THE IMF: INSTRUMENTS AND STRATEGIES

Lecture 5
LIUC 2009

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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

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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.

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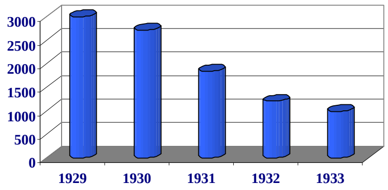
ORIGINS OF THE IMF (cont.)

World trade, 1929-1933

(in millions of U.S. dollars)



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

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ORIGINS OF THE IMF (cont.)

- 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.

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GOVERNANCE

- The IMF is governed by the member countries themselves, through the ***Board of Governors***, which consists of one governor from each member country. Governors are usually Ministers of Finance or heads of Central Banks. The Board of Governors meets only during annual meetings.
- The day-to-day affairs of the Fund are guided by the ***Executive Board***, a group of 24 representatives of the member countries, that meets in formal session at least three times a week. Single-country constituencies: USA, UK, Fr, Ger, Japan, SA, Russia, China
- The IMF has a staff of about 2400, headed by the Managing Director, D. Strauss-Kahn, a French national. The staff come from over 140 of the IMF's member countries (186; *last to join Kosovo in June 2009*)

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GOVERNANCE
Funding, Quotas and Voting

- The capital base of the IMF consists of membership **quotas**, the financial contributions made by the member countries.
- The IMF uses a quota formula to guide the assessment of a member's relative position. Members' quotas are broadly determined by their ***economic* position** relative to other members. A variety of economic factors is considered; these include members' GDP, current account transactions, and official reserves.
- Quotas are paid 25% in foreign exchange reserves and 75% in a member's own currency.
- The quota "deposits" of members are remunerated, and members pay **interest** on the loans they receive from the IMF; the Fund's expenses are paid for by the interest rate spread between the two.

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GOVERNANCE
Funding, Quotas and Voting *(cont.)*

- A member's quota determines, in particular, its **voting power** and **access to financing.**
- **Voting**: 750 (*it was 250*) basic votes for each member + one vote for each SDR 100.000
- **Access to financing**: The max amount of credit that a member may obtain from the IMF is based on its quota. Before the global crisis a member could borrow ex SBA up to 100% of its quota annually and 300% cumulatively. These access limits have now doubled (they are now 200 and 600% of quota, respectively).
- Access can however be increased under **exceptional circumstances** (Argentina 8 times its quota, Turkey 15 times, Hungary 10 times its quota).

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GOVERNANCE
Quotas

- When a country joins the IMF, it is assigned an initial quota in the same range as the quotas of existing members that are broadly comparable in economic size and characteristics.
- The Board of Governors conducts **general quota reviews every 5-year**. *The last quota revision was concluded in April 2008.*
- Ad *hoc quota* increases outside general reviews do not occur often. The last one approved on April 28, 2008 does qualify as *ad-hoc.*

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IMF 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

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HOW THE IMF FULFIL ITS MANDATE?

- ***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.*

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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

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FINANCIAL ASSISTANCE
The reserve *tranche*

- It 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 usually **under conditions**: countries must adopt a program of economic adjustment to correct the problems that led to the balance of payments difficulties

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FINANCIAL ASSISTANCE
Conditionality: ensuring that money is used effectively

- When a member country is seeking a loan from the IMF, it agrees to implement policy measures that will enable it to resolve its BoP problems.
- These measures also serve as a guarantee that the country will be able to repay the IMF.
- Conditionality may take the form of ex ante conditionality (pre-set rigorous qualification criteria) and/or ex post conditionality (monitoring of program implementation).

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FINANCIAL ASSISTANCE
Conditionality: ensuring that money is used effectively

- Loans are normally disbursed in ***installments***, subject to progress in implementing the program.
- Monitoring relies on different tools:
  - ✓ **Prior actions** to be taken *before* the IMF's Executive Board approves financing or completes a review;
  - ✓ **Quantitative performance criteria** *specific conditions that have to be met for the agreed amount of credit to be disbursed;*
  - ✓ **Structural Performance criteria** vary widely across programs. May include measures to improve financial sector operations, reform social security systems, or restructure key sectors.
  - ✓ **Program review** provides a framework to assess whether the IMF-supported program is broadly on track and whether modifications are necessary for achieving the program's objectives.

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FINANCIAL ASSISTANCE
Policies in IMF-supported programs

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

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FINANCIAL ASSISTANCE
How has conditionality evolved in recent years?

