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BANK OF FINLAND ARTICLES ON THE ECONOMY

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BLOG

Conditionality of IMF programs: an ‘afterthought’ that has taken center stage

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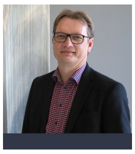

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Consider the task of lending to countries that are in severe payment difficulties, possibly involving significant danger of default. Sounds like a tough assignment, and one that has been on the agenda of the International Monetary Fund almost from the start of its day-to-day operation in 1947. For the Fund, the key to success is program conditionality, an idea which developed almost as an afterthought during the early years of its operation.

At the time, the reconstruction effort from the Second World War was ongoing in a large part of Fund membership. To support global trade and avoid ‘currency wars’ (strategic devaluations of currencies to gain competitive advantage in trade) IMF member countries signed up to fixed exchange rates against the United States Dollar. The fixed exchange rate system concocted in Bretton Woods by the allied nations was a key ingredient of the new global financial order.

One challenge with such a system is the difficulty of computing suitable (‘equilibrium’) exchange rates. This applies during normal times, but especially so during the dynamic and turbulent period of post-war reconstruction. It was therefore expected that some countries would end up with overvalued currencies that made them uncompetitive in international trade. Significant balance of payment deficits might consequently arise that, given the scale of the challenges and uncertainty related to reconstruction, might be hard to finance through normal market based channels such as the international bond markets.

In recognition of this issue the founding agreement allowed exchange rate devaluations under a ‘fundamental disequilibrium’ of the balance of payments. It also tasked the IMF to provide foreign exchange for its members against their national currency. The first countries to use IMF as a source for funds for international payments were France and the Netherlands, which received their first USD transfer in May, 1947, only a couple of months after the IMF had gone live.

All was not, however, well. It soon became apparent that the new global financial order faced a graver problem than the computation of equilibrium exchange rates. Namely, the fixed exchange rate system depended, in effect, on ‘prudent’ monetary and fiscal policies in the participating countries to promote exchange rate stability against the USD. Countries were supposed to avoid overly expansionary monetary and fiscal policies that boosted inflation, thereby eroding competitiveness and pushing them towards a balance of payment crisis.

For many countries, the lure of monetary and fiscal expansion proved irresistible. With growing concern the IMF observed that a large part of its membership suffered from chronic inflation, declining competiveness, and recurrent balance of payment problems. Furthermore, fighting against the negative market reaction to such policies, many countries imposed heavy duties on imports and heavy handed regulation of financial flows. Somewhat depressingly the IMF stated in its annual report in 1952 that the balance of payments problems had been continuous and recurrent. It recognized that most countries had been unable to make substantial progress towards freer international trade. What to do?

The Fund decided to attach conditionality to IMF financing to influence the behavior of the borrower countries. In 1952, it launched the Stand-By-Arrangement (SBA), a loan facility where access to funds was conditioned on economic policies that the Fund deemed prudent. Under the SBA, funds are released in a stepwise fashion during a 'program' period which can last up to three years. During that time the Fund monitors the adherence of the target country to program conditionality.

The Bretton Woods system is long gone, and the IMF has changed in many ways. However, the Fund continues, through its various loan facilities (Chart 1), to be an important source of emergency funding for its member countries all over the world (Chart 2). Program conditionality continues to be an important and durable solution for the Fund to secure its operations and influence the behavior of its program countries.

Chart 1.

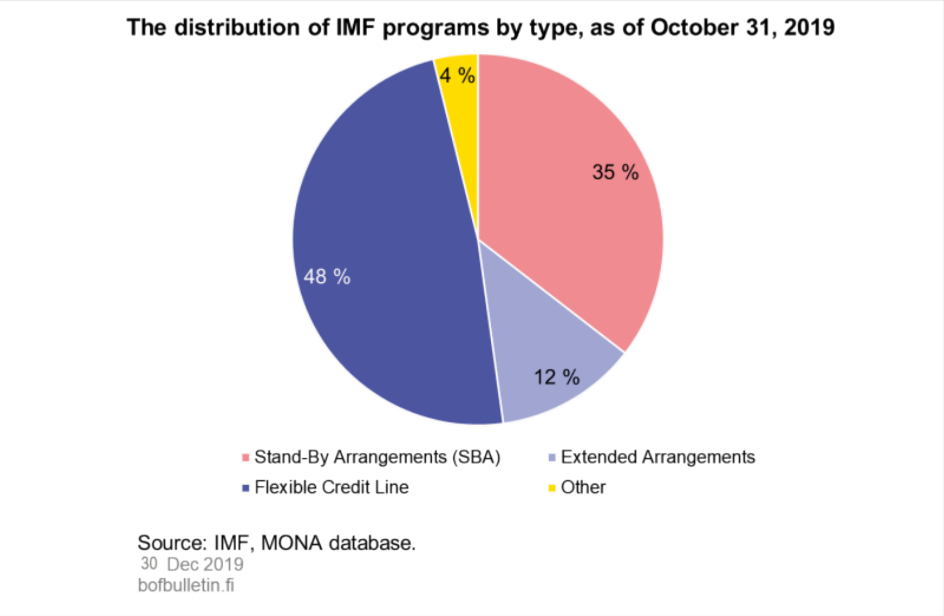
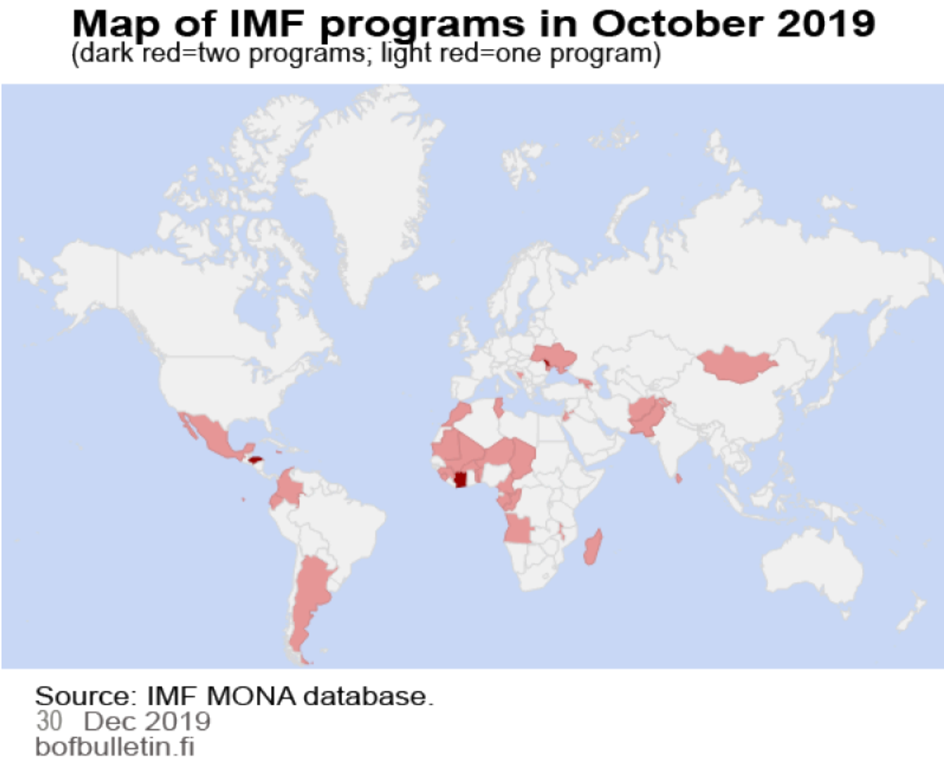


Chart 2.



Tags

conditionality, IMF, lending