# Background Briefing: International Monetary Fund

Lillian Karabaic and Michael Kincaid

## The History of the IMF

The International Monetary Fund was founded in 1945 as the agency charged with overseeing the so-called Bretton Woods system (named after the town in New Hampshire where the summit establishing it was held), as well as promoting postwar global economic growth more generally. Common economic wisdom held at the time that a series of competitive currency devaluations was a significant contributor to the international contagion of the Great Depression (though later Depression scholarship has raised doubt about the importance of this factor). The Bretton Woods plan, by which the US would return to the gold standard and other participating countries would peg their currencies to the dollar, was meant to prevent such "beggar-thy-neighbor" policies. In addition to its oversight and international coordination roles, the IMF also served as an international lender of last resort: any member country facing a balance of payments crisis could apply for a loan that would allow it to repay its sovereign debt on time (from a pool of funds backed by capital contributed by all the member countries).

In the 1970s, rapid US inflation (brought about primarily by the Vietnam War) made the gold standard unsustainable, as the supply of dollars rapidly outstripped the Federal Reserve's ability to maintain enough gold reserves to back them. The combination of the end of dollar-gold convertibility and the rapid increase in dollar supply (causing unexpected monetary-policy effects in the countries that pegged to the dollar) led to the abandonment of the Bretton Woods system. The IMF continues to serve as a "global credit union" as well as an organization for research and international economic cooperation.

## The Present IMF

The IMF has a total of $1.3 trillion in resources at its disposal from its 188 member countries. As of August 9, 2012, it has $243 billion in loans committed, of which only $57 billion have actually been drawn. Thus, the IMF has more than $1 trillion in lending capacity still available. Even relative to the large magnitudes of assistance that will be needed to the various European countries, this is a very substantial asset base. Especially when this figure is combined with the resources of the ECB (see below regarding the current crisis), there is no reason to believe that the international community will be unable to backstop any European country needing assistance.

An important aspect of IMF lending is that it virtually always comes with specific requirements attached, known as "conditionality." Generally these requirements are meant to improve the quality of the borrowing country's macroeconomic policy and resolve the underlying conditions of distress that led to the crisis in the first place. More recently, IMF conditionality has also begun to expand beyond macro policy to address structural issues (such as privatization of government companies and competition in monopoly-dominated sectors) where it is clear that these are an important contributing factor, especially in developing countries. While countries often find it politically convenient to paint the IMF as imposing rigid outside conditions of its own devising (perhaps because such scapegoating can help with domestic politics), a more realistic account is to say that conditionality takes the form of a plan developed, discussed, and agreed upon by country officials in consultation and negotiation with IMF experts (as, indeed, in the present exercise). Some examples of specific plans undertaken to satisfy IMF conditionality provisions are provided in the case studies below.

## What the IMF Does: Two Recent Case Studies

### Brady Bonds and the Latin American Debt Crisis

In the late 1970s and early 1980s, a number of countries in Latin America—including Brazil, Argentina and Mexico—experienced balance of payments crises, brought on by a combination of a spike in oil prices, a collapse in other commodity prices (those exported by the Latin American countries), and tightening monetary policy in the US (in response to US inflation) which led to depreciation of the various Latin American currencies. Interest rates spiked so dramatically that these countries were unable to make payments on their debts, beginning with Mexico in 1982. Numerous American banks had extensive exposure to Latin American debt (a few would have been insolvent if their Latin American loans had been marked to market at the height of the crisis), leading to a contagion effect by which the crisis spread to the US.

US Treasury Secretary Nicholas Brady proposed a plan modeled on Sachs and Huizinga's (1987) "exit bonds" proposal. Essentially, the Latin American countries would be allowed to repurchase their debt at current secondary-market prices, which were by that point much less than face value (in Argentina's case, $100 of bonds were selling for $38). This repurchase amounted to a negotiated debt forgiveness (that is, a partial default or restructuring agreed upon by the creditor), but it allowed the banks holding the debt to recognize losses on their balance sheet rather than continuing to postpone the day of reckoning. In order to do so, the developing country would issue a special zero-coupon bond whose face value was the repurchase amount ($38 in this example) and issue it to the creditor (usually a bank) holding the original loan: the Brady Bond.

Because a Brady Bond was collateralized by a US Treasury bond—and so backed by the full faith and credit of the US Treasury—it was more valuable to a bank creditor than the original developing-country loan it replaced. Aside from the issue of backing, there was also the issue of tradability: in many cases the original bank loan was not securitized and thus difficult or impossible for a bank to remove from its balance sheet even if it was willing to accept a partial settlement. Even in cases where the developing-country debt was in the form of a putatively tradable bond, the market for such bonds was quite illiquid at this time. In cases where there were multiple creditors, the issue was further complicated by provisions of the loan requiring equal pro-rata repayments to all creditors. This rule was designed to prevent preferential treatment of particular creditors (or mistreatment of smaller ones), but it had the effect of making market-rate debt repurchases difficult and encouraging hold-out problems where one creditor could derail the entire deal by demanding unreasonable terms; the clause was renegotiated as part of the Brady agreement.

