

# INTERNATIONAL ORGANIZATIONS in World Politics



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# 7 The International Monetary Fund

*If the IMF had a dollar for every criticism of its purpose and role by the Right, the Left, and the Center, it would perhaps never again have to approach its shareholders for more money to sustain its operations.<sup>1</sup>*

*The IMF is the scapegoat of first resort.<sup>2</sup>*

**R**ecall from Chapter 5 that the IMF was born at the Bretton Woods conference to help manage the international monetary system, to make it more stable and less prone to crises. Over the years, the IMF has become the most powerful source of lending to countries facing economic crisis. Governments that are low on the foreign currency they would use to pay for imports or debts turn to the IMF for short-term loans in hard currency to tide them over. The IMF, in turn, will negotiate a program with the country that requires economic policy changes designed to help the country regain economic health. The “doctor-patient” metaphor is often used to describe the IMF’s work—its job is to treat an ailing country with sometimes bitter medicine. Since the early 1980s, the IMF’s imprimatur has been necessary for countries in economic trouble to receive fresh loans from the World Bank or private sector banks. The IMF has also been described as a sort of *financial cooperative* whose members are countries. They contribute certain amounts of their own currency and gold to the IMF, called *quotas*, based on their global economic strength. Countries that need help can then draw money from the IMF in globally strong currencies such as the dollar or euro.

Making sense of the IMF has been trickier for the public than making sense of the World Bank, because unlike the bank, the IMF does *not* make loans for *projects*, which are more visible and tangible. In fact, the typical IMF loan is called a lending “arrangement.” The IMF works in the area of economic stabilization, and more specifically, through mostly macroeconomic policy tools. When we examine World Bank projects, we can often point to very visual things like the construction of a highway or power plant. Where bank projects have caused harm, we can also literally see it, for example, where a project results in deforestation or the destruction of habitat. It is not as obvious how one can see or explain the harm or good caused by the IMF’s recommendations on macroeconomic policy reform. Put differently, it’s easier for the average person to understand how a traditional World Bank project may impact poverty or the environment than to understand the effects of monetary or fiscal policy changes on a country. (Let’s not forget, however, that the World Bank also makes loans for economic policy reform that are similar to what the IMF does.)

In order to understand what the IMF does and how it works, one must know some basics from international economics, including answers to the following questions: Why do exchange

rates matter? What is a trade deficit? How do interest rates affect an economy? What are the causes of economic crisis in an individual country, and how and why does it spread to other countries? What economic policy prescriptions work best when a country is experiencing an economic crisis?

This chapter will answer these questions as it describes and explains the changing role of the IMF in the international economy. It begins by explaining what the IMF was set up to do and how it is governed, before turning to a discussion of the major turning points in the IMF's history. The chapter then examines the views from some major scholars and critics of the IMF and some of the ways the IMF has responded.

The year 2009 was a banner year for the International Monetary Fund (IMF), as the global financial crisis instantly lifted the institution up from a steady decline in lending and legitimacy and put it back into the frontline of actors working to help countries hit hard by external and budgetary crises. The IMF's lending (arrangements approved) had dropped precipitously from over SDR 41 billion<sup>3</sup> in its fiscal year 2002 to SDR 600 million in 2007, as an improved global economy gave many developing countries alternative lending options, and the IMF suffered under the glare of a variety of critics. In 2008 it began cutting its staff, amid a shrinking loan portfolio. This all changed after the crisis hit. For the first time since the late 1970s, even developed countries were seeking help, including Iceland, whose economy faced a sharp meltdown as its banking system collapsed. In 2013, the biggest borrowers were not developing countries, but rather Greece, Portugal, and Ireland.<sup>4</sup> The IMF's role in the global financial crisis is the topic of Chapter 8.



Protestors dressed like zombies at a rally against the visit of IMF Managing Director Christine Lagarde, Manila, November 2012.

Like the World Bank, the IMF has been criticized for causing more harm than good and has drawn the ire of anti-globalization protestors and others who say the IMF increases poverty and suffering in its borrower countries. The IMF's conditionality, the policy strings attached to its loans, has been under attack for years, and for numerous reasons, including: it is too intrusive, it helps to cause financial crises (that the IMF then has to help to fix), and it is too homogenous and not tailored enough to countries with different domestic situations. Like the World Bank, the IMF is trying to redefine its identity to meet, and sometimes resist, changing and growing demands.

## THE IMF'S MANDATE AT BIRTH

The IMF was created at Bretton Woods to tackle the types of monetary imbalances and other economic problems that plagued the international economy during the interwar years and contributed to the onset of World War II. The IMF would be at the center of an international monetary system aimed at keeping exchange rates stable. If a country was in economic trouble and needed money (more specifically, because it has a temporary balance of payments deficit), the IMF could offer it a loan. Before proceeding with the IMF's history, it is important to take a step back and understand why the IMF was given these roles, and what they meant in practice.

### What Are Exchange Rates, and Why Is Stability a Good Thing?

An exchange rate is the value, or price, of one currency expressed in the other. It is how many dollars you can buy per euro, or how many yen you can buy for a Swiss franc. As J. Lawrence Broz and Jeffrey Frieden note, "The exchange rate is the most important price in any economy, for it affects all other prices."<sup>5</sup> It is easy to imagine that the more stable and predictable these rates are, the more confidence investors have to put their money in other countries, and the more confidence importers and exporters have to buy and sell goods from or to other countries. It is less risky for anyone to put money in another country when there is reassurance the other country's currency won't lose its value. This impacts the average individual, too. If your country's currency is weak, it is more expensive for you to travel abroad and to buy certain imported goods.

During the Bretton Woods negotiations, negotiators were keen to set up a system of currency stability to avoid the terrible impact and legacy of the Great Depression, where world trade shrank dramatically, commodity prices collapsed, and unemployment rose to unprecedented levels. Many countries responded by devaluing their currencies in order to gain some competitive edge vis-à-vis their trading partners. These competitive devaluations were an example of what was called a *beggar-thy-neighbor policy*.<sup>6</sup> If one country, Country A, lowered the value of its currency relative to other currencies, that would make its products relatively cheaper. The result would be Country A would increase its exports and thus the amount of money it was receiving. But if its trade partner, Country B, responded by lowering *its* currency, a vicious cycle began.

