The International Monetary Fund (IMF) in 2009

(a brief introduction)

Historical context and nature of IMF conditionality

The creation of the IMF at the Bretton Woods Meeting in 1944 set out its mandate in the Articles of Agreement. The mandate entails international monetary cooperation, the growth of trade, exchange rate stability, a multilateral payments system and temporary financial resources to help members correct their balance of payments.[1] At this historically renowned Bretton Woods Meeting, the British delegation, led by Keynes, had a distinctly separate proposal from that of the United States for international monetary coordination.

Keynes proposed the *bancor*, a new international means of payment, for transactions between central banks, whose supply would increase with the expansion of world trade. The objective was to avert a return to the deflationary rules of the gold standard and facilitate expansionary economic policies that would enable full employment, which would have been the mandate of the institutions Keynes laid out to manage the *bancor*, called the International Clearing Union.

On the other hand, the US proposal was to continue the use of national currencies, with a central role conferred to the US dollar, and an institution called the International Monetary Fund to address the imbalances created by the inadequacy of US dollar supply for the needs of global commerce. The UK, and most other countries participating in the first Bretton Woods conference, called for IMF resources to be a secondary form of reserves, automatically accessible to countries facing balance of payments problems at a cost. However, the US was concerned that automatic accessibility granted a blank check to deficit countries, and asserted that the loans must come attached to macroeconomic policy conditionality and limits on loan durations in order to guarantee repayment at an agreed date.

Conditionalities initially addressed the specific worries of credit risks harboured by the US. However, through the years, increasing extents of mission creep resulted in a dangerous expansion in the numbers and reach of conditionality, and the original focus on repayment was supplanted by much larger goals of trade and financial liberalization, boosting growth, reducing poverty and reforming institutions and systems within borrower countries. As Carvalho (2008) states, "during the Asian crises of 1997/1998, the Fund seemed to recognize no limit on the legitimacy of its demands from borrowing countries … limiting the scope of national policy autonomy [in borrowing countries] was precisely the point."[2]

Macroeconomic ideology of IMF conditionality

The two distinct aspects of IMF conditionality are that of its *content*, and the *process* by which conditionalities are designed and negotiated between the borrowing country

government and the Fund's staff. In the IMF's role as financial intermediary between rich country creditors, who supply the majority of financial resources to the IMF, and developing country borrowers, the Fund's initial and primary *raison d'etre* for imposing economic conditionalities was that of ensuring repayment of its loans to preserve the revolving nature of its resources.

However, over time, the objectives expanded to various other areas, such as the promotion of trade and financial liberalization policies, the focus on maintaining macroeconomic stability through conservative policies of low inflation and fiscal deficit rates, and the securing of investor and market confidence in the national economy through keeping public debts low and interest rates competitive.

The model of macroeconomic policies espoused by the IMF is called "financial programming," and focuses on a set of core objectives which include low budget deficits, competitive interest rates and reform of critical areas like tax and banking sector. The overall goal is, in short, to maintain sustainable public debt levels, international reserve buffers, and a low rate of inflation. According to the IMF, this will avert capital flight by securing the confidence of foreign investors and institutions and project a message of macroeconomic stability to international financial markets, which will in turn facilitate access to foreign capital and investments.

Led by the US Executive Director on the Fund's Board, who takes policy directions from the US Treasury, the argument that began to underpin the IMF's macroeconomic policy advice is that balance of payments deficits were generated by domestic policies that overstimulated the economy, increasing its absorption beyond its potential output. To remedy this imbalance, contractionary policies on government spending and monetary policies were imposed by the Fund. The logic is that lowering demand in the domestic economy will reduce imports and raise surplus through exports and outputs, which will reduce the absorption of real resources in the national economy and restore balance of payments equilibrium.

This rationale does not account for the fact that most of the large supply shocks that have impacted developing country balance of payments are externally created, such as the oil price hikes of the 1970s, the external debt crisis that hit Latin America in the 1980s, and most recently, the food and fuel price hikes of 2008, to name just a few. These exogenous shocks created BOP imbalances that are not domestically induced and whose impacts are not temporary on the national economy.

This ideological framework which has been instilled in the IMF's mode of thinking, analysis and policy advice is premised on an almost instinctive inclination to link any deficits in the national economy to expansionary fiscal and monetary policies, as opposed to the possibility that it could result from deflationary shocks coming from the international economy. This can be better understood in the context of the historical decision made in Bretton Woods in 1944, which is that countries be penalized for their balance of payments deficits, but not for their surpluses, as was originally proposed by Keynes.

