

# Has the International Monetary Fund (IMF) Evolved into a Defunct Institution?

## 1. The Origin of the IMF

Since the 1970's, global economy has experienced a number of financial crises. These include sovereign debt crisis of 1982-1984, Mexican peso crisis and Russian financial crisis in the early 1990's, Argentina's financial crisis in the early 2000's, and the East-Asian financial crisis of 1997-1998. The global economy has been experiencing severe financial difficulties since 2008. With the bitter experience of the Great Depression and the Second World War, allied nations created multilateral development and monetary institutions for reconstruction, development and stabilisation in the 1940's. Among the institutions created, International Monetary Fund (IMF) has been the key institution established to provide surveillance and assistance in maintaining monetary stability since the 1940's.

The IMF was created at the Bretton Woods Conference held on July 1 - 22, 1944, in the Bretton Woods, New Hampshire, in the United States of America (USA), in the aftermath of the Second World War. The goal was to maintain global financial and economic stability. Its operations began on December 27, 1945, with headquarters in Washington DC, USA. The original membership was 39 countries, which has grown to about 182 countries at present. The IMF was basically entrusted with the responsibility of overseeing the balance of payments and exchange rates of member countries. A mechanism was created for it to provide required assistance to

member states to stabilise the balance of payments and exchange rates by financing external deficits. By construction, the IMF was an international monetary institution that ensures global financial stability through monitoring and assisting when member states experience external deficits, rather than an international development financing institution.

The origin of the IMF was based on the ideas of trio of key experts - John Maynard Keynes (the founder of macroeconomics), Harry Dexter White (Treasury Secretary of the USA) and George Marshall (Secretary of State, USA) - who wanted to establish a post-war economic and monetary order based on notions of consensual decision making and cooperation in the realm of trade and economic relations. Based on the theoretical premise that markets cannot automatically stabilise without government intervention, Keynes proposed at the Bretton Woods Conference to introduce a global single reserve currency and to establish a World Central Bank. It was also proposed to establish an international clearing union. The idea was to provide unlimited access to funds when member states experience instability in the balance of payments emanating from external deficits. These proposals received stringent opposition from the USA-led allies despite the wide spread support from various lobby groups. Keynes believed his proposals would create a more stable and fairer world economy.

While protesting the Keynes's proposals, the USA-led allied nations accepted the fact that a

## O.G. Dayaratna Banda

*Senior Lecturer,  
Department of Economics,  
University of Peradeniya.*

multilateral framework was needed to overcome the destabilising effects of the previous global depression, and to rebuild the economies devastated by the war. In this backdrop, the USA delegation led by Harry Dexter White, Secretary to the Treasury of USA, proposed at the Bretton Woods Conference to establish an international stabilisation fund. This proposal provided the basis for the establishment of the IMF. Under this arrangement, IMF member states would not automatically receive loans when they tumble into external deficits. They would rather have a very limited access to funds with various conditions. The newly-independent poorer nations, which emerged after the collapsed of colonisation, had been given a very little clout in the decision making process at the IMF.

It was hoped that the IMF would create a stable climate for international trade by harmonising its members' monetary policies, and maintaining exchange rate stability. It would be able to provide temporary financial assistance to countries encountering difficulties with their balance of payments. Under the adjustable pegged exchange rate regime introduced in the 1940's, the IMF was entrusted to provide surveillance and assistance which focused on those macroeconomic variables relevant to member states' obligation to maintain the par value of their currencies. The IMF was also interacted with the member states' Central Banks and Ministries of Finance.

The supply of funds when requested by member states was based on conditions limited to macroeconomic variables, such as, devaluation of currency, and reducing budget deficits. The global monetary system was relatively stable under the adjustable pegged exchange rate regime during the period from the 1940's to the late 1960's.

