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THE IMF: THE RECORD AND THE PROSPECT

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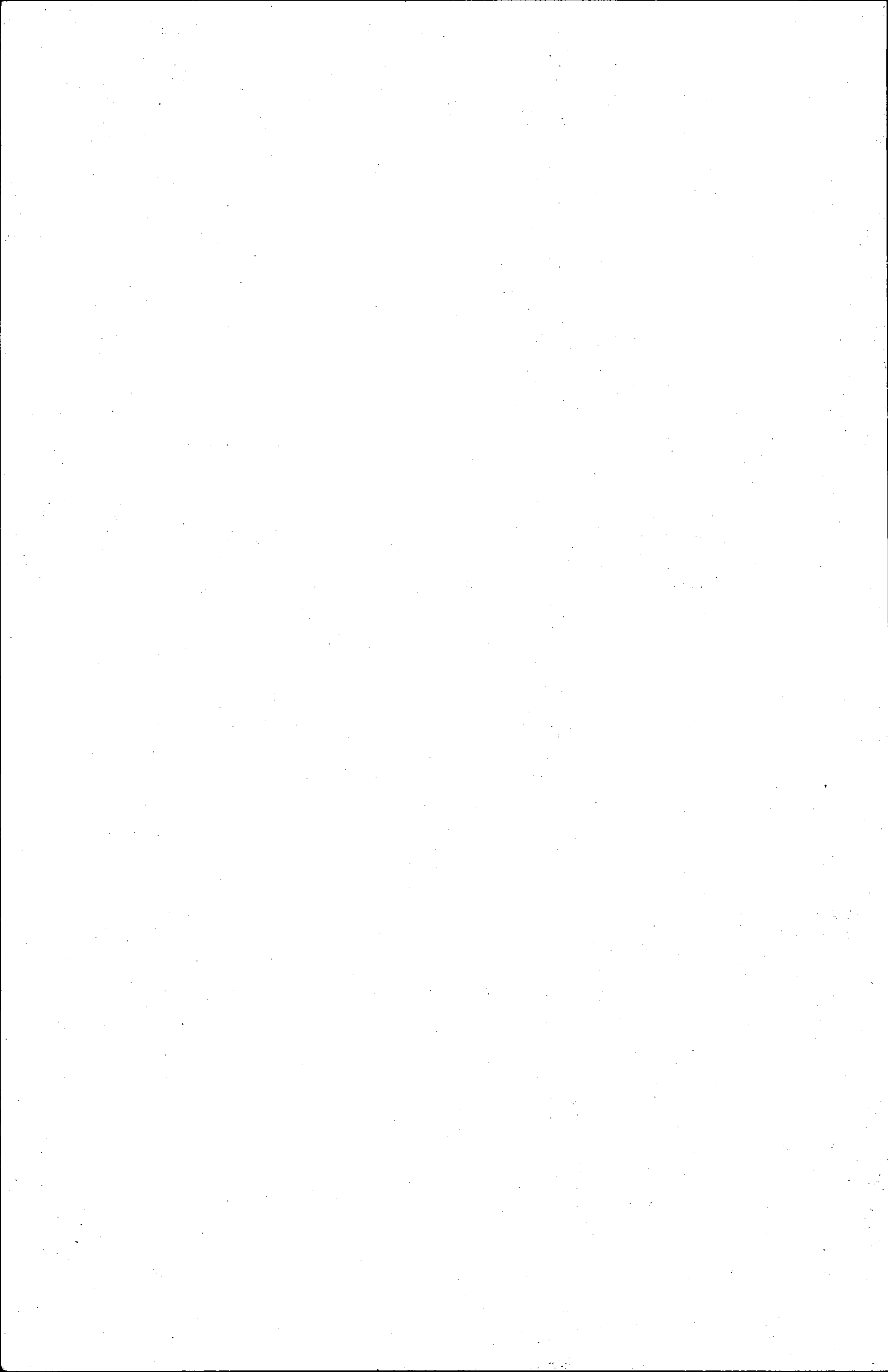

THE IMF: THE RECORD AND THE PROSPECT

1 Introduction

This essay has two purposes: to broaden understanding of the way the International Monetary Fund has functioned in the past and to encourage support for the resumption of the IMF's progress toward a greater central monetary role.

The underlying strength of the IMF throughout its existence has been that it provides a mechanism for the governments of the world to respond collectively to problems arising in the international economic system. The actual mechanism used for substantive coordination has varied widely. At first, it was the agreed exchange-rate system. The formal commitment to stabilize exchange rates was sufficient by itself to exert political pressure on governments to maintain policies that achieved the stability desired throughout the world. The IMF and its staff had a relatively circumscribed operational role, of importance largely in the rare cases when financing was essential or when one major exchange-rate action gave rise to problems of coordination with other exchange rates.

