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Third World Network

The IMF's Financial Crisis Loans: *No change in conditionalities*

April 2009

The IMF had suffered a sharp decline in its lending business in recent years until the present global financial crisis led to an unprecedented resurgence in lending. The Group of 20 (G20) has economically and politically legitimized the IMF by trebling its resources as well as by reinforcing its role as key lending institution for crisis-affected countries in need of balance of payments support. As a result, the IMF's lending portfolio has seen a sudden boost, and the cumulative amount of its loans amounts to well over $50 billion.

As the global financial crisis wreaks havoc in both the financial sector and real economy across North and South, world leaders and global institutions issue ominous warnings of a repeat of the Great Depression of the 1930s. The global growth rate for 2009 is 0.5%, the lowest level since World War II. [1] Leading economic institutions and publications state that the impacts of the global financial crisis on the real economy worldwide will only continue to unfold and intensify throughout 2009.

Rich country banks lie in disarray, credit markets are clogged, demand is contracting across borders, exports are shrinking by the day, and capital is becoming harder to access as public debt mounts and foreign exchange reserves dwindle. However, at the center of the twin crises in both the financial and economic sectors, the International Monetary Fund (IMF, or the Fund) is experiencing a revival of its relevance, particularly by the Group of 20 (G20) forum and European leaders.

The widening current account deficits of emerging market and developing countries, in an environment where bilateral and private market creditors are increasingly unwilling to lend and capital flows are plummeting or reversing, has enabled the IMF to get back into business through its financial loans.

[1] International Monetary Fund, "World Growth Grinds to Virtual Halt, IMF Urges Decisive Global Policy Response," IMF Survey Online, January 28, 2009, http://www.imf.org/external/pubs/ft/survey/so/2009/RES012809A.htm.

Beginning in September 2008, the IMF has to date negotiated Stand-by Arrangement (SBA) loans with nine countries: Georgia, Ukraine, Hungary, Iceland, Latvia, Pakistan, Serbia, Belarus and El Salvador. Countries that have recently requested SBA loans are Guatemala, Costa Rica and Turkey, and more are expected. SBAs compose the bulk of the Fund's lending portfolio and are designed to address balance of payments problems in developing and emerging market countries.

The typical program length is between 12 to 24 months and repayment, at non-concessional interest rates, is due within 3¼-5 years of disbursement. IMF documents describe SBA loans as "the Fund's workhorse lending instrument for crisis resolution."[1] Unlike the Flexible Credit Line, designed for countries with strong macroeconomic fundamentals and a proven track record with the Fund, which do not carry any conditionalities, the SBA loans carry macroeconomic and structural policy conditionalities.

The nine loans disbursed between September 2008 and February 2009 range from a low of $523 million for Serbia to a high of $16.4 billion for Ukraine. They are the largest loans disbursed in the IMF's history, and reflect the recent doubling of loan access limits to 600% of member country quotas. Although the SBA loan facility has also been made more flexible by allowing immediate access to funds and a reduction in the frequency of reviews, these provisions are contingent on how stable the IMF deems the country's macroeconomic policies to be.

The majority of loans are clustered in Central and Eastern Europe, as a result of this region's high exposure to U.S. and European financial markets and banks as well as the fast-paced nature of financial liberalization in many of these countries. However, the regions of South Asia and Latin America are fast joining the IMF's crisis lending portfolio, implying a geographically diverse and complex range of national contexts in policy and politics.

The chart titled "IMF Financial Crisis Loans" in the appendix outlines the Fund's policy conditions and recommendations in the first nine SBA loans. The loan details, as stated in the official loan documents that are publicly available on the IMF's website, cover the areas of fiscal policies, monetary and exchange rate policies and financial sector policies.

This preliminary assessment reveals that the IMF continues to impose procyclical fiscal and monetary policies whose objective is to lower fiscal deficit and inflation levels by reducing public spending and increasing official interest rates. The Fund's fiscal and monetary macroeconomic targets continue to be oriented on a downward bias, which reflects the same overall trend as in loans over the past years as well as during times of financial crises.

