Applied Economics in Action: IMF Programs

By STANLEY FISCHER *

Among the purposes of the International Monetary Fund (IMF) set out in the first Article of Agreement is "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards ... ." Sixty-one member countries are currently in programs with the IMF that allow them to borrow, subject to agreed-upon conditions on their economic policies.

Table 1 provides details on IMF programs in place at the end of 1996.[1] Total commitments were $44.2 billion, all to developing or transition economies. The last industrial countries to borrow from the IMF were Italy and the United Kingdom in 1977, Spain in 1978, and Portugal in 1983. The biggest IMF loan ever was the $18 billion committed to Mexico in February 1995; the Fund has committed a total of $17.6 billion to Russia since 1992.

The bald facts of Table 1 understate the role of IMF programs: in many countries, including the transition economies, the IMF program is *the* critical element in macroeconomic policy, and adherence to the program is in many cases a prerequisite to obtaining other (often larger) public and private loans. This paper provides an introduction to IMF programs and the economic and political economy issues associated with them.

I. IMF Programs

In the traditional *stand-by* loan, the IMF agrees to make specified amounts available to the member country, generally in quarterly tranches over 12–18 months, under agreed-upon conditions on its macroeconomic policies (the "adequate safeguards"). Repayment is made in eight quarterly installments ending five years after each drawing from the Fund. IMF loans are denominated in SDR's, a basket of the five leading currencies, with the interest rate a correspondingly weighted average of rates on short-term paper of the five governments, plus small commitment and service fees.

The IMF also makes longer-term loans under the Extended Fund Facility (EFF). These loans are disbursed, generally quarterly, over three years, conditional on both macroeconomic and structural policies. Detailed program conditionalities are negotiated annually. Repayment takes place starting after four and a half years and ending ten years following each drawing. An emerging pattern in the transition economies is for countries to move from a stand-by, which emphasizes stabilization, to an EFF, which shifts the emphasis to structural reforms while maintaining macroeconomic stability.

The Enhanced Structural Adjustment Facility (ESAF) makes concessional loans to low-income member countries with protracted balance-of-payments problems. The interest rate is 0.5 percent, with repayments in ten semi-annual installments ending ten years after each drawing.[2] Thirty-three countries, over half in sub-Saharan Africa, but also including some transition economies, have ESAF arrangements. Several other special facilities are available under specified circumstances.

II. Program Design

Fund programs are designed to restore balance-of-payments viability, and more

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[1] For a description of the Fund's financial structure and facilities, see International Monetary Fund (1995).

[2] ESAF is funded separately from regular IMF operations, through loans and interest subsidies provided by contributing member countries.

TABLE 1—IMF PROGRAMS AS OF 27 DECEMBER 1996

	Stand-by	EFF	ESAF
Number of arrangements	19	10	33
Average program length (months)	18.3	35.7	36.0
Total amounts[a]			
Committed	24.4	14.1	5.7
Drawn	15.4	4.0	3.2
Number of programs with:			
Countries in transition	7	5	4
Least-developed countries	3	0	19

[a] Billions of U.S. dollars.

generally to restore macroeconomic stability—seen as a necessary condition for economic growth. Extended programs, the EFF and ESAF, with their greater emphasis on structural measures, have a more explicit growth orientation.

The short-term macroeconomics of IMF programs is built around three identities: the central-bank balance sheet, the balance-of-payments constraints, and the government budget constraints (International Monetary Fund, 1987). One essential element is the link between the balance of payments and the central bank's balance sheet, which lies at the heart of the monetary approach to the balance of payments (International Monetary Fund, 1977):

$$(1) \qquad \mathrm{BP} = \Delta\mathrm{NFA} = \Delta H - \Delta\mathrm{NDA}$$

where BP is the balance of payments, NFA is the monetary authority's net holdings of foreign assets, H is the stock of high-powered money, and NDA is net domestic assets held by the central bank. This in turn is linked to the government budget constraint:

$$(2) \qquad \mathrm{BD} = \Delta H + \Delta B$$

where BD is the budget deficit, and B is government borrowing.