The advent of structural conditionality represented a greater degree of intrusiveness on national policy space and political decision-making. Structural conditionalities involve measures that change the structures of institutions and incentives in borrowing countries, such as trade and financial liberalization, tax reforms, banking sector overhauls and privatization of state enterprises. Structural conditionalities were most notorious during the Asian financial crisis, when the IMF prescribed bank closure and privatization measures to Indonesia, Thailand and South Korea which resulted in massive social upheaval and which sharply exacerbated the economic recession in those countries.

The signalling power of the Fund

Given the controversial nature of IMF conditionalities and the constraining effect often posed on national policy autonomy, and in particular national development strategies, the question of why borrowing countries adhere to the conditionalities must be asked. It is not simply the receipt of the next financial instalment from the IMF which is at stake for the borrowers; it is also the access to financing from other sources such as donors, capital markets and other IFIs.

The signalling power of the IMF explains how obtaining a positive macroeconomic assessment from the IMF facilitates access to credit for developing and especially low-income countries. In order to receive this positive macroeconomic assessment from the Fund, countries will accept the policy recommendations laid out in the Fund's bilateral surveillance reports, or if they are loan borrowers, will comply with the economic conditionalities in its loan program.

This monopoly role of the IMF in macroeconomic assessment sheds light on why the rate of defaults in Fund loans is usually low, as well as why countries that do not even receive financial assistance from the Fund will still adhere to the policy prescriptions of the Fund in its Policy Support Instrument (PSI) program. Through its signalling power, the IMF holds the status of being a 'senior lender,' in that countries will prioritize servicing Fund loans before repayment obligations to other creditors.[3] Civil society critics have emphatically pointed out that the Fund's signalling role can lead to low-quality and high-cost policy advice and analysis, and that the rich country donors who enable this role to the Fund are responsible for this sub-optimal situation.

Civil society advocacy has called for macroeconomic analysis and assessment that is objective, broad and country-driven for developing countries. Such analysis should guide macroeconomic policies as a vehicle for effective aid use and the pursuit of national development policies, not just to signal access to international capital. This need for a broader menu of policy options for developing countries done by not just the IMF, but also by academics and the policy expert communities, should be created with the support of donors.

A 2008 civil society report from the United Kingdom points out that alternative sources and content of economic assessment would "create competition in the market for

macroeconomic assessment, increase the breadth of such assessments, and ensure the use of good practice development principles, such as country ownership and stakeholder participation, which are currently lacking in the Fund. This can improve the information available to both donors and domestic policymakers while also enhancing the capacity of and strengthening institutions in the South."[4]

IMF conditionalities in low-income countries

Unlike advanced and emerging market economies who can access finance in private capital markets and adjust their balance of payments disequilibria by manoeuvring their exchange rates, low-income countries (LICs) do not have that privilege. The IMF is often the most accessible or the only source of loans for low-income countries to address their balance of payments problems or disruption caused by exogenous shocks, such as the fuel and food price increases of 2008, and financial crises, such as the current crisis of 2009.

The IMF has been designing and disbursing concessional (at less than market interest rates) loan programs to LICs for more than 30 years. In the 1980s and 1990s, the loan program was called the Enhanced Structural Adjustment Facility (ESAF) which imposed the much-criticized Structural Adjustment Programs (SAPs). Due to the widely publicized harmful impacts of the neoliberal or economically orthodox policies imposed on developing countries through the SAPs, the IMF discontinued the ESAF in 1999 and created a new facility called the Poverty Reduction and Growth Facility (PRGF).

The PRGF was supposed to carry more country ownership by being based on the participatory Poverty Reduction Strategy Paper (PRSP) and by thus having a greater focus on social needs.[5] However, ten years later the key issues of the IMF's role in low-income countries, its negative impacts on national development policy options and its mission creep into the arena of development finance still remain.

A key critique made by global civil society on the IMF's involvement in LICs is that their policy influence has overstepped their mandate as an international lender for balance of payments problems, and has become indistinguishable from development financing—in which the Fund does not have the expertise or mandate to pursue.[6] A problematic mismatch between the long-term nature of LIC economic problems and the temporary nature of the Fund's balance of payments lending has been alerted to by both civil society and academics. The Fund's macroeconomic framework may be critically misaligned with LIC country development needs, as the focus on low inflation, budget deficit and public debt levels have been found by the policymakers, civil society and other citizens of those countries to often constrain the ability of these countries to meet their public sending needs, particularly in the areas of health and education.

