THE IMF: INSTRUMENTS AND STRATEGIES

Lecture 4

LIUC 2008

WHAT IS THE INTERNATIONAL MONETARY FUND?

- The IMF is an international cooperative financial institution.
- Each member deposits a sum of money into a pool of resources, which is then available for making loans to those members that need financial assistance to pay their external obligations.
- It does not fund specific projects, nor does it provide direct funding to government budgets.
- It makes foreign exchange available to member countries' central banks to add to their reserves.
- Beyond financing: technical assistance, surveillance

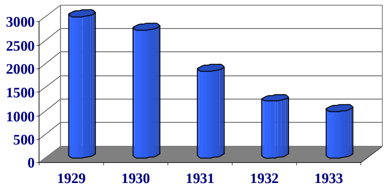
ORIGINS OF THE IMF

- The need for an institution like the IMF became apparent during the ***Great Depression*** of the 1930s.
- In efforts to shield their economies from the effects of the worldwide crisis, governments adopted policies that ***restricted imports and capital flows***.
- Some also sharply ***devalued their currencies*** to try to boost their own exports at the expense of those of other countries.
- The most damaging effect of these policies was a ***collapse of world trade***, which only worsened the problems in the world economy.

ORIGINS OF THE IMF

World trade, 1929-1933

(in millions of U.S. dollars)



Klindleberger, C., "The World in Depression 1929-1939."

ORIGINS OF THE IMF

- Several international conferences convened in the 1930s to address these problems ended in failure, but two economists, White (USA) and Keynes (GB) put forward proposals in the early 1940s for an international institution that would foster international monetary cooperation after the war.
- Negotiations for establishing the IMF were concluded at ***Bretton Woods***, New Hampshire, U.S.A. in July 1944.
- The IMF began operations in Washington, D.C. in May 1946. It then had 39 members.
- The IMF’s membership now numbers 184. It is open to every country that conducts its own foreign policy and is willing to adhere to the ***Articles of Agreement***.

THE MANDATE

Article I of the ***Articles of Agreement*** says the IMF was created to:

- promote international monetary cooperation
- facilitate expansion and balanced growth of international trade
- promote exchange rate stability
- assist in the establishment of a multilateral system of payments
- make financial resources temporarily available to members experiencing balance of payments difficulties

HOW THE IMF FULFILS THE MANDATE?

AREAS OF ACTIVITY

- ***Financial assistance***: the IMF makes its financial resources temporarily available to members with balance of payments difficulties.
- ***Technical assistance***: the IMF provides expert advice to member countries in areas of its competence, including monetary and exchange rate policies, tax and expenditure policies, statistics, banking supervision, and accounting.
- ***Surveillance***: the IMF monitors economic developments and policies in each of its member countries in the context of *Article IV Consultations*. The IMF also monitors the world economic situation and prospects in its bi-annual *World Economic Outlook.*

AREAS OF ACTIVITY: FINANCIAL ASSISTANCE

IMF financial assistance is available only to members that face ***balance of payments difficulties***.

Financial assistance is available under various loan programs that differ in repayment terms, interest rates, country eligibility, and the conditions that are required for loan approval:

- ***Reserve tranche***; a limited amount of unconditional credit
- ***Regular credit facilities***; available under conditions of reform
- ***Concessional assistance***; only for the poorest countries
- ***Other facilities***; for special situations, such as the aftermath of war or a natural disaster

AREAS OF ACTIVITY: FINANCIAL ASSISTANCE

The ***reserve tranche*** is the 25% of quota that member countries have paid in foreign exchange. It is considered part of countries' international reserves (just like any other foreign exchange at the central bank) and is available automatically for countries that demonstrate a balance of payments "need."

Once a member has exhausted the reserve tranche, other resources are available, but ***under conditions***: countries must adopt a program of economic adjustment to correct the problems that led to the balance of payments difficulties.

AREAS OF ACTIVITY: FINANCIAL ASSISTANCE

The role of conditionality: to ensure that borrowed money is used effectively.

The borrowing country promises to undertake ***reforms*** that eradicate the source of the balance of payments difficulties and prepare the ground for high-quality growth

The authorities present a plan of reforms, a "***program***". If the Executive Board is satisfied with the program, the loan is disbursed in ***installments*** (usually over one to three years), tied to progress in implementing the reforms.