The competitive devaluations of the 1930s followed the collapse of what was called the *gold standard*, a system where most of the major industrialized countries at the time promised to



exchange its currency for gold, at a set price. This system was formally adopted by Britain in 1819 and took root in most of the other major economies by the 1870s, as countries realized that this type of stability—a currency always convertible to a specific amount of gold—was great for international trade, investment, and even migration, because it created predictability. As Frieden noted, “The gold standard rates of exchange . . . were so fixed for so long that, it is said, schoolchildren learned them by rote because they seemed as stable as the multiplication tables.”<sup>7</sup> The system collapsed during World War I, and a form of it was revived between 1925 and 1931. By the time of the Bretton Woods negotiations, many policymakers, businesspeople, and even union officials were wary of returning to the rigidity of the gold standard. They wanted something more flexible, so that governments could use policy tools to help manage the economy in ways that were impossible under the old system.<sup>8</sup>

The fund was designed to manage a new monetary system that was more flexible than the old gold standard, but also more stable than a system of freely floating currencies. The new system was a “modified fixed rate” system, or a “par value” system, where currencies were fixed to the dollar, and the dollar was fixed to the price of gold, at \$35 per 1 ounce. The United States government stood behind the agreement and would exchange gold for dollars at this rate. The flexibility built into the system allowed countries to adjust their exchange rates when necessary (if one felt its exchange rate was too high or too low, for example), but a change of over 1 percent required the IMF’s consent. This system allowed for relatively stable and predictable exchange rates, which, in turn, helped to encourage global trade and deepened people’s confidence in international investment.

### What Is a Balance of Payments “Problem,” and What Can the IMF Do About It?

The fund’s other central role was to lend money to countries running low on hard currency. A typical example is a country that is overspending in its trade with other countries. It is buying more (importing) from the world than it is selling to the world (exporting). Since it pays for goods from other countries in dollars, Euros, or other major currencies, having a trade deficit can literally mean that the country’s central bank is running out of hard currency. Looking at trade alone, we would say the country is running a *trade deficit*. Looking at the country’s larger balance of payments—its complete set of payments and receipts vis-à-vis the rest of the world—we would say it has a *current account deficit*, or a “balance of payments problem.”<sup>9</sup> The current account is broader than the trade balance. It includes trade and other measures, such as aid flows. As Paul Blustein aptly put it, discussing the imaginary country Shangri-la, an example used in some of the IMF’s teaching materials:

[I]f Shangri-la runs too large a tab, it may suddenly find itself in the same situation as the individual who has maxed out on his credit cards. Maybe there’s an unexpected shock—a sudden surge in the price of imported oil, for example, or a dip in the price of a key export, such as coffee or computer chips. . . . Sources of hard currency from abroad dry up, because foreign lenders conclude that for the foreseeable future, Shangri-la has little prospect of generating enough proceeds from its exports to pay all its obligations to foreigners. At this point, Shangri-la’s finance minister and central bank governor are likely to be found stepping out of a limousine in that curved driveway in front of IMF

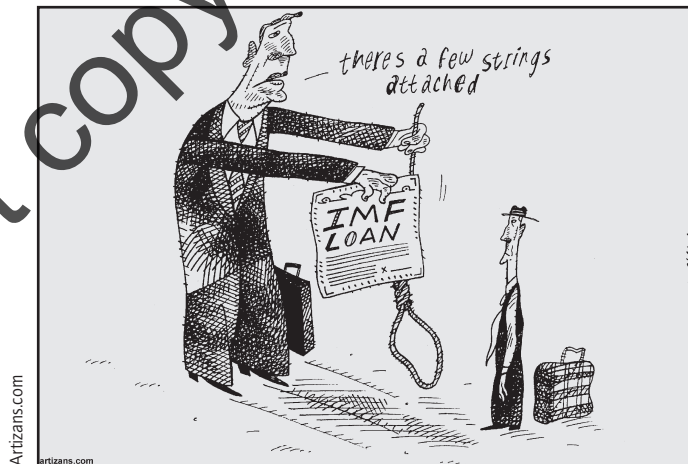
headquarters. The IMF is the only place an overextended country like Shangri-la can obtain the hard currency it needs to obtain vital imports and keep its economy functioning.<sup>10</sup>

The IMF was set up to be able to give countries short-term loans that would offset the balance of payments imbalances, which, in turn, helped the country avoid readjusting its exchange rates. Since making loans gave the IMF something of a bank-like personality, it naturally sought to make sure that countries would be able to repay these loans, and it wanted to be sure that borrowers were fixing their economic problems, so it began attaching *conditionality* to its loans. Conditionality can be thought of as the policy changes the IMF deems necessary for the country to regain its economic health. As the IMF explains it,

Conditionality is a way for the IMF to monitor that its loan is being used effectively in resolving the borrower's economic difficulties, so that the country will be able to repay promptly, and make the funds available to other members in need.<sup>11</sup>

What happens is the IMF agrees to lend a specific amount of money to a country, and in return the country complies with the IMF's conditions. The IMF's main form of nonconcessional assistance is the Stand-By Arrangement, which typically lasts one to two years, with repayment due between three and one-quarter and five years of disbursement. The disbursement of the funds is conditional on the country reaching its economic targets.

In the IMF's early years, conditionality was implicit in some of its lending decisions. Conditionality became codified in the 1950s, and since then it has become extremely controversial, as loan recipients and other critics argued that it was too intrusive and often made things worse rather than better. For example, if the IMF determines that a country has been spending too much, then IMF conditionality may call for spending cutbacks, such as reducing the



A critical view of IMF conditionality.

government's budget. Over time, the IMF's preferred choice of conditionality was clearly what is called in the language of economics as "macroeconomic stabilization based on controlling aggregate demand through fiscal and monetary policy."<sup>13</sup> This meant that a country's balance of payments problems were seen as caused by too much demand (relative to output). The traditional solution, then, was to reduce this demand through fiscal (government revenue collection/spending) or monetary (interest rate, exchange rate) policies. These policy measures tend to create austerity in countries, which can manifest itself as increased unemployment, poverty, malnutrition, and other social and economic ills. Even governments that readily agree to IMF loans with this type of conditionality attached often find it useful to treat the IMF as a scapegoat, blaming it for the country's ills. The IMF's response has been that it is treating the problem, albeit with bitter medicine, but was not the cause of the country's problem.

