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The lending policy of the International Monetary Fund

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There is also controversy about the IMF’s positive assessment of the adjustment made so far, particularly by the major Latin American debtors Mexico and Brazil, and their longer-term prospects for growth and exports. It is true that these countries recorded trade surpluses and achieved positive rates of GNP growth again in 1984, but this progress should be seen in relation to the very deep recession of 1982-83, which was associated with the policy of austerity. Sceptics also point to the still unsolved structural problems in the Mexican farm sector, Brazil’s continuing inflation problem and the far less favourable situation of other Latin American countries.

These considerations demonstrate that the solution of the debt crisis through expansionary stabilisation is fraught with great uncertainty. It is not difficult to imagine situations in which the debt problems of a number of countries would become solvency crises that would make partial debt cancellation unavoidable. Against a background such as that, the IMF adjustment concept would have to be revised fundamentally, as it is based on the notion that after a transitional period the debtor countries would be able to return to a growth path with highly integrated trade and credit relations with the industrialised countries and would continue to be net importers of capital over the longer term.

The Lending Policy of the International Monetary Fund

by Wolfgang Wetter, Hamburg*

In the worldwide economic and debt crisis of the eighties the International Monetary Fund increasingly became the “lender of last resort” for a great many Third World countries. With world trade weak and interest rates high, a considerable number of developing countries got into serious balance-of-payments difficulties. The demand for stand-by and extended arrangements with the Fund rose dramatically. The conditions or adjustment programmes linked to this lending not infrequently led to serious social and political tensions in the countries concerned. The term “IMF riots” was coined, and the conditionality of credit again became the subject of political and academic debate.

The word “conditionality” in the sense under discussion here appears in neither the original Bretton Woods Agreement nor the First and Second Amendments to the IMF Articles of Agreement. Nonetheless, ever since the first Amendment at the very latest, there has been no doubt as to the legal admissibility of conditionality. Article V states: “A member’s use of the resources of the Fund shall be in accordance with the purpose of the Fund and that will establish adequate safeguards for the temporary use of its resources.” (Italics by the author.)

As in the past, the justification for conditionality lies in protecting the revolving nature of (special) IMF resources. That IMF resources must be repaid is not in dispute. The IMF was not founded to make gifts of international liquidity. However, it is debatable whether conditionality guarantees repayment. Some authors consider that repayment is assured solely by the fact that no country can afford deliberately to withhold

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that the repayment of even conditional stand-by or drawing ability. This argument is supported by the fact that the repayment of even conditional stand-by or extended credits is not assured without the willingness of the member country concerned, because during the repayment period the Fund no longer has any sanctions it can apply. The recipient country could rescind or amend measures previously demanded by the Fund or apply. The recipient country could rescind or amend measures previously demanded by the Fund or reverse structural adjustments if the balance of payments shows a lasting improvement for external reasons. The failure to take account of the effect of external factors on the balance of payments also touches upon a sore point regarding the Fund’s principles of conditionality.

The Fund’s Principles

The IMF distinguishes between balance-of-payments disequilibria according to whether they are of external or internal origin and whether they are lasting or temporary. However, the sole criterion for ascertaining the need for adjustment is whether the imbalance is lasting. Temporary difficulties can be financed subject to few if any conditions. In the event of permanent or structural disequilibria the Fund sees its task as being to assist efficient adjustment by countries in difficulties and to use its resources to ease the inevitable frictional losses, thereby preventing the member country from resorting to restrictions that would harm the world economy. This accords with the objectives of the Fund. However, whereas the diagnosis of temporary disequilibria is necessarily open to uncertainty, structural distortions in a world economy that is subject to permanent structural change are far easier to detect. Tying the degree of conditionality to structural criteria is therefore questionable.

The worldwide crisis of recent years provides a graphic example of this. The LDCs are undeniably facing considerable structural problems, but their balance-of-payments difficulties would have been much less serious if the structural problems in industrial countries had not led to a decline in world trade. A further significant external factor in the balance-of-payments difficulties of the LDCs is the increasing protectionism in the USA, Japan and the European Community.