When this exchange-rate system collapsed, the member countries found it useful to support a strengthened surveillance system, under which their contacts with the IMF staff grew closer. This system nurtured the cooperative relationship essential for conditionality—the device of tying lending tightly to the implementation of policies designed to restore the payments position of the borrower. Conditionality allowed the IMF staff and management to exercise a constructive influence. At first, it was used only with the smaller developing countries, but in time it became universal, applying to large industrial countries as well, including France, Italy, and the United Kingdom.

The success of IMF conditionality in conjunction with lending led the member governments to decide that it should be used to help them with other decisions, particularly those related to debt rescheduling. Initially, this extension was also helpful; its record of achievement permitted the IMF to play a crucial role in overcoming the immediate debt crisis in 1982. However, the IMF role was later stretched too far. The subsidiary purpose of helping with debt strategy came to control decisions regarding financial assistance, which was made available even when the policies being followed by the borrowing countries were not consistent with a return to viability. Because decisions were no longer based on compatibility with repayment

terms, lending was guided increasingly by the political preferences of the leading industrial countries. The collegial relationship of the IMF staff with the financial authorities of borrowing countries crumbled, and the credibility of the IMF suffered.

Unless the major powers take a new look at the role of the IMF, there is considerable danger that it will continue on its present path—one foreseen with concern in 1979 by Frank Southard, who served for almost three decades as U.S. Executive Director and then as Deputy Managing Director of the IMF:

> It was not easy to create the IMF and it has not been easy to develop it into a world monetary authority. It *would* be easy for the leading members to reduce it to ineffectiveness or to an institution concerned chiefly with meeting the financial needs of less-developed countries. (p. 45)

There are cogent long-run reasons to change that course. The problems of industrial countries will not be solved by continuing indefinitely with the loose *ad hoc* consultations in Group of 5 and Group of 7 meetings.[1] The beginning made in September 1985 toward developing a more coordinated collegial policy must now acquire more structure. The vagueness of many of the understandings reached contributed to uncertainty and perhaps to the stock-market collapse of October 19, 1987. It is highly unlikely that the basic current problem—the persistent U.S. payments weakness—will be quickly and finally resolved. Plans must therefore be developed to ensure that future official financing of exchange-market intervention to stabilize the U.S. dollar actually encourages U.S. fiscal action.

Such plans will require early agreement on a framework for providing the United States with a lender of last resort. While Toyoo Gyohten, then Vice Minister of the Japanese Ministry of Finance, has suggested the creation of a new $200 billion agency by the United States, Japan, and Europe to provide resources to stabilize exchange markets (Gyohten, 1988), it would seem much more practical to adapt the IMF to this role.

Moreover, it now seems clear that the industrial countries are committed to pursuing policies aimed at greater exchange-rate stability. The next steps toward this end will have to be more formal if they are to increase the responsiveness of fiscal and monetary policies to this objective. Such formality would be achieved most appropriately in an IMF framework.

Looking farther ahead, provision should be made for reducing the international role of the U.S. dollar to ensure against overdependence on one increasingly strained country. The SDR was created in 1970 to meet this problem. But an early revival of SDR creation would be necessary to keep

[1] The G-5 countries are France, Japan, the United Kingdom, the United States, and West Germany. The "summit" G-7 countries are the G-5 plus Canada and Italy.

open this long-term solution, and that is not likely unless the IMF regains an industrial-country role.

Changes in the debt strategy are even more urgently needed. Political conditions in many developing countries of Latin America and Africa are now desperate, and some writedowns of existing debt are inevitable. Effective official support of such concessions for commercial-bank debt has been delayed by the unsolved problem of retaining control over the process. The key could be the requirement that relief be associated with an immediate return to viability. A revitalized IMF could guide the action through a new facility that would be available when creditors had made substantial concessions and debtors had made the necessary policy changes.[2]

Because debtors will vary greatly in their political ability to deliver such a transformation, the process of returning to normality will take years. During that interval, the effort to make the repayments due the IMF will place severe strains on some countries. Relief might be provided through a new low-conditionality facility for debtors ready to cooperate in a holding operation by maintaining order among unsettled foreign claims.

Let me stress that my proposals for an increased monetary role for a reformed IMF are not based on the judgment that nationalism's appeal has peaked. On the contrary, they are based on the judgment that the growing interdependence of countries requires the development of rules that will provide national authorities with an environment they believe will lead to the preservation of essential independence. Consequently, new rules must be expected to circumscribe, not extend, the discretionary power of the IMF in some respects.