IMF conditionality was relatively narrow for many years, but increased in number and scope in the 1980s and 1990s, in response to the fund's growing involvement in developing countries as well as the 1982 debt crisis and the 1997 Asian financial crisis, which are discussed below. Instead of having a dozen or so requirements attached to a loan, the IMF imposed 50 plus requirements. As Devesh Kapur noted, "the Asian countries have had to sign agreements that look more like Christmas trees than contracts, with anywhere between 50 to 80 detailed conditions covering everything from the deregulation of garlic monopolies to taxes on cattle feed and new environmental laws."<sup>14</sup> Facing great criticism, the IMF began cutting back on conditionality and produced revised guidelines on conditionality in 2002. Nonetheless, the IMF's Independent Evaluation Office found in a 2007 report that the number of structural conditions had not declined, which resulted in fresh calls by the IMF's board to better implement its new conditionality guidelines. As discussed in Chapter 8, in response to the 2009 crisis, the IMF reviewed its lending framework and announced a number of ways that it would increase flexibility, including streamlining conditionality.

## IMF MEMBERSHIP AND GOVERNANCE

Chapter 5 discusses the governance system of both Bretton Woods sisters. Today, the IMF has 188 members, which includes virtually every country in the world. The handful of members of the United Nations that are not members of the IMF include small city states such as Andorra and Monaco, as well as the Communist nations of North Korea and Cuba.

A country is assigned its quota when it joins the IMF, and then it can draw on the currencies it needs when it faces economic difficulty. It pays at least 75 percent of its subscription in its own currency, and the remainder in widely accepted currencies or using the IMF's unit of accounting, the SDR.<sup>15</sup> The size of the quota determines how much money a member can get from the IMF. A member can borrow up to 300 percent of its quota each year; although under special circumstances it can receive more.<sup>16</sup> In fact, the Flexible Credit Line introduced in 2009, allows qualified countries to access much higher percentages of their quota (even up to and beyond 1000 percent) for longer periods of time to protect them from "volatility and spillovers" that may result from global crises.<sup>17</sup> As noted in Chapter 5, the country's voting power reflects the size of its quota.<sup>18</sup>

From time to time the quotas are readjusted to account for a country's changing position in the global economy. The most recent effort to adjust quotas, which was designed to give more voting weight and "voice" to the BRIC countries (Brazil, Russia, India, and China) and other developing countries, is discussed in Chapter 8. Yet, it is also important to recall, as James Vreeland aptly notes, that while the IMF's voting structure is based on a complicated accounting system, the fact is the board rarely votes. It mainly operates on consensus. Official votes are uncommon, although one of the top officials of the IMF may "keep track of straw polls" so that there is still a sense of what the majority view is.<sup>19</sup> This means that a focus on "charts and shares" as a way of understanding how the IMF is governed can be misleading. At the same time, though, the board is important since it meets three times a week and makes decisions about IMF programs, policy, and strategy.

## MAJOR TURNING POINTS IN THE IMF'S HISTORY

The IMF has evolved in many ways over the years, but less dramatically so than the World Bank. The IMF launched new financing facilities, took on new countries, and broadened and deepened its economic advice and lending. Some of these changes have been in response to broader trends and/or crises in the international economy; others have been in response to criticism, of which there has been no shortage. Among the most important times of change for the IMF are the closing of the gold window in 1973; the 1982 debt crisis; the 1997 to 1998 Asian crisis; and the 2008 global financial crisis. This chapter examines the first three important times of change, and the subsequent chapter looks in-depth at the fourth.

### 1973: Closing of the Gold Window

The IMF had a few growing pains in its early years, but then functioned fairly well as a referee of the international monetary system, until the system became shaky in the late 1960s. Like the World Bank, it was not able to be a truly global institution at its birth, because the Soviets decided not to join either, and instead, set up their own institution for economic cooperation for East bloc countries, the Council for Mutual Economic Assistance, or COMECON. After the fund opened its doors in 1947, its first years were spent with its board and staff developing policies and lending instruments, and welcoming new members. The first loans were made to France, the Netherlands, and Mexico. There were also some early tensions between France and the rest of the IMF's board, when France was declared ineligible to use fund resources in 1948 when it proposed differential exchange rates for the franc. These were not allowed under fund rules, and the board feared the French plan would destabilize other European currencies.<sup>20</sup>

By the late 1960s, the par-value system was under enormous strain. The fatal flaw of the system was that all currencies were valued vis-à-vis the dollar, and the dollar's own value was off. The United States was spending an enormous amount of money in the 1960s. One reason was its support of the Viet Nam war, which meant rising US military spending. Domestically, President Lyndon Johnson had launched a domestic reform agenda called the "Great Society,"



that also involved increased government spending. Whereas the United States had trade surpluses in the mid-1960s, by 1971 the trade balance was in the red.<sup>21</sup>

Another way to state the problem is that the supply of dollars floating around the world was much greater than the demand for those dollars. Normally, when the supply of something exceeds demand, all things being equal, the price of that item will decline. If currencies had been floating freely, the value of the dollar vis-à-vis other currencies would have declined. Two choices were possible under the Bretton Woods par value system; either the dollar should be devalued or all the other currencies should be revalued. Neither option was seen as politically viable. As confidence in the dollar eroded, more and more people began exchanging their dollars for gold. This resulted in a massive outflow of gold from the United States and increased worries that the US economy could collapse. In a dramatic speech in 1971, US President Richard Nixon announced the closing of the gold window, which meant ending the convertibility of the dollar into gold.<sup>22</sup> The dollar promptly dropped around 10 percent over the next few months, and by 1973 the Bretton Woods system formally linking currencies to the dollar, and the dollar to gold, officially ended.<sup>23</sup> After that, IMF member states had a lot of flexibility on foreign exchange arrangements. Many let their currencies float; some pegged their currency to another one (like the dollar or French franc) or to a basket of currencies, and some joined a currency “bloc.”

At IMF headquarters, staff circulated a tongue-in-cheek obituary, “We regretfully announce the not unexpected passing away after a long illness of Bretton Woods, at 9 p.m. last Sunday. Bretton was born in New Hampshire in 1944 and died a few days after his 27th birthday.”<sup>24</sup> However, despite the demise of the dollar-gold convertibility system, the IMF did not declare failure and shut its doors. Instead, it began a new chapter of its existence.

