Solving the Third World's Financial Difficulties: The Role of the IMF

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I. Introduction

Recently, the International Monetary Fund (IMF) has endured a generous dose of public scrutiny in the United States and in other industrial countries. Because of the so-called debt crisis that has arisen in the past few years among the developing countries, the IMF is being looked to as the cornerstone of international institutions which are capable of dealing with the financial difficulties of the Third World. The sudden interest in the IMF's ability to solve the debt crisis has not resulted simply from an altruistic desire to see the Third World countries get back on their feet again. Rather, the volume of debt assumed by some developing countries has caused justifiable alarm among creditors in developed countries who realize that the adverse effects of the debt problem do not stop with the Third World. A vast and permanent web of interdependence has formed among the nations of the world since the end of World War II and can be felt in political, military, economic and financial areas.

Such interdependence means that if the debt crisis is not brought under control, it will precipitate economic problems for both developing and developed countries alike.

It is the purpose of this paper to analyze the role of the IMF in solving international financial imbalances. It discusses the establishment of the IMF, the ways in which it has changed over time and the procedures which it follows to set a country back on the road to economic stability. Throughout the paper special focus is directed to balance of payments problems of developing countries and their impact upon such countries' financing needs. Finally, the paper presents different viewpoints of various critics with respect to the effectiveness of the IMF's policies so that the reader will have a broad perspective on the debt issue.

II. Historical Background of the IMF

It was 40 years ago that the United Nations Monetary and Financial Conference took place in Bretton Woods, New Hampshire, in July of
One of the principal aims of the forty-four nations participating in the conference was to establish an international institution which would facilitate the maintenance of stable exchange rates. This goal was fulfilled in the creation of the International Monetary Fund.

The Fund has had to change dramatically over the ensuing years to meet the needs of a world economy in transition. The problems which the IMF currently faces are radically different from those problems which were the impetus for its creation. In 1944, the political and economic climate was one which called for the restoration of peace and high standards of living in the western world. The establishment of the Fund was supposed to preclude a recurrence of the economic policies which had been initiated in the 1930's. Faced with high unemployment and declining standards of living, governments then had instituted competitive currency depreciation, tariff barriers, uneconomic barter deals, multiple currency practices, and exchange restrictions (United Nations, 1944). Such policies only served to worsen the state of international trade and did little to improve domestic economic problems.

To avoid repeating the destructive policies of the 1930's, the Fund was established with the following six goals in mind, as contained in the articles of agreement:

(1) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(2) To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(3) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(4) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(5) To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balances of payments without resorting to measures destructive of national or international prosperity.

(6) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members (United Nations, 1944).

The two most important tasks of the Fund were to assist members in financing payments deficits and to monitor exchange rate policies. As difficult it sometimes may be to reduce an idea to written objectives, it is often considerably more difficult to create a system to implement such objectives in a successful fashion. Even so, the system devised at Bretton Woods functioned adequately until the early 1970's. At that time, President Nixon announced that the dollar would no longer be convertible into gold. This precipitated the system of floating exchange rates that exists today.

When the Bretton Woods system of fixed exchange rates broke down, critics began delivering eulogies for the IMF. With the termination of the duty to monitor exchange rates came the feeling that the IMF had lost its central purpose. However, the IMF chose not to pass gracefully into extinction. Instead, it began to shift its attention to the adjustment of balance of payments problems. It is the ability of the IMF to deal with such balance of payments problems which is at the core of the current controversy over the effectiveness of IMF policies.

III. IMF Rehabilitation Policies for Correcting Balance of Payment Problems

The phrase "correcting balance of payments problems" is a very nebulous one. What
exactly can the IMF do to “correct” the problems of a developing economy with balance of payments difficulties?

First of all, the IMF may initiate a program of economic rehabilitation to adjust the payments disequilibria. The specific policies associated with these programs generally fall into three broad categories:

1. the management of the level and structure of aggregate demand;
2. the enhancement of the economy’s supply capacity, particularly that of tradable goods;
3. measures to shift the structure of output toward net exports (Crockett, 1982).

Demand management policies involve establishing objectives for the rates of growth of output and investment, the rate of inflation, and the level of the balance of payments. Since nominal income growth and the balance of payments are affected by the rates of growth of monetary and credit aggregates, targets are set for the rate of growth of bank credit which are compatible with the objectives mentioned above.

Once the overall level of credit expansion is determined, there arises the question of how it is to be apportioned between the government and non-government sectors. First, the level of credit necessary to sustain the output and investment goals is determined. The remainder then constitutes the amount which the government sector can safely borrow without affecting the borrowing capacity of the non-government sector. The Fund monitors, on a quarterly basis, a member’s attempts to abide by the fiscal and credit targets which it has set because deviations from these targets will ultimately affect the rate of inflation. A member which consistently fails to meet these targets jeopardizes its future borrowing capacity.

An IMF-initiated adjustment program will often also include the introduction of new taxes, the raising of tax rates or constraints on spending authority. Governments are usually willing to use policy instruments (such as interest rates and open market operations) to achieve the desired demand management targets. These government budget measures are neither regulated nor monitored by the Fund, however, but are instead controlled by the member’s government (Crockett, 1982).