Objectives and policy frameworks of the IMF's crisis loans

A survey of the objectives stated at the premise of each SBA loan document reveals what primary issues the IMF is primarily concerned with. In each of the nine loans, the key objective of "macroeconomic stability" is linked to a "tightening of monetary and fiscal policies." Other significant objectives are rebuilding international reserves which have fallen to dismal levels, inflation reduction, sustaining capital inflow and averting capital flight, preventing currency depreciation, banking sector reforms and the provision of financial sector liquidity.

While these objectives are myriad and numerous, the central goal of most of these objectives is to secure investor and depositor confidence by implementing an overall framework of macroeconomic adjustments buffering up international reserves, and, for most loans, to establish a flexible, or market-based, exchange rate regime.

In the IMF's macroeconomic framework, this critical confidence of foreign investors is obtained and maintained by achieving 'stable' macroeconomic indicators in fiscal, monetary and exchange rate policies. This reassures the IMF's creditors as well as investors that the Fund's loan as well as foreign debt will be honored. In turn, this security felt by investors ensures that capital outflows will not occur. The Fund acknowledges the influence its loans have in facilitating access to multilateral institutions' funds, reducing uncertainty about the country's economic and financial situations and, importantly, in the credit rating ascribed to the national economy.

The nine SBA loans have fiscal tightening policy conditions centered on reducing the fiscal deficit as a percentage of the national GDP. The target deficit levels range from a high of 4.9% of GDP in Latvia and 4.2% of GDP in Pakistan to a median of 3.9% in Iceland and 3.75% in Georgia, to a low of 2.8% in El Salvador, 2.5% in Hungary, 1.75% in Serbia and a zero overall balance in Ukraine and Belarus. In Ukraine the Parliament will pass a 2009 budget consistent with a zero deficit target, and in Belarus a balanced government budget is seen as necessary to contract demand and consumption as well as slow investment and wage growth.

This is rationale by the IMF as necessary in order to cool and "overheated economy" and to adjust to serious constraints in the access to capital. The average fiscal deficit target across the nine loans is 2.64% of GDP. This fiscal deficit lowering is achieved through "fiscal consolidation plans" which involve restraining and reducing public expenditure as a percentage of GDP. Public expenditure entails public sector wages, pensions, and other social transfers such as minimum wage increases, elimination of subsidies (primarily in fuel and gas), tax reforms and increases and in the case of Belarus and Pakistan, increases in utility tariffs.

In Ukraine, the IMF recommends generating public savings by freezing public wages, pensions and social transfers, postponing for two years any increases in the minimum wage and eliminating consumer subsidies for imported gas. In Hungary, public sector wages have been frozen while the 13th month of bonus salary for public servants has been eliminated. The Fund has also advised Hungary to cap its pension payments, postpone social benefits and trim the resources of government ministries.

In Iceland, the incomes policy agreement between unions and the public and private sector will aim to significantly reduce wages across the board; and, in Latvia two-thirds of its 2.1% reduction in its fiscal deficit will come from a 25% reduction in public sector wages and bonuses in 2009, which is imposed through a ceiling on the Latvian public wage bill. In Serbia, wage growth is to be tightly restricted while in Belarus a zero fiscal deficit is to be achieved by reducing public sector wages.

The elimination of gas and fuel subsidies is the other key mechanism by which public expenditures are advised to be reduced by the IMF. In Ukraine, the Fund states that a "pass through of imported gas prices to consumers and a reduction in gas subsidies" is a central component of public investment cuts. In Pakistan, energy subsidies are to be eliminated while utility tariffs were increased in 2008 by 18%. In Serbia and El Salvador gas subsidies were gradually phased out.