The first oil crisis of 1973, when OPEC members quadrupled the price of oil and embargoed oil sales to the United States, triggered an energy crisis, worldwide recession, and ultimately high levels of inflation. All of this meant the IMF was quite busy making loans to countries facing economic trouble, and it also set up new facilities to help countries meet the increased cost of oil imports and to allow members to borrow higher percentages of their quotas in

### BOX 7.1 FLOATING EXCHANGE RATE BASICS

When currencies *float*, it means that they rise and fall with respect to other currencies based on factors such as supply, demand, market psychology and liquidity, and the economic health of a given country or region. Central banks at times intervene, buying and selling currencies to try to nudge the value of their currency (or another currency) one way or another. Many smaller countries tend to link their currency to a major currency, or allow it to float with careful government intervention. Currencies are traded, internationally, in

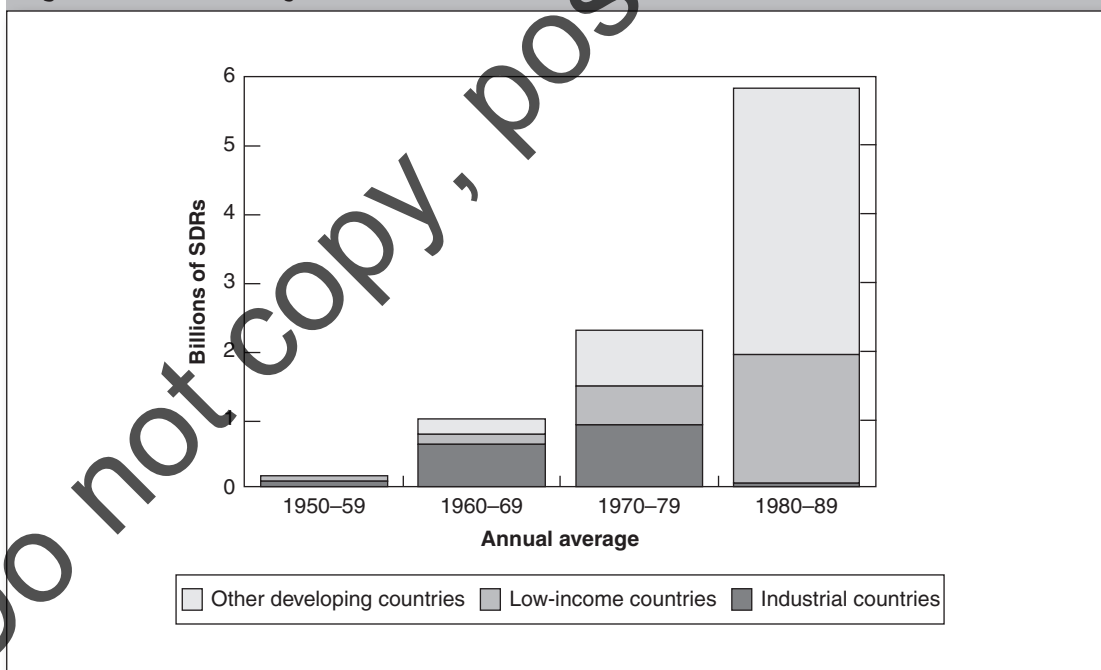
what is called the “foreign exchange market,” where daily turnover is now in the trillions of dollars. The 24-hour foreign exchange market consists of major dealer institutions (banks and other financial institutions) located around the world, who buy and sell on behalf of their corporate and other clients. Some of these dealers are what are called *market makers*, which means they buy and sell at the prices quoted, making a profit on the *spread*, or difference between the two prices.

exceptional cases. The fund established a new Trust Fund in 1976 to help developing countries receive loans with very light conditionality and a concessional interest rate of 0.5 percent a year.<sup>25</sup> By 1977, Great Britain and Italy were also in the queue of countries seeking IMF assistance, joined by the United States in 1978. Drawings by advanced industrialized countries stopped in the late 1970s and did not resume until Iceland knocked on the IMF's door for assistance in the 2009 financial crisis. Meanwhile, in the late 1970s, there was a second sharp increase in oil prices, while US interest rates rose sharply in an effort by Federal Reserve Chairman Paul A. Volcker to curb US inflation. This had a double whammy effect on oil importing developing countries, whose growing debts were largely denominated in dollars (and hence, based on US interest rates). The simmering problems that resulted came to a boil in 1982.

### The 1982 Debt Crisis

The 1982 Latin American debt crisis marked a major new phase in the IMF's evolution. The IMF stepped onto the center stage as the lead crisis manager, organizing the creditor banks and negotiating with debtor countries. The crisis was sparked when Mexico, staggering under a heavy burden of debt, told US and IMF officials on August 12, 1982, that it was facing default on its loans, since it could not make the next payment to US commercial banks and other

**Figure 7.1** IMF Lending, 1950–89



Source: Boughton, James M. *Silent Revolution: The International Monetary Fund, 1979–1989*. Washington, D.C.: International Monetary Fund, 2001, 18.

major banks. The next day, Friday, August 13, 1982, Mexican finance officials arrived in Washington, DC, to work with US and IMF officials to organize emergency help. The negotiations produced \$3 billion from the United States, some of which could be used by Mexico to meet the payments to banks due on Monday.<sup>26</sup> But more money was needed, and quickly. On Friday, August 20, Mexico informed its bankers that it wouldn't be able to make its next payment on the loan principal due on Monday. The negotiations that followed resulted in the IMF gaining a powerful position in working with debtor countries and their creditors throughout the crisis.

The prospect of a Mexican default shook the financial world, as people feared other countries facing enormous debt would follow suit. Several Eastern European countries had already faced possible default in the early 1980s, but Mexico exacerbated the problem because its external debt was so large, at \$80 billion; a default could trigger the collapse of major international banks and therefore create a full-blown global financial calamity. Many developing countries were suffering from the effects of high debt, high global interest rates, weak economies, and skittish bankers. There has been a lot of finger pointing about the causes of the crisis.<sup>27</sup> Some observers and participants blamed the developing countries for pursuing heavy external borrowing to support their domestic spending. Others blamed the big international banks for happily lending without paying close enough attention to what was going on in some of the borrowing countries. Staff members at the IMF itself had expressed concern over Mexico's growing levels of external debt, but according to IMF historian James Boughton, these warnings were "muted" and resulted in complacency by the IMF board.<sup>28</sup> Sixteen of the 27 nations seeking to reschedule their debt by October 1983 were Latin American. The four largest—Mexico, Brazil, Venezuela, and Argentina—together owed \$176 billion dollars, almost three-quarters of total outstanding developing country debt.<sup>29</sup> US banks, meanwhile, were the source of most of the Latin American loans.