The second broad category of IMF adjustment programs includes policies to enhance a country’s supply capacity. The IMF implements supply-side measures to increase the productivity of borrowing members. Such measures are designed to increase efficiency in the allocation of resources, thus improving both the quality and quantity of output. In supply-side management, emphasis is usually placed on the development of the export and import-substituting sectors of the economy. In general, the IMF advocates that a developing economy with balance of payments problems expand its domestic production of goods rather than continue to import such goods. IMF policy also dictates avoiding large, long-term industrial projects because such projects often rely heavily on imported capital equipment. Instead, the Fund recommends investing in agriculture, infrastructure, energy, and quick-yielding projects. Supply side measures may also include an evaluation of pricing policy and the extent to which regulated prices precipitate a misallocation of resources (Crockett, 1982).

In addition to demand and supply management programs, the third type of IMF adjustment program involves enhancing the member’s ability to export. Most often this program will involve a change in the exchange rate in the hope that a more competitive exchange rate will increase exports. Extensive calculations must first be made, however, to project how a change in the exchange rate will affect the demand for and supply of exports and imports (Crockett, 1982).

IV. IMF Facilities for Financing Balance of Payments Deficits

Correcting payments imbalances without adversely affecting output, employment and growth is one of the central economic objectives of developing countries (UNCTAD, 1983). However, current world economic trends to a large degree hinder the achievement of this objective for the following reason. If the external accounts of a developing country were in deficit
due to an excessive level of domestic demand, it would be correctible by demand management policies. However, the present payments deficits of developing countries stem largely from external disturbances such as the collapse of commodity prices, the rise in import prices and interest rate movements (UNCTAD, 1983). The IMF recognizes that developing countries are more severely affected by external disturbances than are industrial nations and also have less ability to correct balance of payments problems (Hooke, 1983). With this in mind, the IMF has established several “facilities” which are designed to help alleviate balance of payments problems peculiar to developing countries. These facilities and others aimed at correcting specific difficulties are briefly described below.

Any country's balance of payments can be thrown into deficit as a result of various exogenous factors. For instance, in 1973 and 1974 when oil prices rose sharply, the IMF established special oil facilities to enable countries to finance their inflated oil bills. A subsidy account was even established to help developing countries pay the interest on money borrowed to pay for imported oil (Hooke, 1983).

Sometimes unusual circumstances such as drought or frost will reduce sharply the available export volume of a commodity. When a country which exports primary products (usually a developing country) experiences temporary export shortfalls due to factors largely beyond its control, it can borrow money from the IMF’s compensatory financing facility (CFF).

Similar to the CFF is the buffer stock financing facility, which makes financing available for the purpose of dampening fluctuations in export prices. This is done through the stockpiling of commodities, so that in the event of a shortage, a country will have an inventory on hand to fall back on. Financial resources from this facility are used to finance both the stockpiling of commodities and related expenses.

Inadequacies in structural factors, such as in production and trading patterns, are yet another cause of balance of payments difficulties. For example, a country may be producing goods for which there is little international demand and importing other goods which could be produced domestically. Alleviating such structural distortions, while at the same time minimizing losses in output and employment, is a process which often takes a considerable period of time and requires more external financing than is provided by basic Fund lending. In such cases, the extended Fund facility can provide the necessary financing to correct the structural weakness over a suitable time period, usually within 10 years (Hooke, 1983).

Still another special facility set up solely for the benefit of developing countries was the trust fund. In 1976, with the role of gold in the international monetary system greatly reduced, the Executive Board of the IMF decided to sell 50 million ounces of the IMF’s gold holdings. The profits from the sale of gold (i.e., the difference between the auction price and the former official price of SDR 35 per ounce1) were to be placed in a trust fund for eventual distribution or lending to qualifying developing countries. When the holdings from the trust fund were exhausted in March of 1981, the total amount distributed equaled $4.6 billion (Hooke, 1983).

V. Some Criticisms of IMF Policy

The adjustment of balance of payments problems is not as simple as it may have sounded in the previous sections. Experts in business, government and academia have increasingly questioned whether the IMF is pursuing the proper policies in its handling of the developing world’s financial difficulties. The most severe critics go so far as to argue that commercial banks could effectively do the work of the IMF. In this last section, some of the intricate problems and dilemmas associated with financing and adjustment will be analyzed.

As previously mentioned, the current balance of payments problems of most developing countries stem primarily from the collapse of

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1The SDR (special drawing right) is the official reserve currency of the IMF. It is a weighted average of a basket of currencies which includes the U.S. dollar, the French franc, the British pound, the German mark and the Japanese yen. The SDR’s value is allowed to float against its component currencies. Its value at the time of the writing of this paper (Spring 1984) was approximately $1.10.
commodity prices, the rise in import prices, and interest rate movements. The advice that the IMF has offered to them is to lower imports by developing import substituting sectors and to increase exports. While this program could work in the case of a few countries, when applied to a multitude of countries it seems unachievable. If every country increases its exports, who is going to increase its imports? (Wolman, 1983)

The answer is certainly not the industrialized countries, where political and financial leaders have recently managed to contain inflation, but only at the expense of growth. Slower growth means fewer imports. Furthermore, many industrialized countries have been advocating import restrictions. This being the case, the question remains: Who is going to import the increased exports of the developing countries?