By largely ignoring external factors in the assessment of balance-of-payments disequilibria, the Fund inevitably lays itself open to criticism. In this connection Edward M. Bernstein, a member of the US delegation at Bretton Woods, also points to the principles of the Fund Agreement, whereby the balance-of-payments adjustment process should be related to the causes of the problem. “If the deficit, for example, is the result of excessive demand, then the proper remedy is to restrain domestic expenditure. But if the cause of the deficit is a cyclical change in international economic conditions, then the deficit should be financed by credits until there is a recovery in the world economy.” Bernstein considers that this principle is still valid today and covered by the current Agreement. Indeed, in a decision of 1979 the Executive Board of the Fund emphasised that adjustment programmes had to pay due regard to the domestic situation in member countries and the causes of their balance-of-payments problems: “In helping members to devise adjustment programs, the Fund will pay due regard to the domestic, social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems.”

The record of Fund adjustment programmes shows, however, that it interprets its own decisions too narrowly.

Adjustment Programmes

Criticism of conditionality intensified in the eighties, as the Fund turned increasingly to supply-side factors to overcome the structural weaknesses of many member countries. One complaint was that even the extension of financing to three years under stand-by and extended arrangements was not long enough to correct serious...
Table 1
New Loan Commitments
(billion SDRs)

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<td>New loan commitments approved</td>
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<td>under stand-by and extended arrangements</td>
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<td>Industrial countries</td>
<td>0.7</td>
<td>4.9</td>
<td>1.0</td>
<td>-0.8</td>
<td>6.6</td>
<td>12.1</td>
<td>2.4</td>
<td>10.6</td>
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<td>Developing countries</td>
<td>-</td>
<td>3.8</td>
<td>0.1</td>
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<td>b) Purchases, other than a)</td>
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<tr>
<td>Industrial countries</td>
<td>4.6</td>
<td>0.2</td>
<td>0.6</td>
<td>0.6</td>
<td>1.0</td>
<td>1.5</td>
<td>3.0</td>
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<tr>
<td>Developing countries</td>
<td>1.7</td>
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<td>0.1</td>
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1 Including supplementary financing and enlarged access where applicable; net of cancellations and expirations.
Note: Components may not add to totals because of rounding.

It cannot be denied that the governments of member countries in difficulties consent to the IMF conditions in their "letter of intent". However, it is also true that the so-called IMF riots are not the inventions of over-zealous journalists. The recent cases of the Sudan and Argentina illustrate the social and political problems that may be caused by supply-side measures supported by the Fund.

The Fund counters the first criticism with the argument that it does not assume that structural imbalances can necessarily be cured during the lifetime of a stand-by or extended arrangement. Instead, its policy is intended to bring the member country to a balance-of-payments or current account position that is "self-financing", in that it gives the country renewed access to private sources of capital by means of which complete adjustment can be achieved. This argument sounds plausible, but it is surrounded by great uncertainty. It cannot be taken for granted that after so short a time a country's creditworthiness will have been restored to the point where subsequent finance can be raised on acceptable terms in international markets. Doubts on this score are supported by empirical studies into the efficiency of IMF adjustment programmes.

The Fund answers the second charge by pointing out that the analyses underlying the adjustment programmes and the conditions based on them are discussed with the governments concerned. To opt for the "right" course is itself a "painful" decision, as the industrial countries themselves know well enough; however, it is an issue that cannot be handled in detail in this article. 9

9 Cf. for example Sydney D e l l, op. cit.
The Fund’s Mandate

The objectives of the IMF are set out in Article I of the Articles of Agreement. In the connection that interests us here, Section V is of particular significance. It states that the Fund aims to “... give confidence to members temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity”.15

A fundamental problem in the interpretation of this clause lies in the phrase “under adequate safeguards”. Are safeguards appropriate if they severely infringe the autonomy of a member country, and if they go so far that the Fund increasingly becomes the corrective for a country’s unsuccessful development and growth policy? The answer must be no. A further complication is that the Fund’s corrections do not generally attack the causes of structural deficiencies and hence cannot be efficient over the medium and long term.

This can be illustrated by an example. One measure that the Fund frequently applies and which, in isolation, is perfectly justified in economic terms is the correction of the relationship between agricultural and industrial prices. Incentives to increase agricultural output and to generate investible funds can come about only if market prices can develop evenly. However, the low level of real wages induces many governments of LDCs to keep the prices of agricultural produce artificially low by administrative means. The result is a shortage of domestic products; additional quantities must be imported, imposing a burden on the balance of payments. The correction of relative prices is certainly appropriate to improving the balance of payments, but success will be no more than temporary unless the true causes are eliminated. The causes lie in a fundamentally mistaken development policy, frequently relying on the production of goods which, given the low labour productivity in LDCs, can be produced competitively only by means of high capital intensity.