Based on estimates of the current-account and available balance-of-payments financing and needed additions to external reserves, plus an estimate of the increase in monetary base (in turn based on a money demand function, and assumed growth and inflation rates), it is possible to calculate how much domestic credit the central bank can create. External financing may come from official bilateral and multilateral sources, and estimates are made of the amounts that can or should be borrowed from the private markets. The agreed-upon government budget deficit will be based on an estimate of ΔH and the amount of borrowing that is either advisable or available. Of course, the assumed current account and rates of income growth and inflation have to be consistent with the available financing. This will often require changes in the real exchange rate, as well as in monetary and fiscal policy.

The program itself typically links disbursements to the meeting of specified conditions (performance criteria) on variables such as increases in net international reserves and domestic credit, as well as the budget deficit, which are viewed as policy variables the government can control. Outcomes on other macroeconomic variables, such as the inflation rate or the growth rate, are set as indicative targets but are not subject to conditionality.

Programs are negotiated between the IMF staff and the government of the member country. Staff enter negotiations with detailed instructions, agreed upon within the staff and then by management. Negotiations are often long, involving several negotiating missions, and sometimes contentious, but because the analytic framework is simple, the disagreements are over real issues—for example, whether the budget needs to be as tight as the staff argues, whether inflation should not be reduced less rapidly, whether the agreed-upon balance-of-payments deficit can be larger (for instance, by adding less to reserves), or whether the international community, perhaps the Fund itself, can be prevailed upon to increase its financing.

Despite its name, the IMF often places fiscal adjustment at the heart of the stabilization program. With the typical country negotiating a program suffering from high inflation, a balance-of-payments problem, perhaps a need for debt rescheduling, and a large fiscal deficit, fiscal tightening is usually necessary. Macroeconomic tightening is of course never politically easy; if it were, the country would in most cases not have needed to come to the IMF. Further, the country may have waited so long that drastic action is needed to ensure fiscal and external viability. All this means that IMF programs are often extremely controversial.

IMF programs, especially extended arrangements, often include structural elements, among them trade liberalization, price liberalization, privatization, the introduction of indirect means of monetary control, foreign-exchange market liberalization, banking-system restructuring, tax reform, subsidy cuts, and changes in the structure of government spending. Many of these measures are in the purview of the World Bank, with whom coordination and cooperation is essential. Increasingly, IMF programs pay attention to the details of fiscal adjustment, seeking for instance to ensure that social spending is protected. These structural measures are more likely to be indicative targets than performance criteria.

Once the program has been negotiated, it is presented to the Executive Board of the IMF, consisting of 24 Executive Directors representing 181 countries. Eight directors each represent a single country, the largest countries among them; the others represent a group or constituency of countries. Voting is weighted by the country's quota share in the Fund, with the United States the largest shareholder at 18.3 percent. The Board generally accepts the recommendations of the staff, largely because the staff brings to the Board only proposals that it will accept. Since negotiations with a country continue throughout the life of a program, the Board will often use a meeting to send signals about what it will and will not accept in the future.

The Executive Directors are generally finance-ministry or central-bank officials, who keep in close touch with their authorities. It is worth emphasizing that all IMF programs, in securing Board approval, are thereby approved by the international community. All programs have of course also been agreed to by the borrowing government, to be sure possibly in circumstances where there are no alternative sources of finance.

The first tranche of a Fund loan is normally drawn on Board approval. Disbursement of subsequent tranches depends on satisfaction of the performance criteria, and on an overall review by the Board, advised by the staff, of the implementation of the agreed-upon policies. If the performance criteria have not been met for a good reason, the staff may recommend that they be waived and the review passed. This flexibility, while desirable, is a potential source of dynamic inconsistency. However, waivers are not routinely proposed, and many programs are interrupted because agreed-upon measures have not been carried out.

