingent on serious reforms of the IMF – especially in the areas of governance and accountability.

Introduction

At the last meeting of the G-20 in London on April 2, 2009, an agreement was reached to increase the resources of the International Monetary Fund by up to $750 billion (USD), for a total that could reach $1 trillion.

Much of the increase in funding for the IMF still has to be approved by the governments of the contributing countries.

The assumption was that the increase in resources for the Fund would allow it to help low- and middle-income countries that face severe problems during the current economic crisis. Certainly there are many such countries that are in need of assistance as the world recession continues to deepen. However, this was also true during the last major economic crisis of 1997-1999, which began in Asia and spread to Russia, Brazil, Argentina, and numerous other countries.

During that time and for some years afterwards, the IMF was widely criticized for having prescribed inappropriate and even procyclical macroeconomic policies that worsened the economic situation in countries that borrowed from the Fund. Among the critics were prominent economists. Jeffrey Sachs, currently Director of the Earth Institute at Columbia University, called the IMF "the Typhoid Mary of emerging markets, spreading recessions in country after country."[2] Nobel Laureate economist Joseph Stiglitz, who was then Chief Economist at the World Bank, also criticized the Fund for its mishandling of the Asian crisis, and went on to write systematic critiques of a number of IMF policies: for an unrealistic "market fundamentalism," for maintaining overvalued exchange rates for the benefit of foreign investors, for "pursuing policies that are in the interests of creditors," and other errors of analysis and judgment.[3]

Such errors were clear in the Fund's handling of the crises of the 1990s. [4] The Fund failed to act as a lender of last resort, when it was most urgently needed in Asia, as countries such as South Korea, Indonesia, Thailand, the Philippines, and Malaysia fell victim to a severe shortage of foreign exchange. It then imposed procyclical policies and in some cases, such as South Korea, set unrealistic inflation targets that would be impossible to achieve, given the currency depreciation, without a severe economic contraction. In Indonesia the IMF also failed to arrange a rollover of the short-term foreign debt owed by Indonesian non-financial firms. Indonesia was thus unable to stabilize its currency and economy, and firms could not obtain the necessary credits for essential imports and even exports. The IMF's own Independent Evaluation Office later conceded that "[I]n Indonesia… the depth of the collapse makes it difficult to argue that things would have been worse without the IMF…"[5]

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[2] Sachs, Jeffrey. "Rule of the Ruble." *The New York Times*. June 4, 1998.

[3] Stiglitz, Joseph. (2003). "Globalization and its Discontents." New York: W.W. Norton & Company Inc.

[4] For a review of these policy failures and their impact on the IMF and its relations with borrowing countries, see Weisbrot, Mark. (2007). "Ten Years After: The Lasting Impact of the Asian Financial Crisis," in *Ten Years After: Revisiting the Asian Financial Crisis*. Washington DC: Woodrow Wilson Center for International Scholars. p 105-118.

[5] IMF Independent Evaluation Office. (2003). "The IMF and Recent Capital Account Crisis: Indonesia, Korea, Brazil," p. 38. Washington, DC: International Monetary Fund. Accessed online on April 20, 2009 <http://www.ieo-imf.org/eval/complete/pdf/07282003/main.pdf>

In Argentina, the Fund lent tens of billions of dollars to support an overvalued exchange rate that inevitably collapsed, while attempting to adjust the economy to this unsustainable exchange rate through contractionary macroeconomic policies. When the inevitable sovereign debt default and exchange rate collapse occurred at the end of 2001, the Fund again failed to act as a lender of last resort. Instead, it (together with the World Bank) drained a net 4 percent of GDP out of the country in 2002, while pressuring Argentina to pay more to its foreign creditors, and opposing some of the most important economic policies that facilitated Argentina's recovery and ensuing six-years of rapid economic growth.[6]

Partly as a result of these experiences, many middle-income countries "self-insured" and piled up reserves that would enable them to avoid any need to borrow from the IMF. From 2003-2007, the Fund's loan portfolio practically disappeared, shrinking from $105 billion to less than $10 billion. Just two countries, Turkey and Pakistan, owed most of the $10 billion. This collapse in lending was partly due to the relative growth and stability in the world economy during this period, and the lack of major financial crises – as the Fund has argued. But there is no doubt that it is also due to the fact that governments actively sought to avoid the IMF's influence, in some cases even paying off large amounts of outstanding debt (Brazil $15 billion, Argentina $9.8 billion)[7] in order to clear their books with the IMF entirely.

The IMF has occasionally, although very rarely, acknowledged having made policy mistakes. In April 2007 the IMF's Independent Evaluation Office released a report that examined the experience of 29 Sub-Saharan African countries that underwent Poverty Reduction and Growth Facility (PRGF) programs, and were therefore subject to IMF conditions, from 1999-2005. The report was highly critical of the IMF's role, and among other findings noted that nearly three-quarters of the aid money reaching these countries was not spent. Rather, at the IMF's urging, this money was used to pay off debt and to add to reserves.[8]

But the Fund has not taken any institutional measures to hold anyone accountable for results that were in some cases economically disastrous -- e.g. Russia, Argentina, and Indonesia. As Stiglitz has noted: "It has never asked why the mistakes had occurred, what was wrong with the models, or what could be done to prevent a recurrence . . ."[9]

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[6] See, Weisbrot, Mark and Luis Sandoval. (2007). "Argentina's Economic Recovery: Policy Choices and Implications." Washington, DC: Center for Economic and Policy Research. Accessed online on April 20, 2009 http://www.cepr.net/index.php/publications/reports/argentina-s-economic-recovery-policy-choices-and-implications/; Frenkel, Roberto and Martín Rapetti. (2007). "Argentina's Monetary and Exchange Rate Policies after the Convertibility Regime Collapse." Washington, DC: Center for Economic and Policy Research. Accessed online on April 20, 2009 < http://www.cepr.net/index.php/publications/reports/argentinas-monetary-and-exchange-rate-policies-after-the-convertibility-regime-collapse/>; Cibils, Alan, Mark Weisbrot and Debayani Kar. (2003). "Argentina Since Default: the IMF and the Depression." Washington, DC: Center for Economic and Policy Research. Accessed online on April 20, 2009 <http://www.cepr.net/index.php/publications/reports/argentina-since-default-the-imf-and-the-depression/>.