Accordingly, a radical revision of the overall development strategy is generally needed to correct structural payments imbalances. However, this the IMF cannot deliver and in any case it would be incompatible with its mandate. It is therefore only a slight exaggeration to say that many of its structural adjustment programmes are no more than first aid. The intensified collaboration between the IMF and the World Bank in the structural field indicates that the IMF itself has already recognised this. Nevertheless, if the Fund’s structural measures in the context of adjustment programmes merely cure the symptoms, it is high time that the IMF rethought its policy of conditionality and adjustment.

There is a further argument against the Fund’s policy of conditionality that should not be ignored. Even though the majority of world trade is now conducted under a system of flexible exchange rates, the international adjustment process is asymmetric. Surplus countries can accumulate international liquidity with impunity, while deficit countries must adjust. Under its Articles of Agreement, however, the Fund is required to pay just as much attention to eliminating surpluses as to eliminating deficits,16 although in reality it only has the power to do so in the case of deficit countries that turn to it for help. This argument is therefore “morally” justified, but in practice the Fund’s executive organs cannot pursue a different policy, given the distribution of power within the organisation.

Moral Hazard

Between 1960 and 1982, 78 % of all extended or stand-by credits was granted to only 42 member countries.17 This ratio shows that there is a substantial number of member countries that repeatedly or even regularly draw on Fund resources; it also demonstrates how questionable the justification for Fund conditionality is.

Only recently the US Treasury complained about the problem of “regular customers” in a report to Congress. It cited the Philippines, Turkey, Yugoslavia and a string of African countries, bemoaning their inadequate success with IMF adjustment programmes. In the Treasury’s view, such countries cannot be helped by means of IMF loans; in these cases the Fund should simply carry out more rigorous economic surveillance and leave the World Bank and its structural adjustment programmes to deal with structural problems. The Department also stresses that the Fund is not a development aid agency. It advocates granting such countries IMF resources solely as a “reward” for initial success. The Treasury sees the need to break the credit habit but, failing that, advocates IMF loans subject to harsh conditions, as it claims that balance-of-payments problems are at the root of weak growth in certain LDCs.18

15 IMF: Articles of Agreement, Article I (V).
18 Sydney De I1, op. cit., pp. 25 f.
Hence, according to the US view, there are on the one hand IMF member countries for whom Fund programmes do not work because the countries make no serious adjustment efforts as the existence of the Fund guarantees the availability of balance-of-payments financing on favourable terms,\(^1\) while on the other hand there are countries for whom the results of adjustment are insufficient only because the Fund’s conditions are too soft. Here the Fund must take firm measures, but without becoming a development aid agency. As indicated above, the latter demand is inconsistent.

In most cases, far-reaching conditions necessarily penetrate ever deeper into the structure of economies and ultimately constitute a correction or redirection of the development process. Wanting to solve the problem of “regular customers” by means of a “drying-out cure” means nothing more than reminding the Fund of the principles for granting stand-by or extended arrangements. These lay down members’ drawings and

\(^{19}\) Vaubel sees this view of “moral hazard” applying to all Fund lending; cf. Roland Vaubel, op. cit.

repurchases; the Fund has the option to refuse further instalments of credit if the performance criteria are not fulfilled.\(^{20}\) If adjustment programmes were efficient, there should in fact be no regular customers. The fact that they exist is a condemnation not only of the countries concerned but also of the Fund itself.

If the conditionality being applied by the IMF is inefficient and inappropriate to the present status of the Fund, should it not be left to private credit markets?

**Private Conditionality**

Shifting conditionality into the private domain is tantamount to demanding the suspension of Fund lending and hence questions the Fund’s very existence. This demand is based on the thesis of moral hazard: owing to the existence of the IMF as lender of last resort, member countries see no pressing need to pursue a policy that would prevent the emergence of at least fundamental balance-of-payments problems. If countries are totally reliant on private credit markets, they have no choice but to fashion their economic policy according to private lenders’ requirements as to creditworthiness, for “in the market, conditionality is automatic, perfect and unavoidable”.\(^{21}\) A “bad” economic policy automatically leads to a higher interest rate spread or completely closes the country’s access to credit.

If this demand were met in the next few years it would undoubtedly have disastrous effects on the world monetary system and the world economy, given the debt situation of the LDCs; without the participation of the IMF, many rescheduling schemes would probably not come about.