The fund stepped in by offering Mexico significant financial support, if Mexico would in turn negotiate an adjustment program with the fund. The Mexican team, led by Mexico's Secretary of Finance, Jesús Silva Herzog, worked closely with the IMF and US officials in a process that was not without its bumps and high drama. At the end of the day, an IMF program was seen as important to show Mexico was making appropriate economic reforms and to act as a green light to Mexico's creditors to justify and offer new loans. But banks were not exactly standing in line to offer Mexico more money. The fund's managing director, Jacques de Larosière, put unprecedented pressure on the commercial banks to come up with new money for Mexico to fill a gap between what was already available and what Mexico needed to stay afloat.<sup>30</sup> The fund was well placed to take on this leadership role. The hundreds of banks (large and small) with outstanding loans to Mexico and other developing countries needed some outside actor to help them coordinate themselves; the fund was obviously more of an independent actor than an individual creditor country, plus it had long experience in helping to coordinate its member states. As Boughton concluded,

While there was no specific mandate that made it more natural for the IMF to play that role [of coordination] than, say, the World Bank, the fund demonstrated an ability to step in quickly and forcefully when the indebted countries requested its assistance.<sup>31</sup>

Ngairé Woods called the IMF conditionality the “first rendition of what would later be called the Washington Consensus.”<sup>32</sup> The IMF’s conditionality for Mexico and other countries affected by the crisis emphasized a reduction in government spending, including government subsidies on basic consumer goods, higher taxes, and policies to reduce inflation.

Following Mexico, a number of other countries lined up to negotiate a deal that included new loans and tough IMF conditionality. These included Brazil, Argentina, Chile, Ecuador, Peru, and Uruguay. Outside Latin America, the Philippines and Côte d’Ivoire were also affected in 1983 and 1984.<sup>33</sup> Fears of a global crisis began to recede by 1984, even though developing country debt continued to grow and economic growth remained stagnant.

Major creditor countries started talking about the possibility of debt relief for countries, ways for banks to write off principal, reduce the interest rates on loans, or other measures that effectively reduce the amount of money countries’ owed. Two plans launched by the United States, the 1985 Baker Plan (named after US Treasury Secretary James Baker III) and the 1989 Brady Plan (named after US Treasury Secretary Nicholas Brady) offered ways to respond to the fact that debtors were still drowning in debt and banks were not eager to increase net lending. Baker’s program called for debtor countries, specifically 15 heavily indebted countries, to renew their efforts at reforming and liberalizing their economies, with increased lending from the World Bank and Inter-American Development Bank, as well as significant increased net lending from commercial banks. The Brady Plan went further, calling for banks to voluntarily come up with debt-reduction schemes, and possibly new lending, for debtor countries engaged in economic liberalization. Debt reduction is anathema to private banks and many inside the IMF, and there was strong opposition to this plan. Countries also doing their best to meet their debts also don’t like to see their neighbors getting a free lunch. Nonetheless, the Plan went forward, with the fund deeply involved in negotiating the details with banks and the countries seeking relief.<sup>34</sup> The fund also launched new policies to allow countries to buy back some of their own debt with fund resources. By the middle of 1994, 18 countries received deals under the Brady Plan, resulting in debt forgiveness of \$60 billion, and new loans from banks, as well as the World Bank and IMF.<sup>35</sup> By the early 1990s, the debt crisis was over. Looking back on it, economists argued that this was a crisis of liquidity, rather than insolvency. That meant it was a temporary crisis caused by the inability of countries to come up with enough foreign exchange to make required payments on their debt. It wasn’t a permanent problem that countries simply could not earn foreign exchange.

### 1997–1998 Asian Crisis

The 1990s, unfortunately, were no easier on the IMF than the 1980s. The decade began with the fall of Communism and the heady challenges the formerly socialist countries faced in dramatically reorienting their economies to a market-based system. Criticism of the fund began to pick up speed, with some arguing it was providing an inadequate amount of support to the region, or offering counterproductive advice, or even that its policies helped to contribute to the onset of the crisis. The “Fifty Years Is Enough Campaign” was launched in 1994, on the 50th anniversary of the bank and fund. It argued that the Bretton Woods institutions promoted unsustainable development, which was environmentally destructive and resulted in increased poverty.

Mexico faced another crisis in 1994, dubbed the “peso crisis.” The IMF responded by approving its largest ever financial package to date. But this paled next to the more frightening, far-reaching crisis that occurred in East Asia in 1997 and 1998. To put things in perspective, in 1982, the IMF provided Mexico with \$3.7 billion dollars. During the peso crisis, it provided \$17 billion, out of a \$40 billion dollar total package. The amounts given to East Asia were even higher, totaling over \$100 billion. The IMF ended up lending a total of \$35 billion dollars, and rounding up an additional \$77 billion from other sources. These large IMF “bailouts” were quick, emergency lending arrangements to countries made in hopes of averting the spread of crisis to an ever growing number of countries. The IMF’s role in the Asian crisis was highly controversial, and prompted a fresh round of criticism that the institution was seriously misguided or incompetent, or both.

### What Was the Asian Financial Crisis?

The crisis was a series of sharp declines in a number of Asian countries’ currencies and stock markets. It spread to Russia (1998) and then to Brazil (1999) and stood poised to threaten the rest of the world, too. It began in Thailand and quickly spread to Indonesia, Malaysia, the Philippines, and South Korea before heading up to Russia and across the globe to Brazil. The crisis was defined by enormous economic disruptions, contracting economies, bank closures, political instability and the resulting painful human costs—increases in unemployment and poverty—and the corresponding declines in living standards.

Many observers were quite surprised that a major economic crisis would have East Asia as its epicenter, because for many years these Asian countries were admired for their rapid economic growth and increases in living standards. Indeed, East Asian countries were seen as a role model for other developing countries.