[7] "Argentina announces early payment of IMF debt." Associated Press. December 15, 2005. Accessed online on April 21, 2009 < http://www.laht.com/article.asp?CategoryId=14093&ArticleId=209037>.

[8] IMF Independent Evaluation Office. (2007) "An Evaluation of The IMF and Aid to Sub-Saharan Africa." Washington, DC: International Monetary Fund. Accessed online on April 20, 2009 < http://www.ieo-imf.org/eval/complete/pdf/03122007/report.pdf>

[9] Stiglitz, Joseph. (2003). "Globalization and its Discontents," p. 230. New York: W.W. Norton & Company Inc.,

The Fund has made some changes with regard to some of the conditions attached to its lending. In response to the criticisms of the Meltzer Commission, established by the U.S. Congress to examine the lending of the IMF and World Bank in the wake of the late 90s failures, the IMF reduced the number of structural conditions attached to its lending. (These are conditions such as privatizations, pension or labor market reforms that were often unpopular because of their adverse impacts on lower and middle-income wage earners).

The Fund has recently committed to eliminating "structural performance criteria" in future loans starting on May 1. However IMF statements made it clear that this does not mean that the Fund will stop negotiating structural reforms in its agreements.

In October 2008, the IMF announced a new lending option, the Short-Term Liquidity Facility (SLF) that would not carry any conditions for the borrowing country. While there were no conditions attached to this type of loan, the IMF did require *pre*-conditions. Eligible countries had to have "track records of sound policies, access to capital markets and sustainable debt burdens".[10] On the policy side, eligible countries were expected to have strong fiscal positions, low and stable inflation, sustainable current account balances and a strong international reserves position. But there were no takers for these loans.

The Fund then introduced another facility in March, the Flexible Credit Line (FCL), similar to the SLF but with longer repayment terms and the ability to tap the funding as needed.

But the institution has not been reformed, and the question remains whether it can be expected, in this current crisis, to pursue appropriate macroeconomic policies in its lending; or whether it is necessary to insist upon reforms as a condition of any new infusion of funds. This paper will examine this question in light of the Fund's recent activities and in the context of the global economic recession.

[10] IMF External Relations Department. "Press Release: IMF Creates Short-Term Liquidity Facility for Market-Access Countries." October 29, 2008. Accessed online on April 20, 2009 <http://www.imf.org/external/np/sec/pr/2008/pr08262.htm> See also, "A New Facility for Market Access Countries – The Short-Term Liquidity Facility – Proposed Decision." IMF Proposed Decision. October 27, 2008. Accessed online on April 20, 2009 <http://www.imf.org/external/np/pp/eng/2008/102708.pdf >

Balance of Payments Support During a Recession

It is important to recognize that the main purpose of providing balance of payments support to a developing country in a time of recession or approaching recession is to enable the government to pursue the expansionary fiscal and monetary policies necessary to stabilize the economy. The United States, for example, is countering the current recession with policy interest rates lowered to zero, quantitative easing (including the financing of some $1.7 trillion of debt through the creation of money), and an expansionary fiscal policy involving a proposed budget deficit of 13.1 percent of GDP for 2009[11] – more than double the size of any deficit in the post-World-War II era.

The main reason that many low- and middle-income countries cannot pursue similar policies is that they can run into balance of payments difficulties and foreign exchange constraints. To illustrate by counter-example, China has accumulated $1.9 trillion in foreign exchange reserves. As a result, it is in a situation that is similar to that of the United States, in that it can spend as much as it chooses in order to stimulate the economy, and also pursue an expansionary monetary policy, without worrying about foreign exchange constraints.

A country that is running a current account deficit and – due to the crisis – is no longer receiving enough foreign capital inflows in order to finance such a deficit, is in a very different situation.

Any increase in growth relative to the baseline will tend to worsen a country's balance of trade and therefore current account balance. This is because imports will tend to grow faster than exports. Also, if investors see fiscal or monetary policies that they think will lower the value of the domestic currency, this may promote further capital flight, which worsens the balance of payments problem. Also, if the domestic currency drops precipitously, this can cause balance sheet problems in countries where the private or public sector has borrowed heavily in foreign currency.

Thus, the purpose of providing balance of payments support, as is done through an institution such as the IMF, is preferably to allow the country to continue growing while gradually reducing its current account deficit to a sustainable level. Indeed, at a time like this, when the world economy is actually projected to shrink by 2.75 percent, for the first time in 60 years, a strong argument could be made that balance of payments support should be provided without any procyclical policy changes for at least the next two years. In other words, we would not expect interest rate hikes, monetary tightening, spending cuts or tax increases during this time.

Of course, a country can reduce its current account deficit by reducing its growth and therefore reducing imports. A severe recession can improve the trade balance rather quickly, as happened in Argentina from 1998-2002. A country can also sometimes attract more foreign capital through higher interest rates, which also slows the economy. But these measures should be avoided in a time of national and world recession. The main purpose of

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[11] Congressional Budget Office. "A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook." March 20, 2009. Accessed online on April 20, 2009 <http://cbo.gov/doc.cfm?index=10014>

providing hard currency to countries in a time of falling aggregate demand should be to enable them to pursue expansionary rather than procyclical policies.

There may be an argument that in some cases, a country is on a path that is so wildly unsustainable – either in its balance of payments or its public borrowing – that adjustment must begin immediately, even in the midst of a steep downturn. But even in such a case the purpose of external assistance should be to ease the adjustment process.