In 2007, a study by the Center for Global Development in Washington, D.C. examined whether the IMF constrains health spending in LIC countries. Based on in-depth case studies from Mozambique, Rwanda and Zambia, a working group of 15 policy experts assessed criticisms that the Fund's macroeconomic policies challenge the delivery and

capacity of the health sector in low-income countries. The report found that the IMF's fiscal policies have often been too "conservative or risk-averse," and that the Fund had not adequately explored "more expansionary, but still feasible, options for higher public spending."[7] The report also demonstrated that the Fund's monetary policy of targeting low inflation rates, usually in the single-digit range of 5-7%, is not justified by empirical evidence. The report called on the IMF to "help countries explore a broader range of feasible options," and with "less emphasis on negotiating short-term program conditionality." Similarly, the fight against HIV/AIDS in sub-Saharan Africa has been stagnated because public spending in the health sector is kept restrictively low through loan conditionalities. Where the primary objective of low spending limits is low inflation targets, civil society organizations and academics have argued that increasing public spending will not always result in high inflation, especially in developing countries with excess capacity.[8]

In reference to the education sector, ActionAid's International Education Team demonstrated that a major factor behind the chronic and severe shortage of teachers is that IMF policies have required many poor countries to freeze or curtain teacher recruitment. Their research in Malawi, Mozambique and Sierra Leone revealed that the IMF exercises critical influence in setting the annual ceilings on public budget expenditures, which includes the public wage bill out of which the salaries of teachers are drawn.[9] As the public wage bill is reduced in expenditure size through the policies set forth in the IMF loan, the governments of these countries freeze or reduce the recruitment and salaries of teachers, making the IMF partly responsible for the under-development of health and education social sectors in LIC countries, where these very social sectors are a critical component in building their development path. The counter-productive nature of donor aid and donor-approved IMF loans is highlighted in that although rich country donors may attempt to boost education and health services through their foreign aid, the policies which their representative directors approve on the Board of the IMF have the opposite effect.

A 2007 report by the IMF's Independent Evaluation Office (IEO) on foreign aid to sub-Saharan African countries found that significant percentages of disbursed aid were not spent on development needs because of IMF policies requiring certain ceilings on international reserve levels and low inflation rates.[10] The report noted that about 37% percent of all annual aid increases to African countries in a span of several years was diverted to shoring up international reserve levels. The report also found that, among countries perceived to already have sufficient currency reserves, only about $3 of every $10 in annual aid increases was programmed to be spent, and up to $7 out of every $10 was redirected and diverted by IMF into either paying down domestic debt, building up international currency reserves, or both. The main driver behind the un-used aid was found to be the Fund's prioritization of very low levels for inflation. Low-income countries unable to obtain low inflation rates of 5-7% were permitted to spend only 15% of their annual foreign aid increases, or just $1.50 out of every $10 in annual aid increases by donors.

IMF as 'financial crisis firefighter'

In the contagion of economic and financial crises that affected Asian and Latin American developing countries in the late 1990s, as well as in the current financial crisis of 2008-9, the Fund almost instantaneously became the crisis firefighter through the disbursement of loans. During times of financial crises, the Fund's geographical scope spreads, its economic impact augments, and its institutional coffers are replenished anew. The danger lies in the re-establishment of the IMF's relevance, necessity and power due to it being the only international lender of last resort in times of crisis. This enables the Fund to bypass the very policy reforms that have been called for by external stakeholders, including its own national members, for many years. In this sense, financial crises are good times for the IMF even while they bode bad times for the world economy, nations and region.

Prior to the current crisis, the Fund was slipping into a haze of obsolescence and irrelevance. The world's middle-income developing countries that had suffered the Fund's economic austerity conditionalities during the financial crises of the late 1990s re-paid their debts to the IMF soon after they started their recovery process. As such, the IMF's primary loan recipients have been low-income countries who have no other choice but the Fund to access financial assistance. Now, for the first time in over a decade, the Fund is signing loan agreements with high- and middle-income countries, particularly in Eastern Europe. Indeed, the IMF is back in business, back on the negotiating table, and back on the world economic stage. After being repeatedly labeled as "irrelevant" and portrayed as obsolete in a new world economy defined by emerging market economies' economic muscles, the IMF is now being heralded by media headlines that read: "The IMF is back in business" and "The Fund is back in town."