### What Happened?

The crisis was triggered by a collapse in Thailand’s currency, the baht, on July 2, 1997, when it lost around a quarter of its value overnight.<sup>36</sup> The initial problem was mainly about exchange rate speculation, but it quickly blew into something much bigger. A number of external and domestic factors created the conditions for this to occur. One contributing factor on the external side was the rapid growth in private capital flows. Private capital flows are money flowing from one country to another between private sector actors. Some examples are purchases by investors in one country of stocks or bonds in another, foreign direct investment (where companies or investors from one country invest in business opportunities in another country), lending by banks in one country to banks or companies in another country, and so on. Net private capital flows to Thailand and other Asian countries had grown dramatically between 1990 and 1996, surging from around \$21 billion to 107 billion dollars.<sup>37</sup> But this money was heading into countries with mixed, and often weak, levels of regulatory supervision over banks, problems compounded in some cases by corruption. The weak domestic context created a situation that undermined domestic banking systems. Looking back, commentators observed that no one was keeping a close eye on whether Asian companies and banks were taking on too much risk, or borrowing too much. Some observers also criticized



the IMF for urging the East Asian countries to liberalize their capital markets, exactly the type of actions that allowed so much capital to flow in, and later, out. In other words, this capital market liberalization played a role in the subsequent regional and global instability. One of the most visible signs of crisis was the fact that when Western investors, banks, companies, and hedge funds get nervous (or want to speculate, especially in the case of hedge funds) they can rather quickly take their money and run. The money rolled out as quickly as it rolled in, which greatly exacerbated an already precarious situation.

The match igniting this explosive mix arose from the relationship between the baht, the dollar, and the yen. The baht was relatively fixed in terms of the dollar, at roughly 25 bahts per dollar, and was kept stable by daily purchases or sales of dollars by the central bank.<sup>38</sup> In the summer of 1997, the Japanese yen declined about 35 percent vis-à-vis the dollar. Japan is one of Thailand's major trading partners, so suddenly the baht was much stronger in relation to the yen. That meant that Thailand's exports became more expensive to Japanese consumers, and therefore Thai exports declined.<sup>39</sup>

Investors grew nervous. Thailand, and other countries in the region, also had inflated stock market values and property prices. Confidence in the Thai economy and in neighboring economies started declining. These circumstances put pressure on the baht to decline, but it couldn't—it was tied to the dollar. Foreign investors began selling their holdings in Thailand (for dollars and other currencies). Some market participants, like hedge funds, sold the Thai *short*.<sup>40</sup> This is a technique used in financial markets where you can actually sell something before you buy it. In this case, hedge funds sold baht, betting that they would buy it back at a much cheaper rate at a later date. The Thai central bank was in a real fix—it couldn't keep producing foreign exchange, and it couldn't keep propping up the baht. Finally, in July, the baht began its decline and by January 1998 it had lost half of its value. Billions of dollars in capital began to hemorrhage out of Thailand and then its neighbors, too, including Indonesia, Taiwan, South Korea, and Hong Kong. Some of this occurred because investors and speculators were betting which country would be the next to see its stock market in freefall. The central banks of these countries, in turn, were seeing the foreign exchange reserves drained, which would mean they couldn't provide dollars and other currencies to their big corporations, or others, that needed the money to run their business and make payments to their foreign creditors. Journalist Thomas Friedman popularized the term "Electronic Herd" to describe the big international players, which included commercial banks, pension funds, mutual funds, and insurance companies, and other actors trading stock and currencies.<sup>41</sup>

The IMF played a central role in trying to defuse this crisis, by organizing the massive bail-out packages to help governments avoid defaulting on their foreign debts and to try and restore investor confidence in these markets. The IMF's basic approach was to try to reestablish financial market confidence in these countries by making sure the vulnerable countries had enough money to dissuade speculators and others from attacking their currencies, money that could be used by domestic firms to repay their dollar-based loans. (Of course, one of the side effects of this provision of hard currency is that rich people inside the country could get dollars at an attractive exchange rate, and then send those dollars out of the country.)<sup>42</sup> The packages to Thailand, Indonesia, and South Korea, for example, included loans that central banks and governments could use to repay debts and macroeconomic plans that included high interest rates (to attract investors). But the IMF staff felt they shouldn't just put short-term Band-Aids

on the problem, but instead, should try to get at the deeper problems facing these economies. The IMF packages included major restructuring of the financial sectors, which included closing banks. They also called for other far-reaching measures, often very specific, detailed reforms.<sup>43</sup> For example, the Indonesia agreement included the elimination of the company that monopolized sugar and flour, the elimination of a Clove Marketing Board, and the end of barriers to investment in palm oil plantations.<sup>44</sup>

Journalist Paul Blustein, in his book *The Chastening*, does an excellent job of bringing to life how dramatic and tense the negotiations were and explaining the perspective and role of individual participants from the involved countries, banks, and international institutions. Thailand, for example, refused to negotiate a rescue loan with the IMF even as the baht was declining rapidly, because its key officials (the central bank governor and his deputy, among them) were ambivalent about IMF support and policy conditionality. In Indonesia, the fund called for the closure of sixteen shaky banks, but did not simultaneously work to strengthen the banking system. The result was that people became nervous that other banks might also be weak, which prompted a run on Indonesia's privately owned banks and fears that the nation's entire banking system might collapse.<sup>45</sup>

The South Korea case was probably the most dramatic. By early 1997 South Korea seemed like it was in relatively good shape, with strong exports and even government surplus. The weak link was that a few of the country's major conglomerates, called *chaebol*, had gone bankrupt, and this weakened the banking system. The threat of default by South Korean banks would make a bad situation even worse. As the crisis unfolded, Blustein details how it was US officials behind the scenes that were influencing the IMF and calling for deep structural change in Korea's economy that went well beyond what the IMF traditionally called for. After several days of nonstop negotiations the resulting deal included a record \$21 billion from the IMF and more than \$55 billion from the World Bank, Asian Development Bank, and the United States and other countries. South Korea agreed to major structural reforms that would result in a more open economy, more competition in its financial sector, the ability of foreign investors to greatly increase their involvement in public companies, updated and more transparent corporate accounting practices, and more.<sup>46</sup> Five days later, on December 8, the Korean won came under attack, falling by its 10 percent limit against the dollar each day for five days.<sup>47</sup> The financial markets detected some back-paddling from the Korean side and became aware of how low Korea's foreign exchange reserves really were. Simplifying the resulting negotiations to their barebones minimum, Blustein explains that in the end, the crisis in Korea abated when international banks agreed to reschedule their short-term loans. The banks, concludes Blustein, "got away with murder. They foolishly injected billions of dollars of short-term loans into a country with a shaky financial system, yet they were suffering no losses."<sup>48</sup>