In September 2002, the IMF Board approved new conditionality guidelines (ownership, streamlined conditionality, country specificities, clarity)

AREAS OF ACTIVITY: FINANCIAL ASSISTANCE

Typical policies included in IMF-supported programs

- ***Fiscal policy measures*** to reduce government deficits to a size that can be financed without causing macroeconomic problems and that makes government debt dynamics sustainable
- A ***monetary and exchange rate policy*** that supports sustainable balance-of-payments and external-debt positions
- ***Structural reform measures*** that improve the functioning of labor and product markets
- Measures to maintain or ***improve the soundness of the banking system*** and the infrastructure of financial markets

FINANCIAL PROGRAMMING

Financial programming is the exercise that ensures that the various policies contained in an adjustment program will produce the economic goals set by the authorities and that these policies are consistent with each other.

This last point is important, because the various monetary, fiscal, and exchange-rate policies influence each other and a host of economic variables. We need to make sure that these policies do not work against each other; they should form a consistent financial framework for reaching the goals of the adjustment program.

AREAS OF ACTIVITY: FINANCIAL ASSISTANCE

Regular IMF Facilities subject to conditionality

***Stand-by Arrangements (SBA)*:**

- short-term loans to cover BoP deficits of a temporary nature
- loan installments paid out usually quarterly, over 12 to 18 months
- installment release subject to periodic review of economic policies
- loan repayments are made over a period of between 2¼ and 4 years

Extended Fund Facility (EFF):

- medium-term loans, often to support structural reform
- loan installments paid out over period of three years
- installment release subject to periodic review of economic policies
- loan repayments made over period between 4½ to 7 years

AREAS OF ACTIVITY: FINANCIAL ASSISTANCE

Concessional Assistance

Poverty Reduction and Growth Facility (PRGF):

- Purpose: support programs that
  - ✓ build sustainable balance of payments positions
  - ✓ foster durable growth
  - ✓ lead to higher living standards and a reduction in poverty
- 78 low-income countries are currently PRGF-eligible
- Loan terms:
  - ✓ disbursed in installments over three-year period
  - ✓ subject to regular review of economic policies
  - ✓ 0.5 percent interest rate, 5½ year grace period, 10-year maturity

AREAS OF ACTIVITY: FINANCIAL ASSISTANCE

Other loan facilities

***Supplemental Reserve Facility (SRF)*:** financial assistance for balance of payments difficulties due a sudden loss of market confidence. Loans are expected to be paid back within 1 to 2½ years. There is an interest surcharge of 3 to 5 percentage points to encourage early repayment.

Compensatory Financing Facility (CFF): established in 1963 to assist countries experiencing either a sudden shortfall in export earnings or an increase in the cost of cereal imports caused by fluctuating world commodity prices.

***Emergency Assistance (EA)*:** for countries that have experienced a natural disaster or are emerging from armed conflict. Basic rate of charge, although interest subsidies are available in some cases. Loans must be repaid within 3¼–5 years.

AREAS OF ACTIVITY: FINANCIAL ASSISTANCE

Other facilities

Policy Support Instrument (PSI), Oct. 2005: a non-lending programme which will provide policy advice to poor countries and send a signal to donors and markets about the quality of a country's economic policies.

The Exogenous shock Facility (ESF) (nov 2005): will provide cheap financing to low-income countries (annual per capita income below $895) that are experiencing shocks but which do not have a PRGF programme. For countries which do have a PRGF programme, the Fund will simply increase support to deal with the shock. Access will be determined on a case-by-case basis, but the "norm" for annual access is set at 25 per cent of the member's quota in the Fund up to a maximum of 50 per cent.

AREAS OF ACTIVITY: FINANCIAL ASSISTANCE

A new loan facility following the current crisis

- ***Short-Term Liquidity Facility*** **(SLF) oct 29, 2008**
  - **Purpose**. Provide large, upfront, quick-disbursing, short-term financing to help countries with strong policies and a good track record address temporary liquidity problems in capital markets.
  - **Eligibility**. Countries with a good track record of sound policies, access to capital markets and sustainable debt burdens may qualify
  - **Conditions**. Financing is made available without the standard phasing and loan conditions of more traditional IMF arrangements.
  - **Size of loan**. Up to 500 percent of quota, with a three month maturity.