Procyclical Macroeconomic Policies

In recent months, the IMF has repeatedly emphasized the need for counter-cyclical macroeconomic policies in order to prevent the world recession from deepening and to speed recovery. A recent IMF staff paper reads: "The International Monetary Fund has called for fiscal stimulus in as many countries as possible, including emerging market and advanced economies."[12] However, IMF Managing Director Dominique Strauss-Kahn has also stated: "Of course, not every country can undertake fiscal stimulus . . . Some will need to contract their budgets rather than expand them."[13]

If we look at the agreements that the IMF has negotiated since September of last year, we find that all of them contain procyclical policies.[14] For example, they all require countries to reduce their fiscal deficit, mostly through spending cuts. It is questionable in most or possibly all of these cases whether this is the appropriate policy in the face of serious contractions in private spending.

In one agreement - El Salvador's January 2009 Standby Arrangement - there is hardly any fiscal tightening. The target for the fiscal deficit is 2.8 percent for 2009, as compared with a 2.9 percent projected deficit for 2008. However, this is much worse than it seems. In 2001, El Salvador adopted the U.S. dollar as its national currency. It therefore cannot use exchange rate policy –i.e. depreciation – to stimulate its economy. On the contrary, the rush to the relative safety of the U.S. government-guaranteed financial system and the U.S. dollar over the last 12 months has caused the dollar to appreciate substantially against other currencies. The use of the U.S. dollar also eliminates most options with regard to counter-cyclical monetary policy.

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[12] Freedman, Charles et al. "The Case for Global Fiscal Stimulus," IMF Staff Position Note, SPN/09/03, March 6, 2009. Accessed online on April 20, 2009 <http://www.imf.org/external/pubs/ft/spn/2009/spn0903.pdf>

[13] Dominique Strauss-Kahn, Managing Director of the International Monetary Fund. Speech at the 44th SEACEN Governors' Conference in Kuala Lumpur, Malaysia. February 7, 2009. Accessed online on April 20, 2009 <http://www.imf.org/external/np/speeches/2009/020709.htm>

[14] For a summary of most of these agreements, see: Muchhala, Bhumika. (2009). "The IMF's Financial Crisis Loans: No change in conditionalities" Penang, Malaysia: Third World Network. Accessed online on April 20, 2009 <http://twnside.org.sg/title2/finance/2009/twninfofinance20090302.htm>

El Salvador receives remittances of about 18 percent of GDP from the United States. The rate of growth of these remittances began to fall in 2006. Since October, the monthly year-over-year growth in remittances has been continuously negative (See Table 1). It is worth noting that the 6.7 percent drop in remittances in the month of March amounts to a sizeable drop in income for the country, relative to a year ago, about 1.2 per cent of GDP.

TABLE 1
El Salvador: Monthly Inflow of Remittances

	Remittances	
	(US$ millions)	*(yoy, % change)*
	2007	
January	270.9	14.0
February	269.0	7.7
March	320.2	3.5
April	310.3	13.2
May	338.0	2.2
June	310.0	7.0
July	324.6	13.9
August	312.2	6.3
September	281.6	3.8
October	323.8	7.6
November	283.5	1.4
December	351.1	0.6
	2008	
January	275.5	1.7
February	298.3	10.9
March	338.4	5.7
April	338.5	9.1
May	353.4	4.6
June	334.4	7.9
July	332.1	2.3
August	305.7	-2.1
September	304.7	8.2
October	304.3	-6.0
November	264.8	-6.6
December	337.5	-3.9
	2009	
January	252.4	-8.4
February	275.1	-7.8
March	315.8	-6.7

Source: Banco Central de Reserva de El Salvador.

TABLE 2
El Salvador: Measures of Economic Activity
(year-over-year percent change)

Year and Quarter	Real GDP Growth	Index of Economic Activity	Industrial Production Index
2005-Q1	2.29	1.96	3.29
2005-Q2	2.97	5.39	4.24
2005-Q3	3.45	3.83	5.59
2005-Q4	3.61	6.22	7.49
2006-Q1	4.43	5.13	4.70
2006-Q2	4.25	5.93	3.02
2006-Q3	4.14	4.85	1.59
2006-Q4	3.92	5.55	1.47
2007-Q1	4.22	5.68	4.11
2007-Q2	4.61	4.92	5.07
2007-Q3	4.81	4.37	4.30
2007-Q4	4.95	6.12	3.38
2008-Q1	3.35	3.29	2.25
2008-Q2	2.92	4.98	0.99
2008-Q3	2.16	0.96	0.28
2008-Q4	1.79	-4.65	0.04
2009-Q1	…	-4.74[/1]	0.06[/2]

Source: Banco Central de Reserva de El Salvador.
Notes:
1/ Data refer to January 2009 only.
2/ Data refer to the January-February 2009 period only.

El Salvador also exports about 9.6 percent of GDP to the United States. The IMF also forecasts a sharp drop in foreign capital inflows, from 3.3 percent of GDP for 2008 to just 0.3 percent for this year. The most recent available figures from El Salvador's Central Bank show that economic activity decelerated in the last quarter of 2008 (see Table 2). Given El Salvador's large dependency on U.S. remittances and trade, further substantial shocks are likely as the U.S. recession continues throughout this year and possibly into the next year.

By restricting El Salvador from further government spending, the IMF Standby Arrangement is preventing the government from using practically its only remaining policy tool to counteract severe external shocks to its economy. This could worsen the country's downturn significantly beyond what it would be if expansionary fiscal policy were allowed.