### Assessing the IMF Role in the Asian Crisis

While there had been criticism of the IMF before the Asian crisis, the discussion was especially relevant by the late 1990s because, for many, the crisis showed that the IMF had truly failed in its mission to promote global stability; it did not avert the crisis, and its lending policies during the crisis were seen by many as wrong-headed. Some high-profile economists,

such as Paul Krugman, Jeffrey Sachs, Joseph Stiglitz, and Jagdish Bhagwati, argued that the IMF's actions exacerbated East Asia's economic problems. Some of the criticism became remarkably personal. Stiglitz, the former chief economist of the World Bank, for example, mused that

the older men who staff the fund—and they are overwhelmingly older men—act as if they are shouldering Rudyard Kipling's white man's burden. IMF experts believe they are brighter, more educated, and less politically motivated than the economists in the countries they visit. In fact, the economic leaders from those countries are pretty good—in many cases brighter or better-educated than the IMF staff, which frequently consists of third-rank students from first-rate universities.<sup>49</sup>

When asked in an interview to respond to Stiglitz's critique, IMF chief Michel Camdessus replied that he would not, because,

Here in France you are in a country where people like soccer, and of course, in soccer you should never score against your own team—the Bretton Woods team, in this case. Stiglitz' lack of intellectual integrity in all of these comments does not leave him very well placed to criticize our performance. Such unjustified and misguided criticisms don't deserve to be answered.<sup>50</sup>

Beyond the personal criticisms, the Asian crisis forced the international community to consider what went wrong and how global financial institutions, policies, and structures might be reformed to strengthen what was commonly called “the global financial architecture.” It is true that criticism of the IMF came from across the political spectrum, so it would be misleading to think there was any international consensus about what the IMF did wrong. One major line of criticism attacked the IMF's conditionality—it was too intrusive, or detailed, or simply the wrong policy choices for the problem at hand. A second line was that IMF involvement in such massive bailouts increases the problem of *moral hazard*.

### Problems with IMF Conditionality

Many commentators and economists argued that the deep structural reforms the IMF urged countries to undertake had nothing to do with the short-term problem behind the crisis—speculation on the financial markets. Asking a country to make deep structural reforms may unnecessarily intrude on a country's sovereignty. For example, the IMF asked Indonesia to end government corruption.<sup>51</sup> One can argue that this is certainly not a bad thing to do, and it would result in a more efficient and healthy economy. But the fact is that these deep changes may be moving away from the immediate issues behind the crisis.

Moreover, critics argued that the IMF's policies in East Asia were the same traditional ones it used in other parts of the world, like Latin America in the 1980s, and that these were not appropriate to use in Asia.<sup>52</sup> The traditional policies, as noted above, are aimed at reducing government spending and tightening credit, and they are useful for countries experiencing balance of payments deficits caused by excessive demand. But in Asia, excessive demand was not the

source of the problem for most countries. A particular problem was that higher interest rates effectively strangled already weak economies. When interest rates are higher, people and businesses take out fewer loans to use to buy things (such as homes or equipment or new workers). One side effect of these various problems is that they may result in more intense crises if countries, fearful of the IMF's far-reaching conditionality, try to avoid going to the IMF when they are in trouble. Martin Feldstein added to the medical metaphors surrounding the IMF by comparing it to the "painful dentist," whose patients avoid going in until it is absolutely necessary.<sup>53</sup>

### Moral Hazard

Many commentators argued that the Asian crisis raised the problem of *moral hazard*. Moral hazard refers to situations where insurance against bad outcomes encourages more risky behavior. In other words, if you have an old car that is fully insured, you may not be careful about locking it up or getting into a fender-bender because you know you'll receive insurance money if it is stolen or dented. Something that is supposed to *protect* (in this case, insurance) can ultimately *undermine* safe behavior.

This term was first used to discuss the unintended consequence of setting up central banks to act as a lender of last resort in case a domestic banking system is threatened with collapse. The problem is that if banks know they have a regulatory safety net, they may take more, rather than fewer, risks because they know they will be bailed out if something goes wrong. Unsurprisingly, we have seen this term used many times in the current financial crisis.

In the case of the IMF, there has been concern that if investors, banks, and governments know the IMF will arrive with large bailout packages in times of trouble, this may result in more reckless behavior by all of the above. Investors may make more risky investments and governments may encourage looser regulation. Scholar Kapur added a twist to the term, arguing it can apply to the IMF itself. In other words, the IMF may have an incentive to take risks in its own policy advice to countries, because it has its own form of insurance: No IMF staff ever gets fired for poor policy advice. In addition, the IMF is usually first in line of creditors to be repaid.<sup>54</sup>

### Other Critiques

As one of the opening quotes of this chapter inferred, there are plenty of other critiques. The Meltzer Commission, a special US Congressional commission (2000) that made recommendations on how to reform international financial institutions, considered 12 principal criticisms in its report. They ranged from "The IMF is too powerful" to "the IMF's interventions have not been associated, on average, with any clear economic gains to recipient countries."<sup>55</sup>

The Meltzer Commission concluded that the IMF, as well as the World Bank and regional development banks, would improve their performance if they were more accountable and "had a clearer focus on an important, but limited set of objectives."<sup>56</sup> For the IMF, this would mean making short-term loans for countries that need short-term liquidity. Some of the Commission's recommendations were seen in subsequent efforts by the IMF to revise and make more flexible its lending policies.