The IMF loan program used during times of financial crisis is the Stand-by Arrangement (SBA) loan, which is described by the IMF as "the Fund's workhorse lending instrument for crisis resolution."[11] SBAs, which are non-concessional and based on market interest rates, 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 SBA was originally designed as a preventive facility that would guarantee the right of a country to access IMF funds as long as the country prepared a *Letter of Intent* (LOI) pledging to implement a set of economic policies favored by the Fund. However, the SBAs soon transformed into a different kind of loan, as borrowing countries requested the SBA not as a preventive measure but when they were already in the throes of a deep balance of payments problem. The LOI acquired the status of a pre-condition to the loan, and soon IMF staff themselves took over the task of drafting these letters. Economic conditionality acquired the term, "performance criteria," which evaluated compliance with the LOI and upon which installments of financing were contingent.

The Asian financial crisis

The Asian financial crisis of 1997-98 is now seen as one of the most significant economic events in recent world history. The crisis began in early July 1997, when the Thai baht was floated, and spread into a virulent contagion—leaping from Thailand to South

Korea, Indonesia, the Philippines, and Malaysia. It led to severe currency depreciations and an economic recession that threatened to erase decades of economic progress for the affected East and Southeast Asian nations.

The sequence of events triggered a self-reinforcing spiral of panic, which many analysts argue was premised on the rapid and deep scale of financial, or capital account, liberalization in the region. Financial liberalization led to surges in capital flows to domestic banks and firms, which expanded bank lending, ultimately resulting in a rapid accumulation of foreign debt that exceeded the value of foreign exchange reserves. As international speculation on dwindling foreign reserves mounted, the regional currencies came under attack and depreciated severely.[12] The Fund has been widely acknowledged as one of the key institutions that espoused financial liberalization in developing countries. Within the IMF the official position on the free movement of capital changed dramatically over the years. By the late 1970s the Fund's bias was in favor of financial liberalization, a position which was reflected in the redefinition ascribed to balance of payments equilibrium from a state of zero next exports to a situation where current account deficits could be financed by the free flow of capital.

The crisis-affected Asian countries learned a critical lesson through their loan programs with the IMF. The Fund provided more than $100 billion in emergency funds to Thailand, Indonesia, and Korea—the three worst-hit countries—with the goal of restoring investor confidence and ameliorating the economic crisis. However, rather than achieving their stated goals, the Fund's programs seemed to accelerate capital flight. Steven Radelet and Jeffrey Sachs (1998) argue that the IMF's inappropriate focus on "overhauling" financial institutions in the heat of the crisis worsened investor confidence by re-emphasizing domestic financial weaknesses.[13]

Furthermore, the structural reforms of the IMF programs at the time have since been termed "mission creep," because they included reforms in areas that are not typical of the Fund's financial surveillance. Indeed, the Fund's Independent Evaluation Office revealed in a 2003 report that it was said at the time in policy circles in Jakarta that the list of structural reforms in IMF programs "was grabbed by the IMF team off the shelf of the Jakarta office of the World Bank."[14] Critics of the IMF loan programs demonstrate how the high interest rates prescribed by the Fund, and intended to curtail currency depreciation, induced a severe "credit crunch" that exacerbated the financial dilemmas of local banks and firms and had a sharp deflationary effect on domestic economic activity.

IMF loans in the current financial crisis of 2008-9

The financial and economic crisis of 2008-9 has come to be known as the most severe financial meltdown since post-World War II. While the origin of the crisis was the sub-prime crisis in the US housing market, due to the porous cross-border connectivity of international financial transactions the crisis spread to all corners of the world in lightning speed. The effects on developing countries were of massive proportions: export revenues plunged, foreign reserve levels shrank to dangerously low levels, capital flows inverted from robust net positive flows to net outflows, investments and spending

stagnated, remittances dropped, and growth and output came to a grinding halt. Many developing countries, and in particular the transition countries of Eastern Europe, have over recent years enacted a rapid and forceful financial liberalization process, which left their economies intensely vulnerable to external shocks and their banks and financial institutions with deep levels of exposures. As their currencies started to devalue, the large proportion of borrowing that had been done in foreign currency forced a severe exposure to banking crises and volatile financial instability in these countries.[15]

Beginning in September 2008, a series of countries started to sign SBA loans with the IMF. In terms of financial size, these were the largest loans disbursed in the Fund's history. This remarkable expansion in the size and scope of the IMF's loans was due to the internal changes made by the Fund to double access limits for loans, increase available resources for loans and provide faster, simplified loan procedures. The Fund's expansion was also a result of the critical decision made by the G20 Summit on 2 April in London which almost trebled the lending coffers of the Fund from $250 billion to $750 billion.