## **2. Collapsing of the Adjustable Pegged Exchange Rate Regime in the 1970's**

Between the Bretton Woods agreement in 1944 and the 1960's, the IMF used a gold standard pegged to the United States dollar as the basis for international trade. Britain got itself into many financial troubles that caused chaos with the official price of gold. Speculation in gold pushed unofficial prices upwards to the extent that official rates were too low and official gold transactions came to a standstill. In 1971, the USA suspended convertibility of gold into USA dollars. After attempts to find a new regime for currency conversion rates had failed, the pound Sterling was allowed to float. When the USA dollar was devalued twice in fourteen months, all attempts to peg international currency rates were abandoned in 1974. What presented here is, in fact, a very condensed version of the events between 1944 and 1974, but the result was that the role of the IMF was almost irrelevant because the Bretton Woods agreement and the part of the white plan on which the IMF had been established had collapsed. That would have been the perfect time to reform the IMF for establishing a new international monetary arrangement. Unfortunately, the IMF made a comeback in a new form adopting a patchwork approach to maintaining international monetary stability. Meanwhile, continued internal problems in Britain forced the

British Government to go to the IMF as a lender of last resort. This happened in late 1976. This was a turning point in the way the IMF worked. The loan to Britain was made conditional on Britain making internal policy changes according to the dictates of the IMF. This was a world changing event. The IMF had been converted into a political machine of rich countries, especially of the USA, that could impose policy onto an independent country in exchange for a loan.

As a result of the British experience, developed countries began to avoid borrowing from the IMF, and since 1977, the only countries to borrow from the IMF have been developing countries. Initially, developing countries borrowed from outside of the IMF to overcome their deficits, but their borrowings escalated to the point where they were borrowing to repay the existing loans. The IMF gave loans to struggling developing countries on 'Stabilisation Programmes'. The required structural changes included abolition or liberalisation of foreign exchange and import controls; exchange rate devaluation; and anti-inflationary domestic programmes including control of bank credit and higher interest rates, lower budget deficits through curbs on government spending, increases in taxes, abolition of subsidies, controls on wage increases, dismantling price controls, and greater hospitality for foreign private investors.

By the mid 1980's, many countries in Latin America and Africa were under the supervision of the IMF. This came about largely because falling commodity prices triggered the 1980's debt crisis. The IMF provided the conditions in which private banks would be guaranteed that their loans would be repaid, and in return private banks were required to provide more money for long-term loans. In return, for

short-term loans, the IMF takes over 'supervision' of a country's economy. This supervision guarantees that investment banks will receive high return on monies lent to poor oil-importing countries on a long-term basis.

The end of the Bretton Woods pegged exchange rate system created a dilemma for the IMF as to what it should monitor in its surveillance missions, if there is no par value system for it to oversee. The amended articles provided very limited guidance for stabilisation under a flexible exchange rate system. This is the beginning of mission creep of IMF, resulting in the IMF to get involved in any issue that can affect the balance of payments and the monetary situation in its members. The IMF began to intervene into almost all domestic policy issues of consumer states. As a result, the credibility of the IMF as an international monetary institution tended to severely deteriorate.

## **3. Criticisms against the IMF's Current Role in the Global Economy**

In recent years, signs of the loss of confidence of IMF have surfaced. Argentina, Brazil, Russia, and Uruguay prepaid the obligations to the IMF. The multilateral debt relief measures were established showing the inadequacy of past efforts of the IMF to deal with the debt of the poorest countries. Very large foreign reserves have piled up in some Asian countries, such as China and Japan, creating global imbalances. Academic criticisms against IMF have also mounted in recent times. The IMF has forced its new broader functions into its existing distortions and inefficient decision making structures and governance arrangements without changing the existing interpretation of its mandate. With these patchwork amendments to the operations of the IMF, many distortions and problems have emerged.

Uniformity was one of the principles of the IMF's operations. However, uniformity does not make sense when its services are only being utilised by its developing country member states. Interpretation of the Articles of Agreement as including a political prohibition is problematic. Though IMF cannot consider political issues in decision making, since it has been designed as an apolitical entity, political and other non-economic factors, and issues have dominated the decisions and conditions imposed by the IMF on consumer states, indicating that its decisions are highly influenced by the political considerations of supplier countries (or rich countries) (Bradlow 2006).