Blustein argued that the IMF was simply too ill-equipped to stand up against the enormous flows of private capital that can enter and exit countries with such great speed. The size of markets and disruptions overpowers the fund's capacity. In the end, he concluded, "the fund's efforts to contain the crises were analogous to a team of well-trained orthopedic surgeons trying to cure a ward of patients experiencing emotional breakdowns."<sup>57</sup> The problem wasn't just the IMF's alone, because the institution was working with high-ranking officials at the US Treasury, Federal Reserve, and related agencies from the other Group of 7 (G7) advanced economies—none of whom proved any better at safeguarding the global economy.<sup>58</sup>

## IMF Response

Unsurprisingly, the IMF made various attempts to defend its actions. Kenneth Rogoff, the IMF's chief economist, argued in an article entitled "The IMF Strikes Back" that it isn't true the IMF encourages moral hazard, because very often private investors don't escape as easily as some believe. He cited data that private investors lost more than \$325 billion as a result of the Asian crisis and the Russian debt default of 1998.

In terms of the common criticism that the IMF austerity program increases a country's suffering, he reminded us that "developing countries don't seek IMF financial assistance when the sun is shining; they come when they have already run into deep financial difficulties, generally through some combination of bad management and bad luck."<sup>59</sup> Governments also find it politically helpful to blame the IMF when they have to take difficult policy actions, like cutting government spending. Rogoff also raised the counterfactual—what would happen to countries in crisis if the IMF didn't step in? Things could be worse if countries defaulted on their loans or found their currency in free fall. "Blaming the IMF for the reality that every country must confront its budget constraints is like blaming the fund for gravity," he concluded.<sup>60</sup>

## PERSPECTIVES ON THE IMF

Many scholars, including economists and political scientists, have conducted research that seeks to explain in more detail what factors shape how the IMF performs and behaves.

One area of research examines how effective fund programs have been at helping countries get back onto their economic feet. Political scientist J. R. Vreeland surveyed the literature on this topic and concluded that it produces contradictory results on indicators that include inflation, balance of payments, and economic growth.

He explains that a major reason for this is because evaluating the IMF's activity is complicated. Countries seeking help face different circumstances. There is consensus that the IMF has had a positive, significant impact on balance of payments problems, but not on whether the IMF has helped to lower inflation.<sup>61</sup> In the area of promoting economic growth, the IMF has been weak, with some studies even showing the IMF has a negative impact on economic growth.<sup>62</sup> The mixed results may or may not mean the IMF is doing something wrong. The recipient countries play a role, too. They may not be complying with the IMF's policies. Vreeland also cites studies that show compliance in some areas is higher than others.<sup>63</sup>



Scholars also admit measuring compliance is tricky, and even when we know that countries are not complying, it is not always easy or possible for the IMF or its major shareholders to punish noncompliance.

Political scientists Michael Barnett and Martha Finnemore present a constructivist argument on what is wrong with the IMF and why it matters. They argue that IMF staff have gained a great deal of authority and autonomy as a result of their specialized expertise in economics. They developed and disseminated the economic models that shape how the IMF has responded to countries. In particular, this explains the IMF's emphasis on balance of payments problems and the policy prescriptions that follow. When policies failed, the IMF's response has been to expand conditionality, rather than to retrench. The result of this logic of expansion, they argue, has been an unmanageable proliferation in IMF goals, which can result in organizational dysfunction. This dysfunction can occur as the organization struggles to do too much with limited resources, or as the goals themselves may clash. An excellent example of the latter is how the goal of capital market openness conflicts with the goal of economic stability, as we have seen with the Asian financial crisis.<sup>64</sup>

Economist William Easterly has argued that a central problem with the IMF, as well as other major international organizations who give money to developing countries, is that they advocate a "top-down" approach in foreign aid, an approach that applies global blueprints without following through on implementation and results. He calls the big aid organizations "Planners," and he contrasts them with "Searchers," people and organizations who work "at the bottom" in developing countries to find out what is really needed. "In foreign aid," Easterly argues

Planners announce good intentions but don't motivate anyone to carry them out; searchers find things that work and get some reward. Planners raise expectations but take no responsibility for meeting them; Searchers accept responsibility for their actions. Planners determine what to supply; Searchers find out what is in demand.<sup>65</sup>

His argument was inspired, in part, by his observation that Western nations have spent over \$2 trillion dollars on foreign aid in the last fifty years and still cannot get inexpensive medication to prevent poor children from dying of malaria. Yet, somehow, other people on the same planet can manage to deliver millions of copies of Harry Potter books to bookstores by the launch date. This illustrates the differences between Planners and Searchers.

He also argues that the multilateral organizations are too centralized, an observation repeated elsewhere. Of the major multilateral organizations, the IMF is one of the more centralized. For example, while the World Bank has moved a lot of its staff to developing countries in the past decade, the IMF typically has only one "resident representative" in each country, and that person has limited powers. Most of the work is done in Washington, DC, and IMF staff then fly to countries for brief visits, spending their time in finance ministries, central banks, and nice hotels. As Stiglitz passionately noted,

Modern high-tech warfare is designed to remove physical contact: dropping bombs from 50,000 feet ensures that one does not "feel" what one does. Modern economic management is similar: from one's luxury hotel, one can callously impose policies about which one would think twice if one knew the people whose lives one was destroying.<sup>66</sup>

These are examples of a variety of perspectives on what is wrong with the IMF, and there is no consensus on how to reform the institution. Critics who passionately argue that the IMF should be shrunk or abolished have counterparts who argue that it should be expanded with greater powers. We should now expect more evaluation of the IMF's performance in the euro crisis, as the latest chapter in thinking and debate about how the institution can continue to evolve to handle future challenges.

## CONCLUSION

This chapter has charted some major points in the IMF's history, and we can see that, like the World Bank, it has sought to evolve and adjust to global economic and financial issues and pressures. This chapter has shown some of the ways that it has been less institutionally flexible than the World Bank and offered examples of its modest adjustments. The bank, for example, over time has hired staff with PhDs in a variety of areas beyond economics, including environmental engineering, sociology, political science, and anthropology. The IMF still relies primarily on economists. The bank has played a leadership role, albeit contested, in issues such as poverty reduction and the environment. It more actively engages with civil society than the IMF. The IMF points out that its work is essential in issues such as reducing poverty, but clearly that is not the central focus of its work in fostering international monetary cooperation and seeking to ensure global stability. At the same time, the bank is struggling more with the sheer number of goals and mandates than the IMF, which has been more successful at avoiding mission creep. Perhaps one of the best tests of the IMF's legitimacy and performance will be to see how all of the changes that have taken place impact its ability to prevent or react to the next global financial crisis. After all, some scholars remind us that such crises are a permanent fixture of life, and the question is not "whether," but "when."<sup>67</sup>

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