Analysis of the SBA loan documents reveals that the key objective of 'macroeconomic stability' is directly linked to a "tightening of monetary and fiscal policies." This implies that the Fund is tying economic stability to procyclical fiscal and monetary policies whose objective is to lower fiscal deficit and inflation levels by reducing public spending and increasing official interest rates and/or restraining the growth of money supply. Procyclical policies can dangerously exacerbate the economic downturn in affected countries, as recovery requires fiscal boosts and increased credit supply, rather than the opposite. 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. The Fund's objectives include buffering international reserves which have fallen to dismal levels, targeting inflation to low levels, preventing currency depreciation and providing financial sector liquidity where needed. Through these objectives the core goal of averting capital flight is to be achieved, and through maintaining the free flow of capital across borders investor and depositor confidence is to be won over.

In the IMF's macroeconomic framework, this sought after 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 will be repaid by the borrowing country, and that foreign debts owed will be honored. In turn, this security felt by investors ensures that capital outflows will not occur. The Fund acknowledges the influence, or signaling power, 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.

Fiscal policy conditionality in IMF loans require borrowing countries to reduce fiscal deficits 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.[16]

The elimination of gas and fuel subsidies is another 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, calling for an increase in gas prices for households. 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. Instead of recognizing the need for increasing government expenditure to overcome the recession, the IMF is increasing cost burdens on taxpayers and consumers by increasing electricity tariffs and taxes in these already contracting economies.

The loan reviews conducted by the Fund throughout 2009 reveal that in the core areas of pro-cyclical fiscal and monetary policies, the Fund continues to impose more of the same. In fact, in Latvia, Serbia and Ukraine, subsequent installments of their IMF loan financing was delayed or halted because the Fund required deeper reductions or reforms in fiscal policy, primarily in public expenditures and tax reforms.[17] The one notable difference is that as the economic recession manifested in more severe levels of downturn than the IMF had forecasted or analyzed in its initial loan documents, the percentage of fiscal deficit relative to GDP was increased, and in some cases, increased significantly. However, these increased fiscal deficit targets are, in most cases, temporary, and are set to decrease by 2010. It is also hard to know whether the Fund allowed for higher fiscal deficits or whether the degree of economic downturn caused the borrowing countries to have no other choice but to increase their budget deficits.[18]

In Hungary's second loan review, the IMF recommends that further expenditure cuts are still necessary. Transfer schemes are to be further "tightened and rationalized" at the local government level and in public transportation, although "mandatory expenditures" such as unemployment benefits and sick pay are retained. The Fund also asks for tax reforms in Hungary, specifically, a cancellation of tax cuts planned for 2009, and an increase in the value-added tax and the income tax.[19] Hungary's explicitly pro-cyclical fiscal and monetary policies leave very little room to stimulate an economy in recession by means of public spending. Tax burdens have increased as the centerpiece of

Hungary's fiscal austerity package and a low fiscal deficit target restricts the prospect of sizeable public investment expenditures that could boost demand and economic activity

Pakistan's second loan review involves tax increases, tax exemption reductions, and a continuation of tight monetary policy in order to ensure low inflation levels, which, according to the Fund, is threatened by "higher oil prices, higher wages and the fiscal expansion."[20] Pakistan's social support scheme, called the Benazir Income Support Program, while consistently emphasized in the Fund's loan documents with Pakistan, disbursed less money than was originally targeted as only 1.75 million families were approved for income support out of the target for 3 million families. With regard to the political will to increase public spending in Pakistan, the IMF's second review states that the Pakistani authorities "believe that additional revenue measures are politically infeasible in the near term."[21] In Pakistan's contracting economy, where export revenues have been hit hard and capital flows have turned to outflows, the increased cost burdens on taxpayers and consumers being designed and supported by the IMF, such as electricity tariffs and new tax increases, is fast resulting in a bad situation made worse. And with a prohibitively expensive cost of borrowing due to high interest rates, borrowers are not only denied necessary access to financing and credit but are also starting to increasingly default on their existing loans.