2 The Record

The creation of the IMF was agreed upon by the governments of the major Allied powers in 1944 to encourage the development of a more open and stable international economic system at the end of World War II. The IMF was designed to promote at the international level the policies the authorities were pressing at the national level. In this section, the record is selectively summarized under five headings. Under the first, the institutional arrangements that make possible the IMF's flexibility in scope and in the provision of finance are described. The focus then shifts to the automaticity of the rules that were first established for the exchange-rate system. The discussion of financing arrangements and conditionality emphasizes the need for the finan-

[2] Since this essay was written in December 1988, U.S. Secretary of the Treasury Nicholas F. Brady has announced a new plan. As noted later, the Brady Plan goes quite some distance in the direction proposed, but it leaves some major steps to be taken before a definitive solution of the debtors' problems can be achieved.

cial authorities of the borrowing countries to subscribe freely to IMF objectives. Next, the evolution of the IMF's debt role from service to the debtors to service to the creditors is recounted. Finally, this change in role is shown to have led to conditionality problems caused by the increasing alienation of the debtors and the growing inability of the IMF to assist their return to growth.

Institutional Arrangements

The negotiations at Bretton Woods in 1944 leading to the agreement to create the IMF focused on the achievement of an orderly exchange-rate system supported by the power to give financial assistance to help maintain that order without resorting to foreign-exchange restrictions or an overly severe contraction of demand. One unique feature of this effort was the creation of a permanent financial institution bringing together the major economic powers of the world. Despite the later decision of the Soviet Union not to join, the plan to create a cooperative framework succeeded to a far greater extent than could reasonably have been expected. Germany and Japan soon joined, as did virtually all the former colonies when they gained independence. Although the number of members grew rapidly, weighted voting kept the major industrial countries firmly in power. Since 1946, the problem has not been to create the power to act but to reach agreement on how to use this power.

The machinery to develop cooperative responses to emerging problems begins with the Executive Board, which now consists of twenty-two Directors appointed by all the membership. Working full time on the problems of the world, these Directors have developed expertise on virtually all the relevant international monetary issues, ensuring that the main questions associated with any proposal are intensively addressed in advance of any formal negotiations. The Executive Board is served by a management and staff capable of either initiating proposals for action or assisting national proposals.

The grouping of members in preparation for negotiations on action has also been developed. The industrial countries have standing arrangements for achieving group policy positions in the so-called "G-10" framework (now consisting of the summit G-7 countries plus Belgium, the Netherlands, Sweden, and Switzerland). Routinely, issues are debated and draft positions produced in meetings of the deputies of the G-10 finance ministers; positions are decided at a subsequent ministerial meeting. The majority of developing countries participate in a similar grouping—the so-called "G-24"—with the same procedures, but unfortunately with limited negotiating effectiveness due both to their minority voting power and, all too often, to a lack of focus attributable to the diversity of their interests.

Since its creation in 1974, the Interim Committee, the committee of

twenty-two finance ministers, each representing the same constituency as the twenty-two Executive Directors, has been the final arbiter on any issue. As this committee meets every six months, it normally can act expeditiously on all proposals.

An important feature of the IMF organizational arrangements is its extraordinary flexibility on financing. The financing base comes from the $120 billion of currency contributions from members, much of which is not usable at any particular time because it is in the currencies of members in payments difficulty. But the flexibility comes from borrowing arrangements that at present can provide another $20 billion and have an unusual capacity for expansion when a need is acknowledged. Most countries provide resources through their central banks, which regard claims on the IMF as foreign-exchange resources, the acquisition of an asset considered to be completely distinct from foreign assistance and national budgets. In principle, the IMF—comprising all the major countries—has the ability to mobilize financing far exceeding that of any single member. But here, as with all its other powers, the actual capacity is dependent on reaching a high degree of unanimity. In practice, not only the United States but also other power blocs, including blocs of developing countries, can prevent action. The real task ahead is not to call a conference to create a new institution or to develop new powers for the IMF, but to achieve consensus for specific collaborative actions to ease the problems facing the international economy today.

The Exchange-Rate System

The most sweeping power in the original Articles of Agreement of the IMF was intended to be the power over exchange rates. In principle, apart from an initial permission to move the rate a cumulative 10 percent, all changes in exchange rates had to receive prior approval from the Executive Board. In practice, this ostensible control over a major instrument of economic policy proved to be largely illusory. Despite the commitment to prior approval, in fact decisions were made on national authority and the IMF Executive Board had little choice but to rubber-stamp approval on short notice—usually over a weekend—on the basis of hastily prepared staff papers. Although frequently the Executive Board considered the action to be inadequate, such judgments had no significant consequences unless the use of IMF resources was involved (an issue to be dealt with below). And, in the very rare cases when the Executive Board considered the action to be excessive, it could not be certain because the balance-of-payments outcome depended on domestic demand policies that were almost never precisely specified.