The relationship between the IMF and its supplier countries is also problematic. The supplier countries blindly support what the IMF does for the consumer countries. Their dominance in the IMF's decision making process is enhanced by few developments. There has been a declining importance of basic votes. The size of the IMF Board constituencies has been expanding, where larger constituencies imply less ability to focus on policy issues. There is a permanency of the G-7's representation in the IMF, enabling them to develop institutional memories and expertise about the IMF. This has created a situation of institutional inertia, leading to an institutional poverty trap in the IMF. The independence of the supplier countries from IMF means that they can focus on cases of special interest and IMF policy issues.

The relationship between IMF and its consumer member states is another source of distortion. The consumer member states include emerging market economies that need IMF for emergencies and for stamp of approval. In recent times, some countries of this group have attempted to establish their

independence from IMF, so that these countries are similar to IMF's supplier countries. The second category in this group includes poorer countries in the world which depend mostly on official sources of external funds for financing external deficits. The increasing demands from these countries for more funding indicates the evolution of IMF from an international monetary institution into an international development financing institution. The IMF has become an important actor in the policy making process of these countries. However, this has been interpreted as external influences into the domestic affairs of developing countries, since the IMF has not yet developed formal procedures for ensuring that all relevant stakeholders are consulted in taking these decisions (Bradlow 2006).

Current IMF structure of governance and decision making appears to have created many problems. Lack of accountability has been seen as a major problem in IMF's operations. The IMF structure provides for two channels of accountability, namely, the Board of Executive Directors in which most consumer member states are only indirectly represented, and the Board of Governors in which governors appear to have inadequate knowledge of specific operations of IMF. This has generated many consequences. The IMF staff and management are alleged to be operating without effective accountability. This has created uncertainty about the operational and policy-related responsibilities of the IMF. It is also accused of performing its functions without any formal mechanisms through which the accountability can be maintained. The relation between IMF and other international organisations has been strained. The IMF has crept into many areas mandated to the World Bank, the United Nations,

and other international development financing institutions since the 1970's.

The IMF's lending has also been under severe criticism. The initial task of the IMF was to monitor member countries adherence to pegged but adjustable exchange rates and to provide temporary loans to resolve balance of payments problems. However, the IMF created a Trust Fund in the 1970's to make low interest loans to poor countries, and also provided them with traditional stand-by loans, allowing countries to draw loans on various conditions. In the 1980's, these loans were packaged and labelled as structural adjustment facility, which enabled the IMF to drastically change the domestic policy environment of developing countries. These policy interventions have been seen as undesirable for most countries. This particular facility was renamed in 1999 as the Poverty Reduction and Growth Facility. Another facility that was created in the 1960's, Compensatory and Contingency Financing Facility, makes low conditionality loans to countries with temporary shortfalls in exports. The extended loan facility introduced in 1975 makes longer-term loans to countries with a structural payments problem. The Supplementary Reserve Facility introduced in 1998, which is a high loan facility, provides contingent credit line.

All these lending facilities characterise a patchwork approach to providing surveillance and monitoring in order to maintain stability under the flexible exchange rates. These developments also show that IMF has been moving away from its original mandate as an international monetary institution that ensured monetary stability to an international development financing institution that provides

lending for various structural changes and development activities. The IMF was not restructured after the collapsed of the pegged exchange rate regime to meet the needs of the multiple exchange rates adopted by various countries (Bradlow 2006, Nijathaworn 2006, Phillips 2006).