The other countries that have signed IMF agreements during the last seven months have mostly agreed to much more fiscal tightening. For example, Pakistan's Standby Arrangement of October 2008 provides for a reduction of the fiscal deficit from 7.4 percent of GDP last year to 4.2 percent of GDP for the current fiscal year. (The fiscal year begins in July). While this might be a desirable goal, it is questionable whether this reduction should all be done this year, when the economy is suffering from a number of external shocks that are reducing private demand.

Pakistan's exports for the first quarter of this year (January-March) are down 16.8% per cent from the previous year, due to falling demand among Pakistan's main trading partners.

Foreign portfolio investment has collapsed over the last two years, from $3.3 billion in FY 2007 to negative $53 million and negative $957 million for the July-March period of the last two fiscal years, respectively.[15] [16]

Pakistan also depends significantly on remittances from workers abroad, for example in the Gulf Cooperation Council (GCC) states. In 2007/2008 these remittances were 4 percent of GDP. These remittances have held up so far (through February), but they can be expected to decline, as remittances worldwide are falling.

At the time this agreement was signed, there was every reason to believe that these negative demand shocks would get worse. To commit to a deficit reduction of this magnitude in the face of such conditions seems inappropriate.

The Standby Arrangement also states as one of its key elements that "Monetary policy will be tightened… The State Bank of Pakistan (SBP) recently increased its discount rate by 200 basis points to 15 percent and stands ready to further tighten monetary conditions, as needed . . ."[17] This will also tend to slow growth.

TABLE 3
Pakistan: Current Account Balance
(US$ millions, seasonally-adjusted data)

	Current Account Balance
	2008
July	-832
August	-1,353
September	-1,285
October	-2,579
November	-95
December	-426
	2009
January	-33
February	133

Source: State Bank of Pakistan.

Are these measures necessary? One argument on the IMF side would be that the contractionary fiscal policy is necessary to bring down the current account deficit, which shot up to 8.4 percent of GDP in FY 2008. However, in the current fiscal year (since July

[15] "Pakistan: Request for Stand-By Arrangement", p. 33. IMF Staff Report, No. 08/364, November 20, 2008, <http://www.imf.org/external/pubs/ft/scr/2008/cr08364.pdf>
[16] "Net Inflow of Foreign Investment in Pakistan, by Geographical Origin." State Bank of Pakistan, April 14, 2009. Accessed online on April 20, 2009 <http://www.sbp.org.pk/ecodata/Netinflow.pdf>
[17] "Pakistan: Request for Stand-By Arrangement", p. 6. IMF Staff Report, No. 08/364, November 20, 2008, <http://www.imf.org/external/pubs/ft/scr/2008/cr08364.pdf>

2008), this deficit has already disappeared (see Table 3). A large part of the prior increase in the current account deficit, probably about a third, was due to oil prices, which peaked in July of 2008; the collapse of oil prices since then eliminated a big part of the current account deficit. A large reduction in other imports – which so far have declined much faster than exports – got rid of most of the rest of the deficit.

Thus, although the current account deficit was sizeable at the time of this agreement, it appears to have been rapidly reducible. Also, in May of 2008, because of balance of payments problems, the government of Pakistan adopted a number of foreign exchange and import measures, which probably contributed to the elimination of the current account deficit, including the reduction on the import side.[18]

It is worth noting that this agreement provides for Pakistan to get rid of one of the recently proposed exchange controls: the limit of 25% percent for advance payments on imports. This raises another question about IMF policy choices in this agreement, as well as a more general problem with the Fund's policy choices. The IMF has had a long-standing opposition to capital controls. In the case of Pakistan's current account deficit, it might make sense to rely more on foreign exchange controls to reduce the current account deficit, rather than reducing imports by bringing down aggregate demand and therefore output and employment. But the Fund appears to favor the latter option. The tightening of monetary policy is also relevant here: according to the Fund, this is necessary partly to restore investor confidence and reduce capital flight. But capital controls could also contribute to a solution to this problem. Thus, the Fund's preferences may cause it to reject viable options that would allow for higher growth, more employment, and lower poverty rates.

The other rationale for tightening fiscal and monetary policy in Pakistan, despite an economic slowdown, is to reduce inflation. Consumer price inflation averaged 7.8 percent for the 2007 fiscal year but shot up to an annual rate of 25 percent in October 2008, with core inflation at 18 percent. The idea is that this inflation posed a serious enough threat to justify the contractionary policies even in the face of falling aggregate demand. But here, too, the IMF's fears may have been exaggerated. Table 4 shows annual, monthly, and year-over-year consumer price inflation in Pakistan. As can be seen from the year-over-year figures, inflation has fallen from 25.3 percent in August to 19.1 percent in March. It is possible that measures taken in accordance with the IMF agreement since October contributed to the fall in inflation, but it is more likely that the collapse of commodity prices, as well as deflationary pressures both domestically and worldwide contributed to the decline. This indicates that the Fund was too willing to sacrifice output and employment in order to bring down inflation.

[18] According to the IMF, these measures included "(i) a 25 percent limit on advance payments for imports of goods (an exchange restriction subject to Fund approval under Article VIII, Section 2(a)); (ii) the requirement for exchange bureaus to repatriate foreign exchange from their accounts abroad and to sell 25 percent of any foreign exchange receipts in the interbank market; (iii) prior SBP consent for outward remittances of more than $50,000 upon verification of the bona fide nature of the payment; and (iv) a margin requirement of 35 percent for the opening of letters of credit for non-essential imports. With regard to this latter measure, which was introduced at a later date, staff is obtaining additional information from the authorities in order to assess its jurisdictional implications. In addition, the government recently imposed regulatory duties on imports of luxury items."