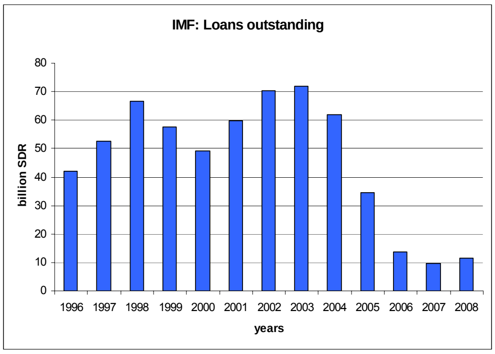
FAST PROCEDURE: *Emergency Financing Procedures*

The Emergency Financing Mechanism has been used in 1997 during the Asian crisis for the Philippines, Thailand, Indonesia, and Korea; in 2001 for Turkey; and in 2008 for Georgia.

When can it be used? When a member country faces an exceptional situation that threatens its financial stability and a rapid response is needed to contain the damage to the country or the international monetary system.

How does it work? (i) The Executive Board is informed about the intention to activate the procedures; (ii) a short report is quickly circulated; (iii) as soon as understandings are reached with the government, the Board considers the request to support a program within 48-72 hours.

How long can the whole process take? Under the emergency procedures, the period between the beginning of discussions on the program and the approval of the program by the Board could be very short.



Data 2008 Sept. 30.

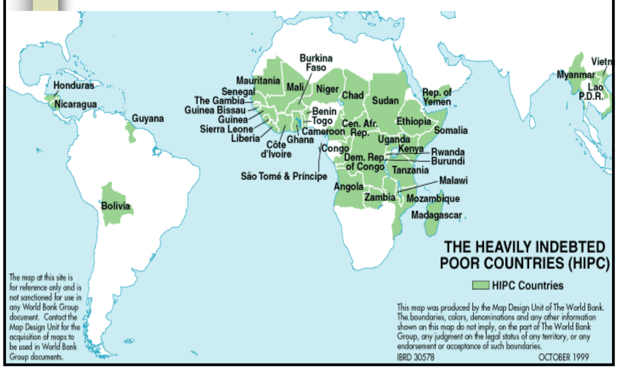
SDR: basket of: • euro, • jap. Yen, $ and £

AREAS OF ACTIVITY: FINANCIAL ASSISTANCE

Concessional Assistance: HIPC initiative

- The HIPC initiative relieves the debt of heavily-indebted poor countries
- What is a heavily-indebted country?
  - The ratio of the net present value of the debt to exports or fiscal revenue is above a certain threshold
- What is a heavily-indebted poor country?
  - The country is an IDA-only country.
- How much debt relief?
  - A country should be in a position to service its external debts without the need for further debt relief and without compromising growth

HIPC-Eligible Countries



STEPS OF THE HIPC INITIATIVE

HIPC: STATUS AS OF SEPT. 2008

Eligible countries: 41

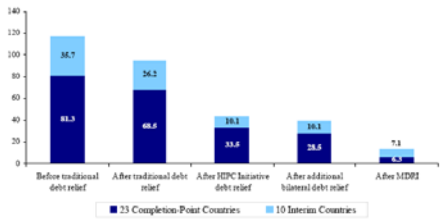
23 Post-completion,
10 Interim countries
8 Pre-decision point

Cost of the initiative: about 71 bil $ in NPV

Beyond HIPC: the Multilateral Debt Relief Initiative (MDRI)

- In June 2005, the (G-8) major industrial countries proposed that three multilateral institutions—the IMF, World Bank, and the African Development Fund (AfDF)—cancel 100 percent of their debt claims on countries that have reached, or will eventually reach, the completion point under the HIPC initiative. In 2007, IaDB joint the MDRI.
- Implementation by IMF: eligibility: all countries with per-capita income ≤ of $380 a year
- Cost of the initiative for 4 Institutions: 28 bill $ in NPV

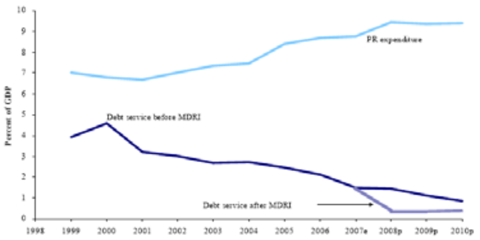
Figure 5. Post-Decision Point HIPCs' Debt Stock under Different Debt Relief Stages
(In billions of U.S. dollars, in end-2007 NPV terms)



Sources: HIPC Initiative country documents, and IDA and IMF staff estimates.
Note: Estimates based on decision point debt stocks.