The IMF's fiscal policy

The IMF's **fiscal policy** aims to reduce fiscal deficits by restraining public expenditure, in which the burden falls on public sector employees, the poor and the unemployed. Country examples of fiscal tightening are as follows:

- In Pakistan the Fund advises a reduction in the fiscal deficit from 7.4% of GDP to 4.2% through lowering public expenditure, gradually eliminating energy subsidies, raising electricity tariffs by 18% and eliminating tax exemptions.

- In Hungary, the IMF has targeted fiscal deficit reductions from 3.4% of GDP to 2.5% through a fiscal consolidation plan which involves freezing public sector wages, placing a cap on pension payments and postponing social benefits.

- Ukraine's fiscal deficit is targeted at a zero overall balance as a binding conditionality in its loan agreement. Public savings are to be generated through freezing public wages, pensions and other social transfers, postponing for a minimum of 2 years any increase in the minimum wage and cancelling tax cuts that were previously scheduled for FY 2009.

While IMF Managing Director Dominique Strauss-Kahn and other senior IMF officials have been urging countries that have fiscal and monetary space to implement fiscal stimulus programs in order to bolster aggregate demand and boost consumption, the advice stated in the IMF's loan conditions are a sharp contrast to their statements.

For example, the IMF's SBA loan of $532 million to Serbia states that "..there is no scope now for countercyclical fiscal loosening. Anything less than a tight fiscal stance could also jeopardize the credibility of the program in the eyes of foreign investors and the Serbian public. Fiscal policy will in addition need to put a tight constraint on wage growth in government sectors and public enterprises."[2]

IMF chief economist Olivier Blanchard said in a December 2008 interview, "What is needed is not only a fiscal stimulus now but a commitment by governments that they will follow whatever policies it takes to avoid a repeat of a Great Depression scenario."[3] Furthermore, in February,

[2] IMF, "Republic of Serbia: Request for Stand-by Arrangement," January 23, 2009. http://www.imf.org/external/pubs/cat/longres.cfm?sk=22640.0.

[3] IMF, IMF Spells Out Need for Global Fiscal Stimulus," IMF Survey online, December 29, 2008, http://www.imf.org/external/pubs.ft/survey/so/2008/INT122908A.htm.

Strauss-Kahn made a statement at the 44th Southeast Asian Central Banks Conference in Malaysia that there is now “a broad consensus on fiscal stimulus to restore growth.”[4]

However, as demonstrated in the attached chart, all nine loan country recipients are being directed to implement the exact opposite policies of public expenditure reductions, fiscal consolidation plans, public sector wage cuts, and the phased elimination of subsidies. While the objectives of these IMF-supported loan policies are to boost foreign exchange reserves and address public debt burdens, there is no clear mention or analysis of the economic and social impacts that these contractionary policies will have in economies that are already contracting in economic recession.

While spending on social safety nets and social assistance schemes are being supported by the IMF in several loan recipient countries, it is important to note that in countries such as **Pakistan** the cumulative increase in social spending is 0.3% of GDP, whereas the reduction in public spending amounts to 3.2% of GDP. So, while the IMF can accurately say that social safety spending is being doubled in Pakistan, from 0.3% to 0.6% of GDP, it is overshadowed by the fiscal deficit reduction required by the IMF, from 7.4% to 4.2% of GDP.

This fiscal deficit reduction is to be achieved by a "fiscal consolidation plan," as termed by the IMF, which involves reducing public spending through: (a) an18% rise in electricity tariffs, (b) the phasing out of subsidies, (c) spending cuts in the government budget, (d) the elimination of tax exemptions in the General Sales Tax and the introduction of a new Value Added Tax law in the parliament, among other aspects. While positive impacts from social spending increases may benefit the national economy, the negative impacts from contractionary fiscal policy in a time of economic recession may well undermine the cumulative positive impacts from social spending increases.

The IMF’s monetary policy

The IMF’s **monetary policy** is focused on reducing inflation through inflation targeting and monetary tightening. According to the IMF, lower inflation levels are to be achieved primarily through increasing the official interest rate. Country examples of monetary tightening are as follows:

- In Latvia, the IMF has advised raising the official interest rate by 600 basis points in 2008. According to the IMF, a reduction in domestic demand is the mechanism through which wage and price inflation are to be lowered.