TABLE 4
Pakistan: General Inflation Rates
(percent changes)

	Annual		Year-over-year	Monthly
2000	3.6		**2008**	
2001	4.4	**March**	14.1	3.1
2002	3.5	**April**	17.2	3.0
2003	3.1	**May**	19.3	2.7
2004	4.6	**June**	21.5	2.1
2005	9.3	**July**	24.3	3.3
2006	7.9	**August**	25.3	2.1
2007	7.8	**September**	23.9	1.0
2008	12.0	**October**	25.0	2.1
		November	24.7	-0.1
			2009	
		December	23.3	-0.5
		January	20.5	-0.4
		February	21.1	1.0
		March	19.1	1.4

Source: State Bank of Pakistan.

In a measure which has not been common in IMF Standby Arrangements, the agreement provides for an increase in spending on the social safety net, in recognition that the contractionary macroeconomic policies in the agreement could have adverse impacts on the poor. However, the amount of spending committed is very small – just 0.3 percent of GDP. It is not clear that this would keep poverty from rising, given the pressures on employment and output that follow from the agreed-upon macroeconomic policies, as well as the cuts in energy subsidies that are included in the agreement.

The Fund has also prescribed fiscal tightening for Ukraine, where GDP is now projected to decline by 9 percent in 2009. The IMF Standby Arrangement approved in October 2008 provided for a zero fiscal balance. At the time, the country was undergoing a number of severe negative external shocks: the price of the Ukraine's steel exports, which amount to 15 percent of GDP, had fallen by 65 percent; Russia had decided to phase out natural gas subsidies, implying a price increase of up to 80 percent in gas imports, which amounts to 6 percent of GDP; and a slowdown in capital inflows due to the international financial crisis. It was also suffering from liquidity strains and falling confidence in the banking system. Given these conditions, and the fact that Ukraine's gross public debt is a very low 10.6 percent of GDP, the agreed upon fiscal tightening would appear to be inappropriate.

The IMF's fiscal target of a balanced budget proved to be politically unrealistic in Ukraine. In early 2009, the IMF suspended the second disbursement of the loan after failing to reach an agreement with the Ukrainian authorities over a budget deficit. Most recently, on April 17, an agreement was reached on a deficit of 4 percent of GDP. But it is important to emphasize that this revision was made only after a struggle with the Fund and the refusal of Ukraine's parliament to accept Fund conditions (they were approved unilaterally by the

executive).[19] The IMF Standby Arrangement for Ukraine also prescribes monetary tightening, and that foreign exchange controls be eliminated as soon as possible. These latter policies are also questionable in Ukraine's situation. There has been considerable pressure on the domestic currency, which had depreciated by about 25 percent in the months before the agreement. This causes special problems for Ukraine because of a high level of private borrowing in foreign currency. At the same time, Ukraine was running a current account deficit of 6.2 percent of GDP and depleting reserves trying to defend the currency. In this situation, foreign exchange controls may be a more sensible means of ameliorating the current account and balance of payments problems, rather than relying solely on fiscal and monetary tightening, which exacerbate the recession.

Hungary, Georgia, Latvia, Serbia, and Belarus all have signed IMF agreements that provide for fiscal tightening that could unnecessarily exacerbate these countries' economic downturns.[20]

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[19] Olearchyk, Roman. "IMF set to unlock loan to Ukraine." *Financial Times*. April 18, 2009. Accessed online on April 20, 2009 <http://www.ft.com/cms/s/0/4ba2eaec-2bb1-11de-b806-00144feabdc0.html>

[20] "Hungary: Request for Stand-By Arrangement", IMF Staff Report, No. 08/361, November 17, 2008, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=22493.0>;
"Georgia: Request for Stand-By Arrangement", IMF Staff Report, No. 08/328, October 6, 2008, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=22403.0>;
"Republic of Latvia: Request for Stand-By Arrangement". IMF Staff Report, No. 09/3, January 9, 2009, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=22586.0>;
"Republic of Serbia: Request for Stand-By Arrangement", IMF Staff Report, No. 09/20, January 23, 2009, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=22640.0>;
"Republic of Belarus: Request for Stand-By Arrangement", IMF Staff Report, No. 09/109, April 3, 2009, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=22853.0>.

TABLE 5
Current account deficit as a percent of GDP and fiscal stimulus plans

Latin America and the Caribbean: Countries with current account deficit between 5 and 22 percent of GDP in 2008, AND fiscal stimulus+ social policies

Country	2006	2007	2008[1]	Fiscal stimulus[2]	Employment and social policies[3]
Bahamas	-25.0	-21.9	-15.1	x	
Barbados	-8.7	-7.2	-9.9		
Costa Rica	-4.9	-5.8	-7.8	x	x
Dominican Republic	-3.6	-5.4	-13.5		
El Salvador	-3.6	-5.5	-6.1	x	x
Guatemala	-5.0	-5.0	-5.8	x	x
Guyana	-19.4	-18.2	-22.2	x	
Honduras	-4.7	-10.0	-13.9	x	x
Jamaica	-11.7	-16.4	-16.0	x	x
Nicaragua	-13.6	-18.3	-23.9	x	x
Panama	-3.2	-8.0	-11.7	x	

1/ Projections
2/ Includes tax cuts or increased subsidies, and or spending increased or brought forward
3/ Promotion of job creation and or social programs

Source: Data from "The reactions of Latin American and Caribbean governments to the international crisis: an overview of policy measures up to 20 February 2009," Economic Commission for Latin America and the Caribbean, United Nations, Chile, February 2009; and from the International Monetary Fund's World Economic Outlook Database, October 2008.

It is worth noting that a recent survey from the United Nations ECLAC[21] shows about half the economies in Latin America and the Caribbean using some form of fiscal measure to stimulate economic activity in 2008 or 2009; the specific measures take the form of tax cuts or government spending. Table 5 lists eleven countries in the same study with a current account deficit between 5 and 22 percent of GDP in 2007. In nine out of eleven cases, the survey found the use of fiscal stimulus, while six cases (within this group) report the use of employment and social policies.