- Up to the early 1980s, IMF conditionality largely focused on macroeconomic policies. Then the complexity and scope of the structural conditions increased significantly, reflecting in part the growing involvement in low-income and transition countries, where structural problems were particularly severe.
- Following harsh criticism on the conditionality approach, a comprehensive review was undertaken to make it more focused and effective.
- It highlighted the need to: require better justification of criticality, establish explicit links between goals, strategies and conditionality, and enhance countries' ownership.
- Accordingly, the IMF has been striving to focus more sharply and be more clear about the conditions attached to its financing, and to be flexible and responsive in discussing alternative policies with countries requesting financial assistance.

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FINANCIAL ASSISTANCE
How has conditionality evolved in recent years?

Ukraine, $16.4 Billion Stand-By Arrangement, Nov 5, 2008,

Key measures to achieve the objectives of the program focus on the following areas:

- ✓ **Monetary and Exchange Rate Policy:** implementation of a flexible exchange rate regime. The independence of the NBU to be strengthened, monetary policy to be tightened to help achieve the 2009 inflation objective of 17 %. Eliminating exchange rate controls asap, measures to improve the operation of the forex market.
- ✓ **Financial Sector Policy** the "bank resolution strategy" with the recapitalization of viable banks
- ✓ **Fiscal Policy** deficit not to exceed 1% of GDP in 2008, on balance in 2009 (excluding bank recapitalization costs).

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FINANCIAL ASSISTANCE
Non concessional facilities

i. Stand-by Arrangements (SBA)

- The bulk of Fund assistance is provided through SBAs.
- Short-term loans to cover BoP deficits of a temporary nature. The length of a SBA is typically 12–24 months, and repayment is due within 3¼-5 years of disbursement.
- Installment release subject to periodic review of economic policies
- May be provided on a precautionary basis *i.e.* where countries choose not to draw upon approved amounts but retain the option to do so if conditions deteriorate
- Total commitment: **SDR 54 billion (***as of August 31, 2009*

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FINANCIAL ASSISTANCE
Non concessional facilities

ii. 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
- Total commitment**: SDR 0 (***as of August 31, 2009***)**

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FINANCIAL ASSISTANCE
Non concessional facilities (cont.)

iii. Flexible Credit Line (FCL) from March 2009

- Provides large, upfront, quick-disbursing financing for countries with very strong fundamentals, policies, and track records of policy implementation and meeting pre-set qualification criteria.
- Particularly useful for crisis prevention purposes.
- Access is determined on a case-by-case basis, is not subject to the normal access limits. Disbursements under the FCL are not conditioned on implementation of specific policy understandings as is the case under the SBA and EFF.
- Already approved: SDR 14 billion for **Poland**, and SDR 7 billion for **Colombia** (May 09), SDR 31 billion for **Mexico** (April 09) In all cases authorities have stated they intend to treat the arrangement as precautionary and not draw on the line.
- Total commitments: **SDR 52 billion** *(as of August 31, 2009*)

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FINANCIAL ASSISTANCE
Concessional facilities

i. ***Poverty Reduction and Growth Facility (PRGF)***

- For ten years, the **pillar of IMF lending to low-income countries**.
- Support programs that build sustainable balance of payment positions; foster durable growth; lead to higher living standards and a reduction in poverty.
- Programs are framed around comprehensive, country-owned **Poverty Reduction Strategy Papers** prepared by governments with the participation of civil society.
- **78 countries are eligible** for PRGF. **22** low-income countries have currently an arrangement in place.
- **Terms**: Annual interest rate of 0.5 percent, with repayments made semiannually, beginning 5½ years and ending 10 years after the disbursement. Access: up to a maximum of 280 percent of quota under a three-year arrangement (may be increased to 370 percent of quota in exceptional circumstances).
- Total commitments: **SDR 2 billion** *(as of August 31, 2009)*

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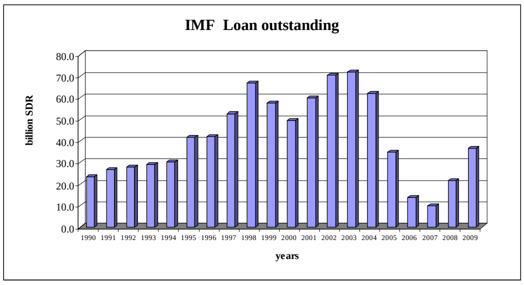
FINANCIAL ASSISTANCE



Data as of 2009 July 31

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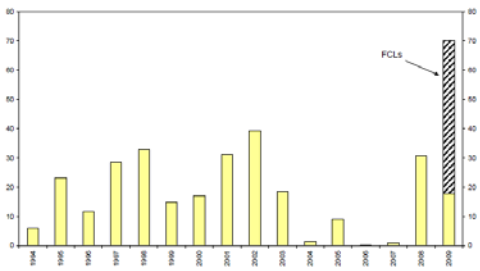
Figure 1. New Commitments, Calendar Years 1994—2009 1/
(In SDR billions)



1/ Data as of May 31, 2009. Gross amount of new commitments not netted for undrawn balances under expired/cancelled arrangements. Includes disbursements under outright purchases, including emergency assistance.