Other obstacles to short run growth in the Third World include high real interest rates in the United States and the consequently overvalued dollar. America's trading partners (some of them developing countries) feel compelled to keep their interest rates close to those in the United States in order to prevent large capital outflows from their economies. Additionally, as a country's currency weakens (for example, against a stronger dollar) imports grow more expensive, fueling the fires of inflation (Wolman, 1983). Thus, developing countries find themselves in the following dilemma. They wish to expand growth, but growth expansion requires increased imports. However, developing countries are cutting back on imports because of rising import prices, and in the end they are also diminishing their prospects for growth.

Unfortunately, this situation is a "two-headed beast" in that the Third World also has a debt problem, in addition to a trading problem, to contend with. Past policies to promote growth have resulted in increased deficits which have been financed in large part by the international banking community. Many countries have borrowed beyond their capacity to back the loans (Clark, 1983). Naturally, commercial banks have retreated from additional lending to countries which are potentially insolvent. Much to the disadvantage of these countries, this retreat has occurred at a time when large deficits make further financing absolutely necessary.

This is precisely the point at which the IMF steps in. A country may use IMF resources to finance its deficit, on the condition that it accept an IMF-approved program of economic rehabilitation of the type discussed earlier in the paper. This conditionality is the IMF "seal of approval" indicating that a country is on its way to getting back on its feet again. Banks will agree to continue lending to countries who have agreed to the terms of conditionality. Unfortunately, what is happening is that banks are keeping some of the doubtful loans on their books at face value rather than writing them off, while more money is lent so that countries can meet their interest payments. At the same time, the IMF is injecting additional funds to assist the debtor countries. In the final analysis, the banks are showing increased profits in spite of the actual deterioration of their loan portfolios (Brimelow, 1983).

For this reason, some critics have accused the IMF of actually worsening the situation. Such criticism is not altogether justified, however. Consider the following scenario. The IMF wishes to prevent a country from defaulting on its loans because of the economic turmoil which might result, such as the failure of an international bank. Such an event would, in turn, adversely affect the economies of creditor countries by reducing the availability of credit and thus raising interest rates. Because the health of developing countries is dependent upon the health of the industrial countries, the crisis would come full circle and further exacerbate the plight of the developing economies. Therefore, both the IMF and commercial banks alike are searching for ways to continue providing the necessary financing without making repayment even more difficult.

A common belief among many critics seems to be that the banks will not be able to collect all of the loans that they have made to the Third World countries (Wolman, 1983). Therefore, the banks will eventually have no choice but to write down the loans to their true realiz-
able value. In a sense, the banks and the governments of industrial nations will have to absorb a fraction of the debt, thereby “socializing” it among the world’s countries (Wolman, 1983).

Because of this specter of “socialization”, central banks have been watching the debt problem very closely. Although the U.S. Federal Reserve is an ardent supporter of the IMF, it realizes that more coordination is needed between commercial banks and the international lending institutions such as the IMF and the World Bank. Partly as a result of Congressional pressure, the Federal Reserve has recently endorsed legislation outlining new regulations which would govern the future of international lending by U.S. banks. The proposal includes:

1. Strengthening the country risk examination and evaluation system;
2. Additional reporting and disclosure requirements to inform the public of U.S. banks’ aggregate exposure (the sum total of money lent out) and of individual banks who are exposed beyond an acceptable level;
3. Requirements that banks write off debts which are unquestionably uncollectible;
4. The establishment of guidelines so that a bank’s current earnings will not be bloated by the so-called “front end” fees which are paid upon the generation of new loans;
5. Strengthening international cooperation among foreign banking regulators, and between the IMF and the commercial banking community. The emphasis here is on better information flows which will lead to sounder lending decisions (Federal Reserve Bulletin, 1983).

While these five points will not solve the debt crisis that exists today, together they can help to reduce U.S. exposure and prevent an escalation of the problem in the future.

VI. Conclusions

It has been the purpose of this paper to explain how the IMF works to alleviate a country’s balance of payments problem. In the process the paper has also discussed different viewpoints on the question of whether the IMF is correct in its handling of the Third World’s current debt situation.

A student of political science learns early in her studies that international institutions do not work toward a single goal. Rather, they view their operations as an ongoing process, requiring changes in the focus of their operations with the changing needs of the world. This philosophy explains why the IMF has a different role in the international monetary system today than it had ten or twenty years ago. But regardless of the time period analyzed, the element which holds an institution such as the IMF together is cooperation. It must be realized that there are currently 146 member countries in this organization, many of which have conflicting interests. It is therefore impossible to resolve a situation like the Third World debt problem in a way such that everybody “wins.” As a consequence, some compromises are inevitable.

As alluded to in the opening paragraph of this paper, isolationism has been replaced in today’s world by a growing global unity. This interdependence makes one nation’s interests indivisible from the interests of other countries. One needs only to examine the debt problem to realize this.

References

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