This does not mean that the exchange-rate rules had no consequences. On the contrary, they dominated the international economic policies of most

developed countries in that period. However, the pressure was put on their macroeconomic policies indirectly via domestic politics, not through judgmental pressure from the IMF Executive Board or staff. The pressure came from an apparent feeling of failure when the value of the domestic currency had to be reduced in terms of the U.S. dollar. Given the stability of U.S. prices from after the Korean War until the mid-1960s, the fixed-exchange-rate system greatly intensified the pressure that the weaker industrial countries put on their politicians to deliver more conservative fiscal and monetary policies. In the circumstances of the times, this contributed to the rapid development of a stable and integrated world economy.

The clear orientation of the system to stability and openness gave the IMF staff a framework for its policy advice to countries. It also opened a significant subsidiary role on exchange rates—guiding the exchange-rate reaction of partner countries when an important country altered its exchange rate. Thus, when the United Kingdom devalued the pound in 1967, the IMF staff was able to help by encouraging partner countries either to avoid or to reduce the adjustment of their own exchange rates; this increased the effectiveness of the U.K. action while limiting disruption to the rest of the world. This advisory role was last exercised at the Smithsonian meeting in December 1971, when the U.S. dollar realignment required agreement on the set of rates for the other major countries. Staff calculations on the structure consistent with a desired trade pattern provided a basis for the final agreement, and the political tensions inevitable in such a situation were curbed.

By that time, however, the basis for the system had been destroyed. The weakness of the U.S. dollar was now so evident that policymakers in the major countries no longer felt the same political pressure to take the macroeconomic measures necessary for exchange-rate stability. The market sensed this lack of policy commitment to an exchange-rate regime. The growing openness of capital movements gave rise to pressures on a scale that could not be contained by intervention and that inevitably led to a period of fluctuating exchange rates.

The IMF, in consequence, suffered a major setback. The central concept on which it was based had gone, and its progress toward becoming the central monetary institution was checked decisively. Nevertheless, the limitations on its central role were masked for a period by its growing activities in financing, including the financing of some major countries. And many believed that the departure from fixed exchange rates would be temporary. The revision of the Articles of Agreement to legalize the new, more flexible system allowed individual fixed rates (except in relation to gold) and left open the possibility of a return to a new universal system of fixed rates, a concept with continuing appeal in most countries primarily because it was thought to increase fiscal discipline.

Of more immediate relevance were the continued regulatory powers over foreign-exchange restrictions and the associated consultation process. The original Articles of Agreement prohibited foreign-exchange restrictions except with IMF approval, which was intended to be granted with time limits. To reinforce the pressure, annual reviews were to be made of the country's progress toward full elimination of restrictions. These reviews were soon developed into a system of annual consultation reports on economic policies affecting the balance of payments. This system survived the abolition of the fixed-rate system and was explicitly strengthened. The consultations now involve wide-ranging staff discussions about macroeconomic policies with the financial authorities of the vast majority of (and all the important) countries.

These discussions are particularly valuable in building contacts between the IMF staff and the financial authorities in a context that the latter usually find constructive. The IMF staff, which is composed in large part of economists with backgrounds similar to those of the officials with whom they are consulting, is able to obtain and analyze information without the constraint that normally arises in discussions with officials owing loyalty to another country. The report developed almost invariably stresses the importance of policies that the financial authorities are urging their political masters to adopt. Consequently, the closing statement of the staff team is usually considered helpful in subsequent internal policy discussions; in some countries, it is distributed to the Cabinet or even to the public.

When the report produced by this staff team is presented to the Executive Board for discussion, the community of interests of financial authorities is once again demonstrated. The Executive Directors, although representing very diverse countries, usually focus their remarks on the need for fiscal discipline—an issue that they would like stressed in subsequent meetings concerning their own countries. The meeting concludes with a summing up for transmission to the country involved. Given this spirit of cooperation, the summary frequently contains strong support for the policies the financial authorities are urging. The collegial spirit shown in individual country discussions has been one of the great strengths of the IMF: it is refreshing in the current international scene to have official representatives from, for example, Germany, Iran, Libya, and the United States regularly making similar statements in the Executive Board![3]

Financing Arrangements and Conditionality

As we have seen, the IMF from its beginning was furnished with substantial financial resources to be made available to member countries when they had