III. Do Fund Programs Work?

Countries borrow from the IMF in part because they need the money. They may also need the certification of their macroeconomic policies implied by their being in an IMF arrangement to obtain financing from other creditors, including the World Bank and the Paris Club. In some cases countries enter precautionary stand-bys in which they have the right to draw but announce their intention not to do so. The motivation in these cases could be to signal to private investors or to official lenders, or as a commitment device, with the government welcoming the discipline of the Fund program.[3]

Much work has been done attempting to evaluate IMF programs, most of it on developing rather than on transition countries where the IMF has played an important role this decade. Two issues should be distinguished. The first is whether the programs supported by the IMF, if implemented, would stabilize the economy and promote growth. Since these policies are essentially those of the current consensus, the question is whether the consensus in favor of macroeconomic stability and market-oriented structural reforms is right. Even within that consensus though, there

[3] Countries also sometimes request staff to monitor the implementation of a program announced by the country but not agreed to by the staff. Because staff monitoring might give a misleading signal that the program has been approved by the IMF, the Board is unenthusiastic about this approach, except as a way-station to a full program.

remain economically and politically important questions of how rapidly and in what sequence to implement policies. For instance, it is often charged that the IMF insists on too rapid reductions in inflation and the budget deficit (i.e., shock treatment). The second question is whether the agreed-upon programs are implemented as designed; and if not, whether alternative approaches would increase the probability of the right policies being implemented.

The most recent IMF staff appraisal (Susan Schadler et al., 1995) examined 45 arrangements. Most had started in difficult conditions. They were on the whole associated with improvements in the external situation, but less so domestically, with few countries seeing significant increases in growth or sharp reductions in inflation; aggregate investment tended to decline, while private investment increased. These findings are broadly consistent with those of many other studies undertaken both inside and outside the Fund. Patrick Conway (1994) finds that lagged effects of programs on growth are generally positive, despite declines in public investment; budget deficits are reduced. In a restrained but more critical appraisal, Tony Killick (1995) essentially agrees with the staff findings (International Monetary Fund, 1995) but is skeptical that IMF programs have much effect on policies, except with respect to the exchange rate. He therefore questions current methods of conditionality, urging greater selectivity in support of locally initiated or "owned" programs.

There can be little doubt that the ideal for the IMF (and the World Bank) is to support well-designed programs that are fully owned by their governments. But such situations are rare. More often, the IMF's political-economy role is to strengthen the hands of reformers within a given country. In considering whether to support programs that are not fully owned, the important question is how much is likely to be achieved even so, and what are the expected costs of failure; in deciding not to support a country, it is necessary to consider what further deterioration the economy will experience without a program. A judgment also needs to be made on the extent to which a more selective approach would increase the number of fully owned programs.

IV. Open Questions

Many questions remain open in the imprecise art of IMF program design, which involves multiple-level principal–agent problems. Most surprisingly, the IMF has not yet converged on the exchange-rate system to recommend in different circumstances. Despite the frequent charge that the IMF adopts a one-size-fits-all approach, its programs support a remarkable variety of exchange-rate systems, from currency boards to free floating. Other recurring issues of program design include the following:

(i) the optimal pace of stabilization, particularly how rapidly to attempt to reduce inflation and the budget deficit;
(ii) the optimal pace of structural adjustment and, more generally, how to design programs to increase growth over the medium term;
(iii) how to ensure that stabilization does not adversely affect the poor;
(iv) whether programs, particularly structural programs, should be kept simpler, and if so, what are the essentials;
(v) whether the IMF should be involved in structural programs at all, or should rather safeguard its "monetary character";
(vi) whether the IMF pushes too fast for too much sophistication, be it in the monetary system (indirect methods of monetary control) or the tax system (pushing the VAT too soon relative to more easily collected taxes, including trade taxes) or elsewhere (e.g., privatization);
(vii) the optimal size of IMF loans;
(viii) how to design, negotiate, and support programs that are more likely to be implemented and owned;
(ix) whether the commitment and signaling roles of IMF programs should become more central.

The issues associated with the design and implementation of IMF programs are susceptible to analysis and research. Many of them are intellectually interesting, and there is the added incentive for working on them—that the answers matter, and for many people, around the world.

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