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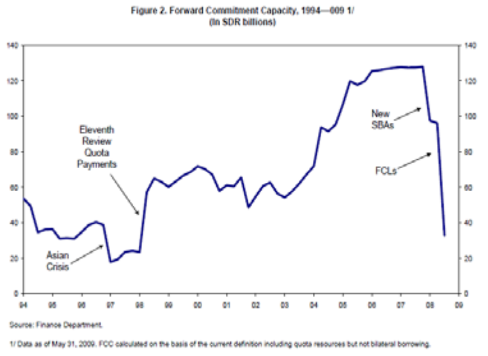

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SURVEILLANCE

- ***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.

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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.

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SURVEILLANCE
Policy Support Instrument (PSI)

- Enables the IMF to support low-income countries that do not want—or need—Fund financial assistance.
- Provide policy advice to poor countries and send a signal to donors and markets about the quality of a country's economic policies.
- Promote a close policy dialogue between the IMF and a member country;
- Provide more frequent Fund assessments of a member's economic and financial policies than is available through the regular consultation process of surveillance;
- The PSI is voluntary, demand-driven, and intended to be supported by strong country ownership.
- To date, the Executive Board has approved PSIs for six members: Nigeria (2005); Uganda (2006); Cape Verde (2006); Tanzania (2007); Mozambique (2007); Senegal (2007).

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TECHNICAL ASSISTANCE

- Helps member countries to effectively manage their economic policy and financial affairs, by strengthening their capacity in both human and institutional resources, and to design appropriate macroeconomic, financial, and structural policies.
- Contributes to the effectiveness of the IMF's surveillance and lending programs, and is an important complement to these other core IMF functions.
- The IMF provides technical assistance in its areas of core expertise: macroeconomic policy, tax policy and revenue administration, expenditure management, monetary policy, the exchange rate system, financial sector sustainability, and macroeconomic and financial statistics.
- Depending on the nature of the assignment, support is often provided through staff missions of limited duration sent from headquarters, or the placement of experts and/or resident advisors for periods ranging from a few weeks to a few years. Assistance might also be provided in the form of technical and diagnostic studies, training courses, seminars, workshops, and "on-line" advice and support.

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THE 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

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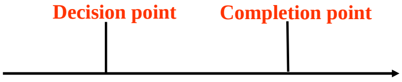
THE HIPC INITIATIVE
Steps of the HIPC Initiative



HIPC: STATUS AS OF JUNE 2009

Eligible countries: 41

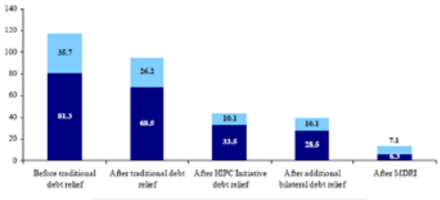
24 Post-completion
11 Interim countries
5 Pre-decision point

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

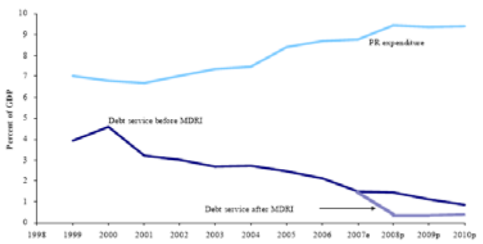
Figure 5. Post-Decision Point HIPCs' Debt Stock under Different Debt Relief Stages
(In billions of U.S. dollars, in end-2007 NPV terms)



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

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HIPC initiative
Challenges remain

- Many of the 16 countries that have not yet completed the requirements for full debt relief face common challenges, including preserving peace and stability, and improving governance and the delivery of basic services.
- It is important to ensure that eligible countries get full debt relief from all their creditors (smaller multilateral institutions, non-Paris Club official bilateral creditors, and commercial creditors, which together account for about 25 percent of total HIPC Initiative costs, have only delivered a small share of their expected relief so far).
- Given the voluntary nature of creditor participation in the HIPC Initiative, the IMF and the World Bank will continue to use moral suasion to encourage creditors to deliver their share of HIPC Initiative debt relief.

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