Thus, expansionary fiscal policy is being used to stimulate economic activity (or to prevent activity from shrinking) in various countries that do not have IMF agreements, even where there are signficant current account deficits. As noted above, the purpose of external assistance in recessionary conditions should be to enable these counter-cyclical policies, not just to protect the balance of payments or reduce inflation.

[21] Economic Commission for Latin America and the Caribbean. (2009). "The Reactions of Latin American and Caribbean Governments to the International Crisis: An Overview of Policy Measures up to 20 February 2009." Chile: United Nations.

Macroeconomic Policy Traps

One of the criticisms of the IMF during the Asian crisis was that it not only mishandled the crisis but that it also - together with its main overseer, the U.S. Treasury - played a major role in causing the crisis by supporting a number of deregulatory measures that removed restrictions on capital flows and encouraged foreign borrowing.[22] Similar policies, as well as others supported by the Fund, may have contributed to the vulnerabilities of emerging market and developing countries in the current crisis.

For example, among the countries with recent IMF agreements Iceland, Latvia, and Hungary face one common difficulty: their private sector's foreign debt is huge. This means that they are especially vulnerable to currency depreciation, because it causes both households and firms to face a serious deterioration of their balance sheets. This limits or precludes the use of currency depreciation as an adjustment to external shocks and fall-off in demand.

Iceland and Hungary have had inflation targeting regimes since 2001. Ukraine did not adopt inflation targeting, but has committed, in a letter of intent to the IMF, to gradually move their monetary regime to one based on inflation targeting and flexible exchange rates. Latvia operates under a quasi-currency board system that has emphasized the maintenance of the currency peg; the system has been in operation for the last 15 years, and is seen as an important instrument to eventually enter the Euro zone.

But inflation-targeting regimes (and also currency boards) are designed to turn the fight against inflation into the overwhelming priority of the monetary authorities. Under inflation-targeting regimes, central banks raise interest rates to target a specific rate of inflation; but in so doing, they also attract capital inflows which tend to cause an appreciation of the currency. The latter encourages the accumulation of foreign debt in the private sector. Under a currency board, on the other hand, capital inflows do not appreciate the currency (relative to the one it has been pegged to), but can promote the acquisition of foreign debt by convincing the private sector that the exchange rate will not depreciate.

Inflation targeting has been in use in a number of high-income countries for some years, and the IMF has recommended it in some developing countries including most recently, Ukraine, Armenia, and Serbia.[23] Also, due to their success in containing inflation pressures, the IMF has sometimes been supportive of pegged rates (as in the convertability system that operated for nearly a decade in Argentina –until it collapsed-, and as in the one that is in operation in Latvia), and similar or related dollarization systems (like the ones in Ecuador and more

[22] Weisbrot, Mark. (2007) "Ten Years After: The Lasting Impact of the Asian Financial Crisis," in *Ten Years After: Revisiting the Asian Financial Crisis*. Washington D.C: Woodrow Wilson Center for International Scholars. p 105-118.

[23] For the Fund's views on inflation targeting, see for example IMF (2006). "Inflation Targeting and the IMF." Washington, DC: International Monetary Fund (especially pages 9 and 11). Accessed online April 20, 2009 <http://www.imf.org/external/np/pp/eng/2006/031606.pdf>. For a more critical view on the Fund's emphasis on inflation controls and promotion of inflation targeting, see Epstein, Gerald. (2007). "Central Banks as Agents of Economic Development," in *Institutional Change and Economic Development*. Helsinki: United Nations University.

recently in El Salvador).[24] But as seen above, these systems can promote a systemic vulnerability which can become critical when economies face terms of trade shocks, international credit crunches, or declines in demand for their exports.

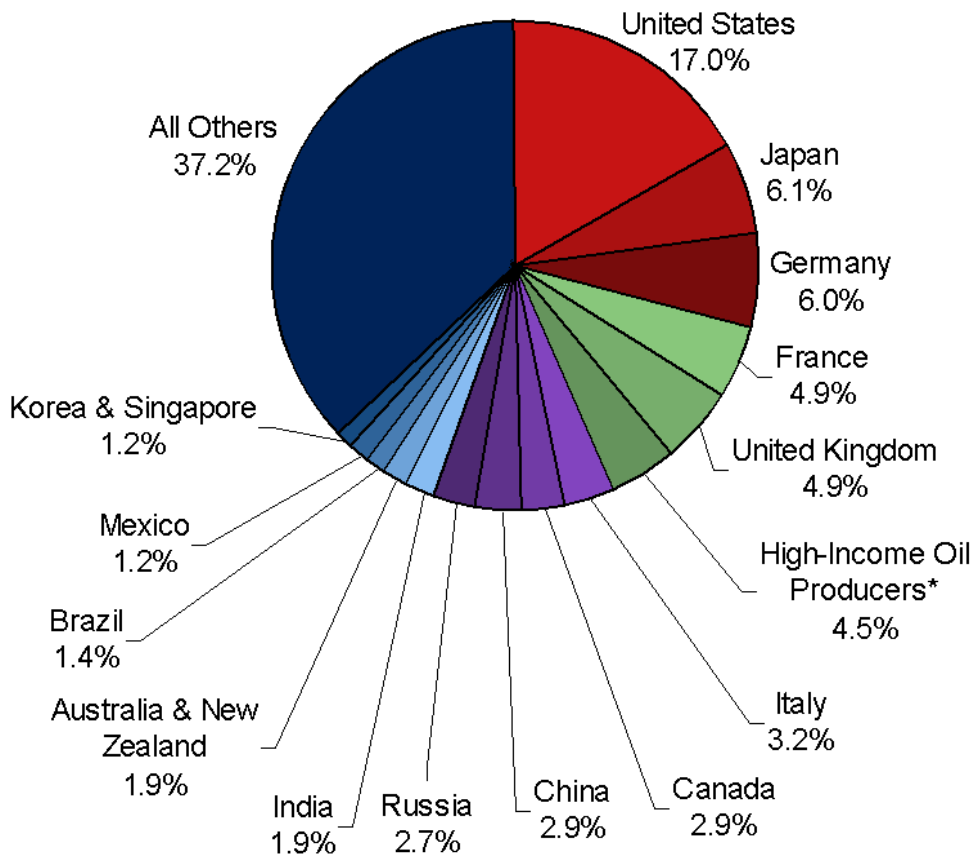
These regimes can therefore help create the vulnerabilities that make economies fragile, and also constrain the set of instruments that could be utilized in the event of a crisis or a sudden reversal of capital flows.