Monetary policy conditionality entails requiring borrowers to hike official interest rates and/or constrain the growth of money supply. This increases the cost of borrowing and reduces the availability of local money and credit in crisis-hit countries at a time when capital inflows, national revenue sources, and consumer demand has decreased significantly, access to capital is difficult and many national currencies have depreciated. In Latvia, the IMF has advised raising the official interest rate by 6% in 2008. According to the IMF, a reduction in domestic demand is the mechanism through which wage and price inflation are to be lowered. Pakistan's interest rate was advised by the Fund to go up to 15%, with the provision that any additional increases that may be necessary will also be implemented.

Crisis-hit countries need counter-cyclical policies to recover first, and stabilize later (not the other way around)

At a time of global economic contraction, developing countries are being affected far more severely due to the greater vulnerabilities they face in their dependence on foreign capital, export revenue and investor confidence, among other factors. Meanwhile, developing countries are not responsible for the current financial and economic crisis and are unfairly suffering its impacts as debt levels increase, social development indicators worsen and local industrial productivity halts. In this context, a wide range of critics in the academic realm, civil society and thinktanks have found grave faults with the Fund's focus on maintaining conservative economic indicators. The line of reasoning is that the Fund should not be advising developing and low-income countries that borrow from the Fund to tighten their fiscal and monetary policies in a pro-cyclical manner that further contracts domestic demand and economic activity. The IMF's objectives of reducing deficits in the national economy, maintaining low inflation and continuation of foreign

debt payments, among other goals, is achieved by shrinking government spending in the very public sectors that employ a mass of workers and that would, if supported through job retention and adequate wages, boost domestic demand and help stimulate activity and output in the national economy.

While increased government expenditure is not necessarily the only antidote for crisis-hit countries to attain recovery, but it is one of the key elements that is being applied and practiced across most of the developed countries and emerging market economies that have ample budget surpluses, such as China. The purpose of IMF lending during a world recession, and in a world where it is the only existing international lender of last resort, should be to provide sufficient reserves so that borrowing countries can pursue the expansionary and counter-cyclical fiscal and monetary policies that developed countries have been pursuing since the onset of the crisis.[22]

The purpose of counter-cyclical policies is to minimize the harmful loss of employment and economic output despite the fact that fiscal or current account deficits will persist into unsustainable levels. One argument is that developing countries should be allowed to finance much-needed public spending increases through their deficits, for a temporary period of time, until the world recession starts to abate. As the report of the United Nations Commission of Experts on the financial crisis asserts, a globally coordinated fiscal stimulus response is imperative: "As countries balance the trade-off of the benefits of expansion against the costs of increased debt-financed government spending, the risk is that they will undertake insufficient action and, as a result, the global stimulus will be deficient."[23] In countries with unsustainable debt burdens, the case for speedy and resolute debt cancellation is more compelling than imposing fiscal austerity measures of the sort that reduces wages, cuts jobs and increases taxes, while the economy is already hurting from the impacts of today's massive crisis in both the financial and real economies.[24]

In order to proactively facilitate recovery from the crisis, the IMF needs to demonstrate that it can support concrete measures for counter-cyclical fiscal policies that boost public spending and domestic investment. The Fund also needs to support beneficial monetary policies that lower domestic interest rates temporarily and maintain an adequate supply of money to foster credit growth and access to credit and loans for developing country citizens who often cannot access credit due to high interest rates.

Although it is every lender's job to be concerned with the ability of the borrower to repay the loan that has been made, many critics of the Fund's approach to responding to the crisis call for a less risk averse approach to seeking repayment guarantees. One intrinsic factor that constrains the adoption of a less risk averse approach is the short-term duration of most IMF loans—given that most loans mature within a 2 to 3-year time horizon, borrowing countries do not have the ability to focus first on bringing their domestic economies back to health, and later on stabilizing their economic indicators and making repayments to creditors. For example, one approach the Fund could take would be to allow borrowing countries that have a low public debt level relative to their GDP to

undertake expansionary fiscal and monetary policies decided on by the government of that country.