- In Iceland, the interest rate was increased by 600 basis points to 18% in October 2008. The IMF stated that a tightened monetary policy in Iceland would help stabilize the krona.

[4] IMF, “Statement by the IMF Managing Director Dominique Strauss-Kahn at the Conclusion of his Visit to Malaysia,” Press Release No. 09/29, February 7, 2009, http://www.imf.org/external/np/sec/pr/2009/pr0929.htm.

- Pakistan's interest rate was advised by the Fund to increase by 200 basis points, to 15%, with the provision that any additional increases that may be necessary will also be implemented. The IMF also advised Pakistan to establish an "interest rate corridor" which could protect international reserves and enable domestic financing of the government to be achieved through market placements of government securities.

In recent months, pressures and exhortations have come from many G7 countries, as well as from the IMF's Managing Director, to increase the IMF's lending to crisis-affected countries and boost its resources. In our opinion, this would be the major mistake of the current crisis. The documentation of the IMF's current loan conditionalities and policy advice demonstrate that the traditionally contractionary nature of the IMF's fiscal and monetary policy framework has not changed. Additional resources to the IMF would give it the means by which to discipline crisis-hit countries the wrong way, worsening the crisis for them.

Third World Network's key recommendation is that in the current context of global recession and credit market turmoil, counter-cyclical fiscal policies that boost public spending and investment while lowering or easing taxes and domestic interest rates are also needed in developing countries.

The IMF should not be advising developing and emerging market country borrowers to tighten their fiscal and monetary policies in a procyclical manner—and this should be a fundamental policy reform before the Fund is endowed with increased funds through member country contributions, NAB increases and gold sales.

In particular, given that the financial crisis today was in part caused directly by procyclical macroeconomic policies, the Fund should not be prescribing them as a solution now, just as it should not have prescribed contractionary policies during the Asian financial crisis of 1997-98.

Fundamental reform of the IMF is needed

There is a growing international consensus in support of reform of the governance, accountability, and transparency in the Bretton Woods Institutions and other non-representative institutions that have come to play a role in the global financial system, such as the Bank for International Settlements, its various Committees, and the Financial Stability Forum.

These deficiencies have impaired the ability of these institutions to take adequate actions to prevent and respond to the crisis, and have meant that some of the policies and standards that they have adopted or recommended disadvantage developing countries and emerging market economies. Major reforms in the governance of these institutions, including those giving greater voice to developing countries and greater transparency are thus necessary. For the IMF, serious consideration should be given to restoration of the weight of basic votes and the introduction of double or multiple majority voting.

Our other key recommendation is that the IMF should not be the primary and dominant vehicle to disburse financial assistance for crisis-affected countries. Other regional and national arrangements, such as the Chiang Mai Initiative in East Asia, and the Bank of the South in Latin

America, should be strengthened and used regionally and internationally where possible. Additionally, mechanisms such as international debt arbitration should be established to address the increasing debt burdens of developing countries.

Additionally, regional efforts to augment liquidity should be supported. For instance, extension of liquidity support under the Chiang Mai initiative without an IMF program requirement should be given immediate consideration. Regional cooperation arrangements can be particularly effective because of a greater recognition of cross-border externalities and greater sensitivities to the distinctive conditions in neighbouring countries.

Due to the inherent procyclical policy bias of the IMF as a lender of last resort, the G20 should not seek to replenish IMF funds and should not legitimize a central role for the IMF as the primary crisis lender. The G20 should instead place emphasis on maintaining aid and capital flows, particularly from the G8 donor countries, while strengthening the capacity of regional lending arrangements across developing countries.

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[1] International Monetary Fund, "IMF Implements Major Lending Policy Improvements," March 24, 2009, http://www.imf.org/external/np/pdr/fac/2009/pdf/032409.pdf.