IMPACT ON DEBT STOCK **Debt relief is expected to reduce the external debt stock by more than 90 percent in end-2007 NPV terms**

Figure 1: Average Debt Service and Poverty Reducing Expenditures[1/]



Sources: HIPC documents; and IMF staff estimates.

[1/] Prior to 2006, figures represent debt-service paid, and thereafter, debt-service figures are projected. For detailed country data refer to Appendix Table 2.

IMF: HIPC and MDRI—Status of Implementation, Sept 08

AREAS OF ACTIVITY: SURVEILLANCE

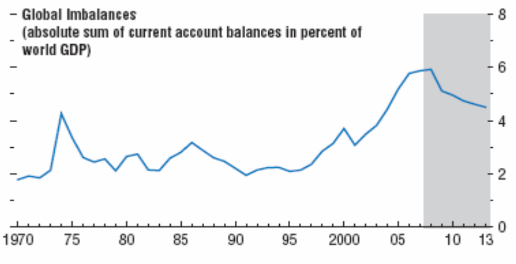
- ***Bilateral surveillance*** is done mainly through ***Article IV consultations***, mostly yearly discussions between IMF staff and each of the 185 member country authorities on domestic economic developments and policies.
- ***Multilateral surveillance*** takes two forms:
  - ✓ the twice-yearly **World Economic Outlook** (WEO) exercise, in which the IMF gives its view on world economic developments and prospects.
  - ✓ The **Global Financial Stability Report:** provides assessments of the stability of global financial markets and identifies potential systemic weaknesses that could lead to crisis.

AREAS OF ACTIVITY: SURVEILLANCE

The 2007 Decision on Bilateral Surveillance

- **External stability** at the center of bilateral surveillance
- “A balance of payments position that does not, and is not likely to lead to disruptive exchange rate movements”
- **Four principles** for members' exchange rate policies
  - Avoid manipulating exchange rates,
  - Intervene in the exchange market if necessary to counter disorderly conditions,
  - Take into account in intervention policies the interests of other members, including those of the countries in whose currencies they intervene,
  - Avoid exchange rate policies that result in external instability.

IMF decision – Global imbalances

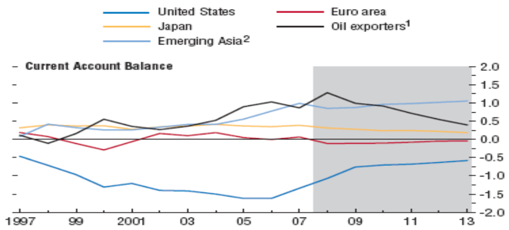


Sources: Lane and Milesi-Ferretti (2006); and IMF staff estimates.

IMF: WEO Oct 08

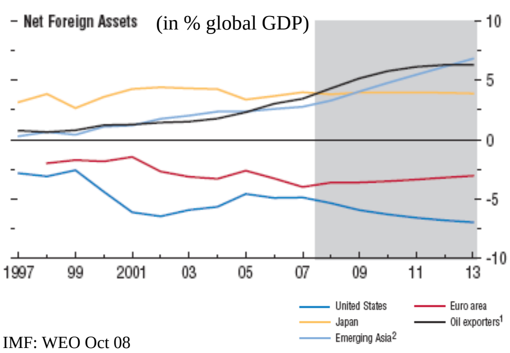
IMF decision – Global imbalances

The U.S. current account deficit has moderated in recent years and is projected to continue to narrow over the medium term, although net foreign liabilities would continue to build. Oil exporters' surpluses have been boosted by rising international oil prices, and although these surpluses are expected to come down, oil exporters are projected to accumulate rising net foreign assets. Emerging Asia would sustain large current account surpluses and continue to build net holdings of foreign assets.



IMF: WEO Oct 08

IMF decision – Global imbalances



IMF: WEO Oct 08

Where next after the current crisis?

- The G20 Summit in Washington on the new International Financial Architecture (Nov.15 08)
- http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html