The developing countries purchased the Treasury collateral bonds with IMF, World Bank, and Inter-American Development Bank funds, as well as whatever of their own foreign currency reserves were available for the purpose. Thus, while the US Treasury played a significant role in negotiating and coordinating the plan, the various international development agencies, not the US, were the actual financial backers. In addition to loanable funds, the IMF provided significant technical and economic support as well as monitoring assistance to Treasury. Conditions that were imposed on these countries in connection with these plans included restructuring tax policy and administration to improve revenue, strengthening of the independence of central banks, and improvements in statistical and accounting systems. In some cases, elements of the plans were unorthodox. For example, despite IMF misgivings, Brazil implemented wage and price controls, and later broke a hyperinflationary cycle by implementing a new currency, ingeniously pegging it to a real-purchasing-power index.

**The Asian Debt Crisis**

Thailand was perhaps foremost among the "Asian Tiger" countries of the early 1990s, experiencing nearly 8% growth during that time. The Thai government largely followed the "Washington consensus" view by deregulating and liberalizing its financial system, and as a result of this and its stable exchange rate, it experienced substantial capital inflows (equivalently, it ran significant current account deficits). Unfortunately, not all of the investment engendered by these inflows was productive; much of it fueled a real estate bubble, whose popping led to bank failures and eventually a full-blown financial crisis. Although the Thai government had not ex ante insured the banking system, there was a widespread perception (perhaps related to "crony capitalism"/"government") that the sector would not be allowed to fail. The IMF also suggested that perhaps the Mexican crisis in 1995 was a contributing factor; perhaps investors reevaluated "their love affair with emerging-market assets."

In the wake of the banking crisis, the IMF pointed out the need for greater exchange rate flexibility in response, since a devalued currency would encourage exports and buffer the inevitable drop in output. It strongly recommended implementing such in phases, gradually expanding the band in which the currency was allowed to move and reducing the weight of the US dollar in the pegging basket—but Thailand refused to do so, continuing to believe that a fixed exchange rate was essential to the country's export success. In fact, because the Thai central bank engaged in a sort of accounting trick, engaging in forward swaps of other currencies for baht instead of outright purchasing them (and not reporting those swaps to the IMF), IMF officials mistakenly believed the situation was under control immediately before the final speculative attack that took down the peg.

Immediately after the central bank ended the peg, Thailand began negotiating with the IMF for a standby line of credit. While some standard austerity/fiscal stability measures were included in the package, there was a significant emphasis on banking reform due to the financial nature of the events precipitating the crisis. Many banking institutions were closed, but depositors and creditors of the survivors ultimately received a guarantee, despite the significant moral hazard concerns associated with the idea of bailing out risky, speculative investments by the financial sector (sound familiar?). A delicate series of fiscal and monetary tightening moves ensued with the goal of restoring investors' confidence in Thailand without causing undue contraction in output.

Shortly thereafter, the Indonesian rupiah fell victim to regional contagion and a very similar series of events—a sudden conversion to floating rates, IMF assistance—transpired there. In the Indonesian case, a failure to guarantee bank deposits as thoroughly as had been done in Thailand prolonged the confidence crisis, and under the Suharto administration some of the issues negotiated were bizarre (for example, the elimination of a government plan to produce and sell cars as well as dissolution of a national agricultural monopoly). Despite Korea's floating exchange rate and relative geographic distance from the affected Southeast Asian countries, it too faced a confidence crisis (perhaps, the IMF felt, related to capital controls and state dirigisme) and ultimately accepted an IMF stability package as well.

## Political Pressures

Pressures from developing economies may somewhat tie the IMF's hands in its dealings with Greece. While the fund was once mostly a lender to poorer and emerging countries, by far its largest loan commitments are now to the Eurozone. While the IMF decision-making structure was traditionally dominated by Europeans, Canada and the United States, more recently the IMF ceded two seats on its board to developing countries in a bid to persuade cash-rich developing economies to contribute more to the fund. Representatives of these countries have suggested that "people living on less than $1/day should not have to worry about bailing out Europe's welfare state."

## Present Involvement in The Euro Crisis

So far, the IMF has pledged over €103 billion to Ireland, Portugal, and Greece as part of the rescue package for the Eurozone, with nearly €40 billion of that pledged to Greece's bailout alone. These loan amounts are on par with the IMF's biggest previous loan, a €30 billion loan to Brazil in 2002. Much of the IMF's role has been to identify and persuade cash-rich countries to contribute to the rescue fund for troubled countries, and while the lion's share of the rescue money has come from the developed world, the IMF has also recruited funding from countries such as China for the rescue package. About 10 percent of the IMF's total lending capacity has been pledged in support of Greece, Ireland, and Spain.

The IMF has played a central role in the negotiations in response to the Euro crisis, working closely with the European Central Bank and the European Commission (the "troika" of lenders). Many believe that only the fund has the clout, money and expertise to serve the crucial role of outside arbiter in the euro zone, particularly as countries like Greece and Germany quarrel with one another. While the ECB plays an essential role by setting monetary policy for the euro zone (mostly guarding against inflation) as well as laying the groundwork for future integration of bank regulation and even Eurozone bonds, its role as the central bank and in particular its strict commitment to inflation mean its involvement is by nature limited. The Fund's involvement is necessary in countries like Greece where underlying structural issues play an important role, such as inadequate revenue collection and labor market rigidities. The IMF will defer specific structural suggestions for Greece until Phase II of the exercise, but it is clear that to a greater extent than the ECB and the EC, the IMF is uniquely positioned to work with Greece to create conditionality plans to address the roots of its economic malaise, following on the success of such IMF plans in Latin America and Asia.