In March of this year the IMF did introduce a new credit line called the Flexible Credit Line (FCL), which provides liquidity for the foreign reserves without any conditionalities. The FCL can be drawn in large amounts and on a precautionary basis that the country can use as and when needed. However, according to the Fund, FCLs are only approved for "countries meeting pre-set qualification criteria," which involves "very strong fundamentals, policies, and track records of policy implementation."[25] This is why the FCL has only been disbursed to three countries so far—Mexico, Poland and Colombia—even though the need for this facility is urgent across most developing countries negatively affected by the crisis. Besides being highly exclusive, the FCL is also problematic because the criteria upon which countries are qualified are not clearly specified or supported by any economic body of knowledge—in essence, the "qualification criteria" is more or less based on the arbitrary judgment of the IMF regarding which countries "give confidence that their economic policies will remain strong." Civil society has argued that with the significant boost to IMF resources provided by the G20 the Fund should "consider providing this kind of support to other countries" who would benefit immediately from a cushion provided to the reserves.

The mantra of financial liberalization: a key driver behind all financial crises

Several IMF loan documents, such as that of Serbia and Pakistan, allude to the overarching goal of averting capital flight; and, where an outflow of capital has occurred, the goal is to rebuild investor confidence. In its preoccupation with attaining blessings from the investor and market, the Fund prescribes pro-cyclical fiscal and monetary policies as a narrow solution. However, the IMF's loan documents hardly ever mention capital account regulations, or capital controls, and in Pakistan's loan it opposes them directly.

Recently, Brazil imposed a tax on certain kinds of foreign inflows to moderate the rise in its currency. Economists from the Institute for International Economics (IIE) in Washington, D.C., Arvind Subramanian and John Williamson, wrote in the Financial Times that Brazil's tax on foreign capital "is of great importance, substantive and symbolic. The symbolic value lies in signaling an end to an era in which emerging markets were enamoured with foreign finance, and in expressing willingness to take action to moderate inflows of foreign finance. Substantively, it is important in increasing the arsenal of weapons that countries can deploy to moderate over- heating of their economies. It is a good illustration of the type of measure policymakers can use to arrest incipient asset price overheating."[26] However, the IMF did not support the Brazilian measure, as a senior Fund official reported to the FT that "governments should not be tempted to postpone other more fundamental adjustments," and that it is very complex to implement such taxes because they have to be applied to every possible financial instrument and have proven to be "porous" over time in a number of countries. As the IIE writers noted, the Fund's response is "disappointing," and reflects business as usual

in terms of the IMF's intellectual approach to financial globalization, where the preservation of foreign flows is "considered sacrosanct by the IMF."

In the aftermath of the Asian financial crisis of 1997-98, a fundamental lesson that was reinforced widely across regions and sectors is that the liberalization of the capital account, or financial liberalization, can have a devastating impact on financial and economic stability, particularly when the flow of capital is on a short-term basis and can be pulled out of the country as easily as it flowed into the country. In this world of free capital mobility, the loss of investor confidence can be triggered overnight and can result in large losses in foreign reserves and currency depreciation, as was experienced during the Asian financial crisis. As the United Nations pointed out during its study of the causes and effects of the Asian crisis, "excessive reliance on external capital needs to be avoided" through a cautious management of capital inflows.[27] Joseph Stiglitz asserts that the dangers associated with capital market liberalization are one of the most important lessons of the Asian crisis, pointing out that "it was not an accident that the only two major developing countries to be spared a crisis were India and China. Both had resisted capital market liberalization."[28] Furthermore, the Malaysian experience during the Asian crisis highlights that developing countries that have liberalized their financial sector can still manage their capital flows through certain policy tools, such as selective capital controls or regulations to discourage or prevent speculation.[29]

While the current financial crisis of 2008-9 may not have the same root causes as that of the Asian financial crisis, the continued policy and signaling endorsement that the Fund gives to capital account liberalization and the pro-cyclical macroeconomic policies that support it implicates the Fund in contributing to the vulnerability of developing countries in the wake of a crisis. The IMF must take on a certain degree of responsibility for having espoused and implemented financial liberalization, as being a key driver behind all recent financial crises. It seems ironic that the Fund would prescribe the very kinds of policies to address the crisis as the policies that have helped formulate the deregulated and liberalized structure of the international financial system, which leads to chronic and recurring financial crises. The Fund should also learn its lessons from the global criticism it received for having exacerbated the economic downturn in Asian countries through its loan conditionalities more than a decade ago. While most of the structural conditions which wreaked havoc through the privatization and closure of banks, for example, have, in good faith, been absent from loan programs during this crisis, the fiscal austerity measures and the tightening of monetary policy remain very similar.

Endnotes

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