[3] I refer here to country discussions in the Executive Board. In discussions on IMF policies, the divisions stemming from divergent economic situations are continuing and deep, as any comparison of G-24 communiqués with those of the Interim Committee will show.

balance-of-payment problems. In effect, the IMF was intended to be a financial cooperative, with a pool of resources available for use on a revolving basis as differences in the phasing of the business cycle in each country created rotating temporary financing needs. Although there were divergences of views, it was initially expected that the resources, although dispensed over time, would be provided virtually on request. As the probable source of the resources in the early years, the United States was the most concerned about control, but even the U.S. negotiators, in my view, did not envisage conditionality as it in fact developed. As it developed, conditionality essentially involves the practice of withholding access to IMF loans until the adjustment policies of the requesting country are judged to be adequate.

The original plans were based on the belief that, for a variety of reasons, borrowing members of the system would find the strength needed to keep the resources revolving. Some weight was no doubt given to the moral obligation of each member of the cooperative to use the resources only for a temporary period, and some to provisions requiring interest rates to rise with the length of use. But more weight was given to the belief that every sovereign country would wish to maintain foreign-exchange reserves adequate to defend its exchange rate. Consequently, responsible authorities were expected always to rebuild reserves to an adequate level and make timely repayment to the IMF. Repayments were envisaged in a period of a few years, which was set at three to five years early in the IMF's history.

This conditionless approach was never tested. The overwhelming needs of reconstruction in most of Europe convinced the United States almost immediately that short-term IMF resources should not be used when more appropriate financing was available through the Marshall Plan. Once the United States had put IMF financing on hold for Europe, it became difficult to restart operations; the reality of a continuing world dollar shortage made the idea of automatic revolving use seem naive.

Nevertheless, the unused IMF resources created their own pressures. For some countries not covered by broad assistance programs, innovative proposals were developed to use IMF resources in support of reform initiatives. To justify an exception to the avoidance of IMF resources by the more important countries, a requesting country featured the special measures it was taking to improve its payments position. Thus the Executive Board came to expect a convincing description of adjustment policies adequate to ensure timely repayment to the IMF. Access to borrowing from the IMF was regarded as a special and unusual privilege for the borrowing country. This cast the IMF staff in the role of ally helping the country to increase the resources available to it in order to overcome its payments problems. At the same time, the staff was motivated to make certain that it had a clear case in order to preserve its ability to justify exceptional treatment. Consequently,

IMF resources were made available only after substantial investigation of the would-be borrower's macroeconomic policies and the collaborative development of a recovery program.

In this way, the staff and the financial authorities of a number of small and middle-sized developing countries with deep problems developed close working relationships. In Europe such ties developed with Turkey and Yugoslavia, and in Latin America first with Bolivia, Haiti, and Paraguay, and later with Argentina and Chile. In such countries, the programs implemented were broad-ranging and the presentation to the Executive Board emphasized the depth of the reform and the commitment of the authorities to achieving a more stable and open economy.

Given the depth of the problems to be overcome, IMF resources were released over time, concurrently with policy implementation. This required periodic staff judgments about the adequacy of implementation. While countries usually were ready to leave the judgments to the staff, some members of the Executive Board felt that the borrower needed more predictability. The issue came to a head over a Bolivian program in 1958.[4]

Bolivia had implemented a particularly dramatic reform in late 1956. It replaced a highly complex multiple-exchange-rate system with a single exchange rate. An economy with probably the highest rate of inflation in the world was stabilized within weeks by drastic fiscal reform and wage discipline. But after some eighteen months, the authorities allowed miners' wages to rise by 30 percent while attempting to maintain the exchange rate. The staff recommended suspending Bolivia's right to use IMF resources until the policy problems were resolved. The Executive Board agreed, but it found the procedure awkward and asked for new provisions. The provisions that were developed called for automatic suspension of the right to use IMF resources when specified limits (called "performance criteria") were not met. These limits were total central-bank credit and central-bank credit to the public sector. These limits were selected because they were directly connected to the decisions of the financial authorities. Provided the authorities followed the agreed financing plan, they had assurance that IMF resources would be available. However, the selection of these limits made the IMF staff vulnerable to criticism that its approach was dominated by certain financial-policy aggregates. In particular, because the control data were derived from banking data, the staff was henceforth classified as following one theory, that of monetarists.

In fact, the staff was open to all theories; it sought agreement only on policy actions. Nevertheless, this basic innovation proved to be effective in

[4] I was head of the staff team on this occasion. The following discussion of the IMF record is based on personal involvement. This has narrowed the selection of countries cited but has permitted a sharper focus on the reasons for key developments.