A phenomenon emerged from this is the principle of conditionality in lending, the centre point of the protest against the IMF. The number of conditions has proliferated since 1950's as the IMF strayed into almost all domestic policy issues of consumer countries. This has happened while there is no proper and adequate representation of consumer states in the decision making process of the IMF. Multiple conditions required by the IMF that are seen to be unenforceable and that the client country with the best will in the world cannot comply. The proliferation of conditions, which do not have sound theoretical or practical basis, has been propagated without due regard to the realities of the consumer states. The proliferation of conditions, their impacts and IMF's This has been documented by many authors Buirra 2003, Goldstein 2000, Dell 1981. Joseph Stiglitz, a Nobel Prize Winner in Economics and an ardent critic of IMF, has argued that the IMF represents only most of USA interests. He argues that: "They'll say the IMF is arrogant. They'll say the IMF doesn't really listen to the developing countries it is supposed to help. They'll say the IMF is secretive and insulated from democratic accountability. They'll say the IMF's economic 'remedies' often make things worse - turning slowdowns into recessions and recessions into depressions. And they'll have a point. I was chief economist at the World Bank from 1996 until last November, during the gravest global economic crisis in a half-century. I saw how the

IMF, in tandem with the U.S. Treasury Department, responded. And I was appalled". There is also a substantial literature on the mission creep of international institutions discussing the evolution of international arrangements into a messy system in the form of international monetary disorder (Babb and Buirra 2004, Bretton Woods Project 2003).

One of the salient failures of the IMF since the 1970's has been its inability to foresee or prevent financial crises, even though IMF was created basically to monitor and prevent financial crises. The IMF's surveillance has not succeeded since 1970 under the multiple exchange rates practised by various countries. It has continuously failed to spot warning signals of trouble in almost all countries - poorer, emerging or advanced countries- since all have experienced a number of financial crises for the past few decades. The IMF has failed to create early warning systems with a view to creating financial stability.

#### **4. Proposed Reforms**

In order to resolve the existing problems in the IMF, a number of things have been proposed. First, two extreme groups propose to abolish the IMF. One group, pure liberals, argues that market is the most efficient and best means for allocating resources, so that, an institution like IMF is not necessary. The other group is of the view that international organisations are merely used by the rich nations to keep poorer and weaker developing countries in their place. This group emphasises the importance of nationalistic institutions compared to international organisations. Though it is possible to abolish the IMF, it is impossible to eliminate the need for an international monetary institution. International trade and finance require cooperation among

countries, not unilateral actions. The second idea is to change the policies of the IMF. It is proposed to limit the IMF's operations to its original mandate. It must confine itself to an international monetary institution rather than an international development assistance institution. Limiting the scope for IMF activities would also curtail mission creep. The emerging consensus is that the IMF should not be involved in financing the structural transformations of individual member countries and should not be in the business of alleviating poverty. These things should be left to World Bank, UN system, and other development financing institutions. However, for this to be effective, the structure of the IMF must be reformed. In this light, some proposes a comprehensive reform programme to rationalise the activities of the IMF.

The proposed reforms include short-term, medium-term and long-term measures (Bradlow 2006 Nijathaworn 2006, Phillips 2006). In the short term, the IMF Executive Board must be made more responsive to its developing country member states. For this purpose, the Executive Board must be restructured so that it includes adequate developing country representation. At present, there is an informal practice of allowing member state's governor or his/her representative to attend the Executive Board. In the medium term, reforms in the IMF structure are necessary to make the IMF more responsive to developing country member states. The developing country membership in the IMF's Board of Directors needs to be enhanced. Reforms are also necessary to make the decision making process of the IMF on a basis that better reveals the preferences of those who will be most affected by the decisions. The majority support of both the groups is essential for taking decisions. In

the long term, a comprehensive reform programme must be introduced to make IMF an inclusive institution, recognised, not only, by supplier countries, but also, by the consumer developing countries.

It is also proposed that the IMF must eliminate conditionality by substituting market interest rates for low cost loans. The persistent borrowing by some countries underscores the need to reform these practices. Low interest loans have not done any good to developing countries. Low interest loans of international financial institutions have made most poor countries highly indebted, because low interest loans accompany many undesirable and inappropriate policy prescriptions. Developing countries would rather be allowed to borrow as necessary at market rates for financing external deficits without conditions so that they themselves will find ways to repay their debt. This will enable developing countries to make and implement policies and programmes appropriate to their domestic realities.