Supposing the Fund had not existed in the seventies, two fundamental questions arise: first, would commercial banks have followed a different, more cautious and circumspect policy? And secondly, would developing countries have pursued a comprehensive economic policy geared towards the balance of payments, or would more of them have sought refuge in protectionism and exchange controls?

**The Role of the Commercial Banks**

In retrospect, it can be seen that in the seventies the international banks followed a carefree credit policy. In view of the abundance of liquidity in international markets, competition among lenders was so fierce that


\(^{21}\) Roland Vaubel, op. cit., p. 298.
countries with a less than good credit rating were able to raise substantial balance-of-payments finance on favourable terms, as Table 2 clearly shows.

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<tr>
<td>Western industrial countries 0.000 – 0.500 %</td>
<td>31.7</td>
<td>40.3</td>
<td>22.4</td>
<td>27.3</td>
</tr>
<tr>
<td>0.501 – 0.750 %</td>
<td>3.9</td>
<td>21.4</td>
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<td>0.751 – 1.000 %</td>
<td>17.6</td>
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<td>over 2.250 %</td>
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<tr>
<td>Developing countries 0.000 – 0.500 %</td>
<td>59.2</td>
<td>53.9</td>
<td>65.2</td>
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<td>0.501 – 0.750 %</td>
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<td>0.751 – 1.000 %</td>
<td>11.2</td>
<td>16.4</td>
<td>17.6</td>
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<tr>
<td>over 2.250 %</td>
<td>1.6</td>
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In 1979, the year of the second oil crisis, the developing countries took up 65.2 % of all Euro-credits, thus obtaining more than US$ 21 billion, or over 34 % of the total volume of credit, at a maximum spread of 0.75 %.22 In 1978 loans totalling only about US$ 5.8 billion, or 8.7 % of the total, had fallen into this category. In the second quarter of 1980 the LDCs were able to obtain finance on these terms amounting to 38 % of the total volume.

What induced the international banks to adopt such a “generous” credit policy at a time when the IMF had already noted the balance-of-payments crisis looming in many LDCs and had responded by establishing the Supplementary Financing Facility?

The reason was the banks’ abundant liquidity and the resultant harsh competition. However, it should be noted that the banks’ awareness of risk increased markedly in 1980. Borrowers were increasingly screened and highly indebted, poorer LDCs often found it difficult to obtain syndicated loans. Nevertheless, large banks were frequently prepared to lend these countries funds in the form of direct credits or “club loans”.23

On the experience of the past, the thesis of the perfect conditionality of private markets is tenable only if one also imputes moral hazard to the international banks; they could lend with little cause for concern, as the IMF in its role as lender of last resort constituted a “guarantee” for the repayment of the loans and the servicing of the debt.

It is also difficult to determine precisely how the LDCs would have behaved had there been no Fund. However, it must be doubted whether many LDCs would have been able to pursue an economic and development policy oriented towards maintaining a good credit rating, given their social, economic and political circumstances. It is much more likely that they would have countered balance-of-payments disequilibria with protectionist and restrictive measures. This cannot be in the interest of the world economy, however. It would have been particularly painful for the poorest of the poor if there had been no IMF balance-of-payments assistance. Even in the seventies these countries had insufficient access to private credit, if at all. They were already dependent on the Fund and had to comply with its conditions, whereas the “richer” countries could escape the Fund’s dictates for a considerable time by borrowing in the private financial markets.

Conclusion

In recent years the IMF has evolved increasingly into an “ancillary” development aid institution. This adverse trend will continue if conditionality is maintained in its present form or even tightened further. It is undeniable that the Fund can lend its resources only for a limited period. However, the conditionality practised by the Fund is not an efficient instrument to safeguard repayment. It is ultimately assured only if the industrial countries help the LDCs more effectively than in the past. To do this, there is an urgent need for the Western industrial countries to pursue appropriate economic policies that will bring about a lasting recovery in the world economy and world trade and to open their markets more widely so that the LDCs can enjoy more of the benefits of the international division of labour than in the past.

A suspension of lending by the IMF would have serious consequences for the international monetary system, at least in the short and medium term. However, Fund lending should be modified by confining it to financing short and medium-term balance-of-payments disequilibria, with the conditions being based on the principles applied to the current first credit tranche. The solution of structural problems would then fall entirely within the competence of the World Bank. The two Bretton Woods institutions should endeavour to collaborate closely in the analysis, formulation and surveillance of adjustment programmes.