[24] The IMF has been very willing to support the implementation of dollarization regimes in developing countries. The Fund's support to the Ecuadoran dollarization plan was instrumental in the renegotiation of their foreign debt at the end of the 1990s. See Fischer, Stanley. "Ecuador and the IMF." Speech at the Hoover Institution Conference on Currency Unions, Palo Alto, California, May 19, 2000. Accessed online on April 20, 2009 < http://www.imf.org/external/np/speeches/2000/051900.htm>. Elsewhere, Fischer has documented the emerging economies' move toward fully flexible exchange rate systems, and towards hard pegs. See his speech "Exchange Rate Regimes: Is the Bipolar View Correct?" presented as Deputy Managing Director of the IMF, at the American Economic Association Annual Meeting. New Orleans. January 6, 2001. Accessed online on April 20, 2009 <http://www.imf.org/external/np/speeches/2001/010601a.pdf>. The same favorable reaction was observed, by the IMF, as a result of El Salvadoran adoption of the US dollar as their currency. On the case of Argentina, the role of the IMF in supporting their currency board system has been examined in Mussa, Michael. (2002). "Argentina and the Fund: From Triumph to Tragedy," Washington, DC: Peterson Institute for International Economics.

The Question of Governance

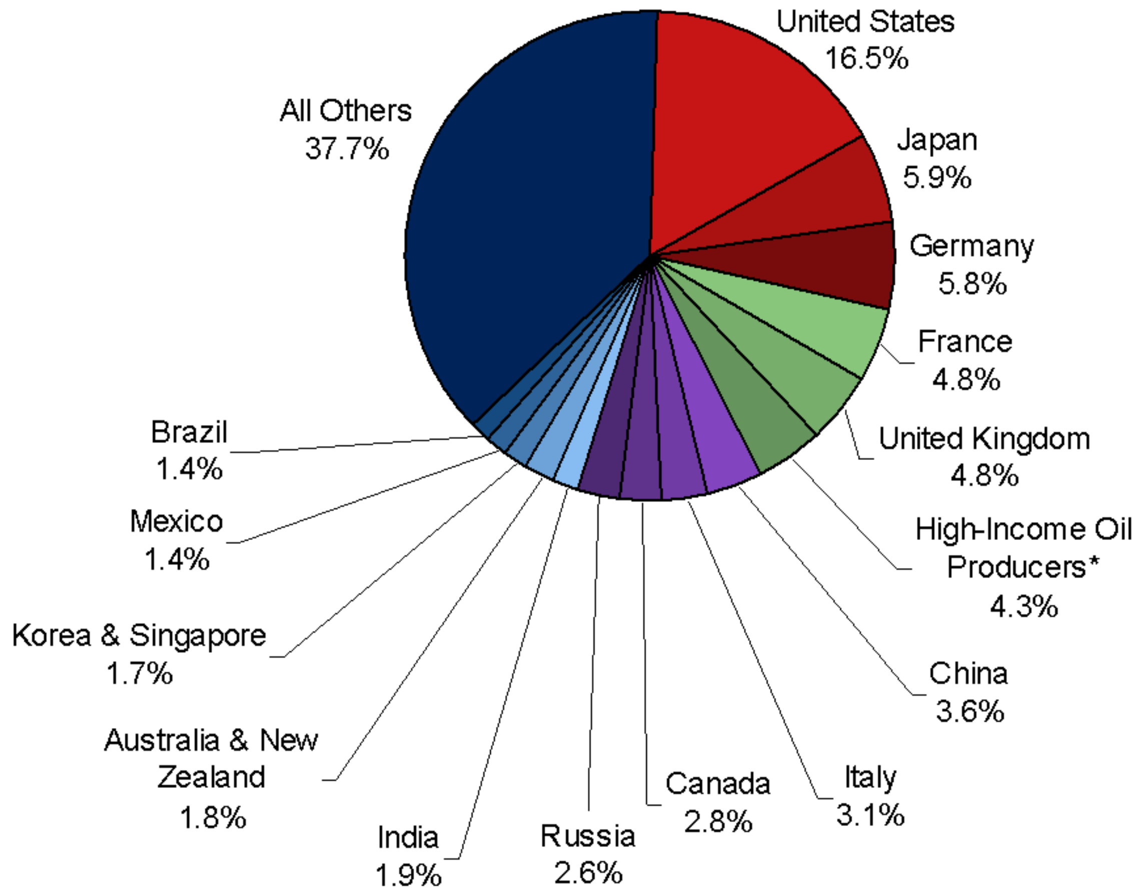
The IMF's governance structure is much more reflective of the world of 1944, when it was established, than of the world today. The United States has 16.5 percent of voting shares, which gives it a veto over some issues; but more importantly, the U.S., Europe, and Japan together have a solid majority of 55.6 percent of the votes. Europe and Japan have almost never voted against the United States in 65 years of the IMF's existence. Thus, the rich countries effectively run the organization, with the U.S. Treasury as the mostly unchallenged leader (despite the fact that the managing director of the IMF is by tradition a European). Low and middle-income countries have almost no significant voice.