The IMF role in the Euro crisis thus far has represented something of a reversal of its stereotypical role as the arbiter of structural adjustment; playing "good cop" to the European Central Bank's "bad cop", the IMF persuaded the European Union to provide more cash to Greece in April and May 2010, brokered an €85 billion assistance package to Ireland, and participated in forbearance negotiations to allow Greece more time to implement spending cuts. The IMF nonetheless retains a supervisory role: for example, Italy has voluntarily asked the IMF to audit its books since November in order to build market confidence that it has been carrying out agreed-upon reforms, and accordingly, the IMF scrutinizes Italy's balance sheet every three months. The IMF will no doubt play a similar role in Greece, where trust in the accuracy and completeness of the sovereign government's accounting is even lower than that in the Italian government.

The IMF's lending in Ireland has largely been a success, forcing necessary downsizing of a bloated banking industry; the Irish government has been able to issue its own bonds again only 2 years after the initial rescue package. Similarly, Spain will likely face an easier recovery than Greece, given that Spain's problems seem to be more concentrated around the popping of a residential property bubble (suggesting targeted measures such as homeowner assistance might work). The relative strength of Spain's industrial base and Ireland's educated young population compared to Greece's tourism- and public sector-based economy suggests that the Fund's involvement in structural reforms in Greece will need to be more extensive, painful, and technically difficult. Perhaps most importantly, Spain's budget was in structural balance before the Euro crisis, whereas Greece's only appeared to meet the Maastricht convergence criteria as a result of untoward accounting practices.

Two months ago, the Troika imposed an austerity package of cuts of €13.5 billion in order for Greece to receive a €41.3 billion loan installment pledged from the three lenders. The majority of the loan package is coming from the IMF, which is as noted above mostly European-funded except for newer cash-rich developing countries. (The US, in particular, has refused overtures from the IMF asking for additional voluntary contributions, claiming that its contribution is sufficient and Europe should manage its own recovery.) Greece has delayed implementing the austerity plan in the face of civil unrest, especially in Athens, and concerns given already skyrocketing unemployment (nearly 25%) that the middle and lower classes in Greece cannot take many more cuts. The plan has yet to be implemented, and thus the rescue loan installment has not yet been provided to Greece.

As of now, the IMF is increasingly concerned about the gridlock in the Euro zone negotiations—especially the tense relationship between the Greek domestic political situation and the international community, and the possibility of knock-on contagion effects on the global economy. The fund calls for immediate action on the euro, notably movement on Greece's austerity plan and rescue loan installment. The IMF warns that in the worst-case scenario, European banks could be forced into a fire sale of up to $4.5 trillion of assets if the crisis continued to get worse, causing asset prices to plummet with devastating global consequences. The IMF's involvement as outside arbiter, policy advisor and financial backstop will be essential to a timely and effective crisis management plan that addresses both short-term liquidity and long-term structural solvency for the Eurozone countries.

## References


[1] The latest warning for Europe. `http://rendezvous.blogs.nytimes.com/2012/10/10/another-wake-up-call-for-europe/`.

[2] The IMF and the euro crisis: Less cash, more impact. *The Economist*, October 2012.

[3] James M. Boughton. Tearing Down Walls: The International Monetary Fund 1990-1999. `http://www.imf.org/external/pubs/ft/history/2012/`.

[4] Steven Erlanger and Stephen Castle. German vision prevails as leaders agree on fiscal pact. *The New York Times*, December 2011.

[5] Jack Ewing. I.M.F. urges Europe's central bank to buy more government debt. *The New York Times*, July 2012.

[6] Jack Ewing. Stirrings of resentment over I.M.F. help for Europe. *The New York Times*, October 2012.

[7] International Monetary Fund. IMF conditionality. `http://www.imf.org/external/np/exr/facts/conditio.htm`.

[8] International Monetary Fund. IMF history. http://www.imf.org/external/about/history.htm.

[9] International Monetary Fund. IMF overview. http://www.imf.org/external/about/overview.htm.

[10] International Monetary Fund. Why the IMF was created and how it works. http://www.imf.org/external/np/exr/facts/glance.htm.

[11] National Public Radio. Foreign policy: 5 easy solutions to the Greek crisis. http://www.npr.org/2012/05/18/152990481/foreign-policy-5-easy-solutions-to-the-greek-crisis.

[12] National Public Radio. IMF chief urges action in tackling euro crisis. http://www.npr.org/templates/story/story.php?storyId=162696585.

[13] Jeffrey Sachs, Harry Huizinga, and John B. Shoven. U.S. commercial banks and the developing-country debt crisis. *Brookings Papers on Economic Activity*, 1987(2):555–606, January 1987.