It is also well-known that the IMF has failed to prevent financial crises either at the global or individual country level. The IMF must be vigilant about the signs of financial deterioration in member states. It must activate the early warning systems to take necessary precautions to prevent financial crises. A significant amount of resources of the IMF needs to be diverted to undertaking economic research on forecasting.

## 5. Concluding Remarks

The existing deficiencies in the IMF structure and the decision making process reveal the need for a new international financial arrangement, that serves the needs of the current globalised economy. Developing countries need to have adequate and reasonable representations in the decision making process. The IMF's

governance structure needs to be amended to make it more accountable and transparent. The existing biasness in the decision making process against the poorer consumer countries must be eliminated.

It is not wise for the decision makers of the IMF to believe that they know all in creating stability and economic development in member states. The decision makers of the IMF must realise that their policies may or may not work, simply because, the deficiency of the existing knowledge. This implies that consumer member states must be allowed a greater freedom for policy choices. The IMF must support prudent home-grown policies, without imposing the things that they think will work for developing countries. They must take the bitter lessons of the structural adjustment programmes packaged and forced to developing countries. The fact, that recent IMF loan facility to Sri Lanka has supported home-grown policy prescriptions proposed by the government should, in this spirit, be commended.

It is important to note that recent economic research has established the fact that various country specific factors tend to dominantly determine growth, development, and stability in developing countries. One size fits all strategy of the IMF has never and will never be effective. Finally, comprehensive reforms have to be undertaken to make IMF a strong monetary institution rather than a development financing institution. This can only be done by eliminating IMF's development financing activities. For comprehensive reforms, John Maynard Keynes's initial proposals for introducing a global single reserve currency along with pegged exchange rates system, establishing a World Central Bank and an international clearing union ought to be seriously rethought. Robert Mundell, a Nobel Memorial Prize Winner in Economics, and

many others have proposed to peg exchange rates of all countries to a basket of currencies. The IMF's surveillance and assistance must be limited to financing external deficits of the member states in order to maintain monetary stability. However, these arrangements should facilitate the freer markets and globalised economy.

## References:

Babb, Sarah and Ariel Buira. (2004). "Mission Creep, Mission Push and Discretion in Sociological Perspective: The Case of IMF Conditionality", Paper presented at the XVIII G24 Technical Group Meeting, March 8-9, 2004, Geneva, Switzerland.

Bradlow, D.D. (2006). "The Changing Role of the IMF in the Governance of the Global Economy and Its Consequences", Unpublished Manuscript, University of Pretoria.

Bretton Woods Project. (2003). "IMF Mission Creep" [www.brettonwoodsproject.org](http://www.brettonwoodsproject.org). Accessed November 5, 2009.

Buira Ariel. (2003). "An Analysis Of IMF Conditionality", Paper Prepared For The XVI Technical Group Meeting Of The Intergovernmental Group Of 24 Port Of Spain, Trinidad And Tobago, February 13-14, 2003.

Dell, Sidney. (1981). "On Being Grandmotherly: The Evolution Of IMF Conditionality" Essays In International Finance No. 144 Princeton, N.J., Princeton University, International Finance Section, October.

Goldstein, Morris. (2000). "IMF Structural Programs", Paper Prepared For NBER Conference On "Economic And Financial Crises In Emerging Markets" Woodstock Vermont Oct. 19-22, 2000, Revised December Institute For International Economics, Washington, D.C.

Nijathaworn, B. (2006). "Some Thoughts on IMF Reform on Crisis Prevention and Crisis Resolution" Paper Presented to the G-7 Workshop on Reforms of the Bretton Woods Institutions, held in Tokyo, Japan.

Phillips, L. (2006). "IMF Reforms: what happens next?" Overseas Development Institute, Policy Brief. UK.

Stiglitz, J. (2000). *The New Republic*, an American political commentary magazine, [www.tnr.com](http://www.tnr.com)