FIGURE 1
Pre-Singapore IMF Voting Rights



* High-income oil producing countries include: Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Brunei, and Bahrain.
Source: Bryant, Ralph C. (2008). "Reform of IMF Quota Shares and Voting Shares: A Missed Opportunity." Washington, DC: Brookings Institution.
<http://www.brookings.edu/~/media/Files/rc/papers/2008/0409_imf_bryant/0409_imf_bryant.pdf>

FIGURE 2
Current IMF Voting Rights



* High-income oil producing countries include: Saudia Arabia, Kuwait, the United Arab Emirates, Qatar, Brunei, and Bahrain.
Source: International Monetary Fund. (2008). "IMF Members' Quotas and Voting Power, and IMF Board of Governors." <http://www.imf.org/external/np/sec/memdir/members.htm>

There have been efforts for many years to reform the governance structure of the IMF. These finally bore fruit in the Singapore reforms of 2006. Figures 1 and 2 shows the voting shares of the IMF before and after the Singapore reforms. As can be seen from the figures, after twelve years of efforts by reformers, the change is very slight. The United States share fell from 17 to 16.5 percent. China, which has the world's second largest economy and 1.3 billion people, went from 2.9 percent to 3.6 percent. South Korea and Singapore (combined) went from 1.2 percent to 1.7 percent. The rest of the changes were much smaller and basically insignificant.

A number of governments have raised objections to giving more money to the IMF without a change in its governance structure to assure some significant representation to countries other than the handful of governments currently in control. At the G-20 meeting in London on April 2, the G-20 communiqué included a statement that was interpreted as saying that the head of the IMF will no longer have to be a European. However, without a change in

the voting structure, it is not clear that this symbolic change will give developing countries any more voice or lead to any significant reforms or accountability at the Fund.

Accountability and Reform

Aside from the concentration of power in the hands of a few governments, with the decades-long tradition of the U.S. predominating among these, there is the problem of lack of accountability. As noted above, it is difficult to find evidence that Fund officials have been held accountable for the major mistakes that were made in the IMF's handling of previous crises, especially in the late 1990s. Part of the reason is undoubtedly that the governments who control the Fund do not have any compelling incentive to hold the Fund accountable for mistakes that negatively impact other, less well-off countries. In fact, the incentives are in the opposite direction: to do so could call attention to mismanagement of the Fund, with the risk that culpability could eventually be laid at the doorstep of the G-7 governments that are the decision-makers.

The Fund's procedures also make accountability very difficult. Policy is formulated in a way in which it is not clear who is responsible when things go wrong. One way to change this would be to require the IMF, in its loan agreements, to provide baseline projections for what the path of the economy would be in the absence of the agreed-upon policy changes. The Fund would also have to provide projections for the same variables – e.g. GDP growth, unemployment, inflation – if the recommended policies were adopted. These are procedures that are followed by the bipartisan Congressional Budget Office in the United States. With these projections, there would be something that the results of the IMF program could be measured against for evaluation. Of course, results will differ from the projections because of unforeseen events; but we would not expect the actual results to be consistently worse than the projections. If they are, then something might be wrong with the policies.[25]

The use of baseline and program-contingent projections would also allow the borrowing government and the public to see what sacrifices they might be asked to make and for what expected gains. If the program promises a short-term loss of 0.3 percent of GDP for a 2 percentage point gain next year and the following year, that might be considered worth the sacrifice. But an initial loss of 3 percent of GDP, with consequent increases in unemployment and poverty, might be considered too much for the same promised gains. The procedures currently in place do not allow for this kind of discussion or evaluation.

The use of baseline and program-contingent projections by the IMF would also allow governments to evaluate the track record of specific economists or teams of economists.

For the present, in the context of a world recession and the IMF's agreements that include procyclical policies, a more immediate reform may be in order. The Fund should be prohibited from attaching procyclical conditions for countries that are in recession or at serious risk of a recession, unless it can demonstrate that such conditions cannot be

[25] See Weisbrot, Mark and Dean Baker. (2004). "Applying Economics to Economists: Good Governance at the International Financial Institutions." Washington, DC: Center for Economic and Policy Research. Accessed online on April 20, 2009 <http://www.cepr.net/index.php/publications/reports/applying-economics-to-economists-good-governance-at-the-international-financial-institutions/>

postponed or adopted more gradually without irreparable harm to the borrowing country's economy.

It will be difficult to guarantee that even these reforms would prevent the Fund from imposing inappropriate macroeconomic policies, in the absence of more thorough governance reforms. However, they would at least provide a basis for future evaluation and efforts to promote accountability and reform.

Finally, and perhaps most importantly in the present situation, the agreements signed since last year should be re-opened for revision. They were negotiated when the IMF had very little in the way of resources. If the Fund's resources are to be greatly expanded, at the very least it can afford to supply more foreign exchange to ease the adjustment process, and allow it to take place more gradually and with a minimum of lost output during the current world recession.

Conclusion

This brief review of current practices and decision-making embodied in recent IMF agreements finds that the Fund's current policy decisions and orientation remain similar to those of the 1990s, when the Fund's mistakes had a serious negative impact on a number of developing economies. Neither the IMF nor its principal overseer, the U.S. Treasury Department, have acknowledged past mistakes or agreed to reforms that would prevent a recurrence.

This has implications for the immediate future of the affected countries, because procyclical policies can exacerbate the world economic downturn. But more importantly, the proposed quadrupling of IMF resources will have implications for many years to come, even after the world economy recovers. Although the new resources are unlikely to reverse the trend of governments avoiding, whenever possible, the Fund's lending and influence, they will help to re-establish an unreformed IMF as a major power in economic and decision-making in low-and-middle income countries, with little or no voice for these countries in the IMF's decisions. This could have long-term implications for growth, development, and social indicators in many countries. Governments that are contributing to this increase in funding should think carefully about these implications and the possibilities of making such increases contingent on serious reforms of the IMF – especially in the areas of governance and accountability.

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