Policy Brief

Towards a More Effective Role for the IMF

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In a nutshell

- **The IMF has played a vital role in stabilizing the macroeconomics of the member countries since its establishment in 1944.**

- **In this brief, we explain how the IMF imposes a very effective role in enhancing international financial stability in general and in a crisis time in specific. Although the IMF represents a very powerful organization in supporting the member countries, it is worth mentioning that there is a lot of criticism regarding the effectiveness of its conditionality, which will be discussed briefly in this paper.**

Background

A major responsibility of the IMF is to monitor the economic policies for the 190 member countries, this activity is defined as surveillance. As part of this process, which takes place at the global, regional, and country levels, the IMF supports member countries in recommending suitable policy adjustments in order to promote economic growth and stability. Moreover, the IMF helps in providing the member countries with technical training to be able to implement fiscal and monetary policies efficiently. It is worth mentioning that the IMF's great support to member countries is in crisis time especially in facing deficiency in balance of payment. A financial aid (grants or loans) that stabilizes the macroeconomic of the struggling country. The IMF assistance is not limited to crisis time only but also in the pre-crisis time, it offers lending programs to member countries that are expected to face financial or economic crisis. The IMF programs are designed to be tailored to fit each country's economic and financial situation. This financial aid which is given by the IMF to member countries is based on conditions like any other loan. The objective of these conditions is to make sure that the country who receives the financial aid will avoid the reasons behind seeking these IMF loans. These conditions act as covenants and collaterals that will ensure that the country will repay the loan in addition to its interests. In this brief, we examine the effectiveness of the IMF role in helping countries face crises through its structural programs. A case study of the IMF's great support in the covid-19 crisis will be discussed.

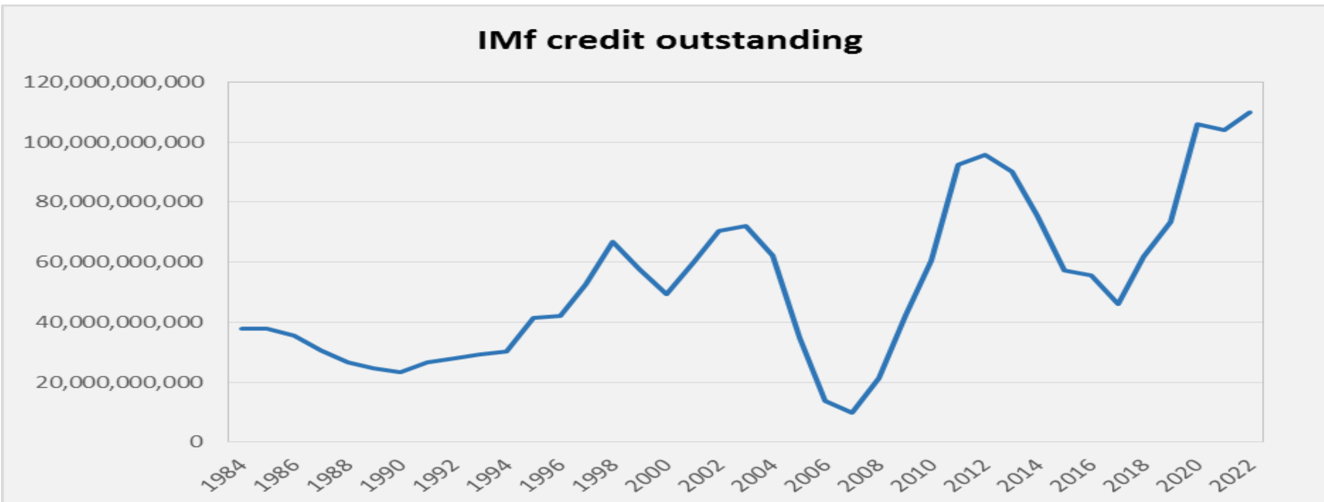
Emergency Finance in response to the global Crisis:

It is worth mentioning that, in the time of global crisis, the IMF provides quick response actions to try to alleviate the harm economic consequences, especially in the developing countries. In figure (1), it shows the volume of IMF aid (in SDR) from 1994 till 2022. It is very clear that the financial aid increases a lot after every global crisis, like the financial crisis in 2008 and COVID-19 in 2020.

IMF and Covid-19 Crisis:

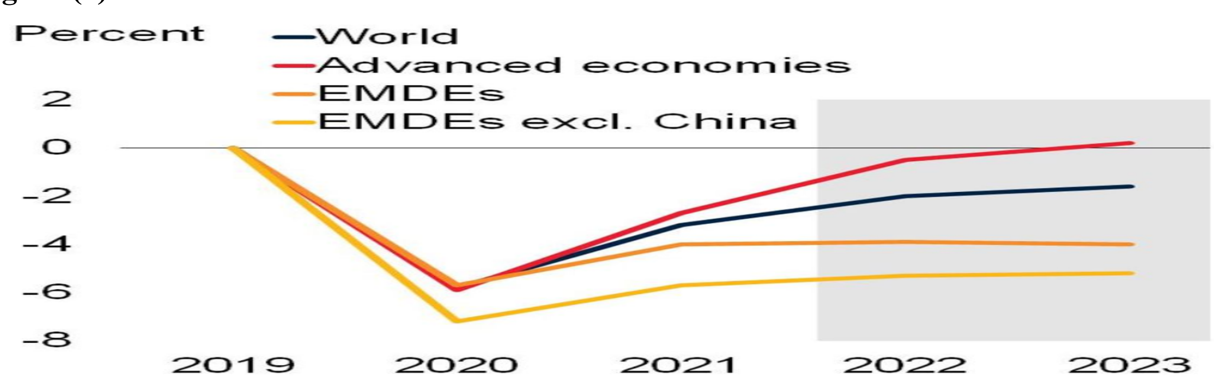
At the time of the lockdown, many countries in the world faced a serious problem in their economic stability, a decline in their GDP and higher unemployment and inflation rates. Figure (2), illustrates the large drop in world GDP in 2020. It is also clear from the graph that the emerging markets will suffer in recovery more than the advanced economies. IMF's quick actions towards this pandemic helped a lot of countries to recover and face the rapid changes. At the time of the pandemic, a lot of member countries requested from the IMF emergency financing aid as a Rapid Credit Facility (RCF) or the Rapid Financing Instrument (RFI). As a result of the pandemic, people are now using fintech-based online services more than before. The new technology in financial service imposes a real risk to policymakers. In addition to the newly emerging digital currencies, the IMF helped policymakers to identify the opportunities and challenges behind such change. Moreover, the IMF supported countries in Asia since not all people there have access to the internet, the IMF supported enhancing connectivity in these countries to ensure more financial inclusion which results in reducing poverty.

Figure (1):



IMF credit outstanding in SDR.
Source:graph generated using dataset from imf.org.

Figure (2):



World GDP
Source: World bank

The Mechanism Of IMF aid:

The international monetary Fund was founded during the international negotiations at Bretton Woods to provide an international system to help recover from the post-second war consequences.

The role of the IMF is mainly focused on stabilizing the monetary systems by giving funds to countries with balance of payment problems. Its role has supported the international economy at the beginning by widening and expanding the world trade market.

There is a great debate among scholars in the literature regarding the efficiency of the IMF's impact on the global economy; some argue that the IMF has the financial capabilities and expertise which can help in tackling the major stabilization problems in the developing countries.

However, others argue that the mechanism of the IMF lending fund to countries, which is conditionality, is inefficient, and causes harm rather than improving the economic performance.

What is the conditionality?

Conditionality is the setting of policy conditions for a loan. The recipient country has to implement several certain policies to get the loan from the IMF. The International Monetary Fund (IMF) has always applied policy conditionality, these conditions are designed to solve balance of payment and macroeconomics imbalances in the short term. And meant to safeguard and guarantee that loans will be repaid by making fundamental improvements in the major economic indicators of the borrowing countries.

Most IMF financing is paid out in tranches and assessed by the degree of borrowing country compliance. Program reviews provide a tool for the IMF to assess whether the program is on track or whether amendments are necessary.

Policy commitments can take one of 4 forms, (prior actions, Quantitative performance criteria, indicative targets, or structural benchmarks)

- prior actions: a set of policies, the borrowing country should implement before getting the loan like price liberation.
- Quantitative performance criteria: quantifiable conditions linked to macroeconomics policies like minimum level of international reserve.
- indicative targets: measurable indicators to assess the effectiveness of the program such as the minimum level of the general government primary balance.
- structural benchmarks: non-measurable indicators to assess the ongoing program performance such as enhancing social safety programs and improving the performance of the financial sector.

These conditions focused on fiscal and monetary policies. In the 1980s, in response to the balance of payments imbalances in many developing countries, new lending instruments were introduced such as the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF). The IMF involved new aspects of the reform on its conditions, such as trade liberalization, price liberalization, and policies to increase tax income (Killick,1995).

The IMF had always demanded a set of conditions before providing any loans, these conditions had become tighter during the period between the 1980s and 1990s. (Dijkstra, 2002).

Conditionality criticism on literature:

In this section, we are going to go through some of the literature that analyzed the effect of IMF policies in achieving economic growth and macroeconomic stabilization in recipient countries, and also the efficiency of the conditionality itself.

According to Abocejo, F. (2014), who investigated the impact of IMF structural adjustment policies (SAPs) on the Philippine economic performance, the IMF conditions were mainly focused on enhancing the liberalization, export-oriented economic efficiency, privatization, reducing government expenditures, and streamlining the bureaucracy. This study concluded that these conditions resulted in deteriorating the Philippine industries because they severely failed to compete with the open market. In addition, the reduction of government expenditures policy resulted in a great failure in improving the poverty rate, education, and social needs in the country.

In a study of The Effectiveness of Policy Conditionality in eight countries (Vietnam, Bangladesh, Nicaragua, Tanzania, Zambia, Uganda, Mozambique, and Cape Verde) (Dijkstra, 2002), the author concluded that most IMF programs in these countries were not fully complied with. Among eleven programs that had been introduced in the 1990s and closed in 1998, only three have succeeded in achieving their primary target; ESAF in Mozambique, the 1994 ESAF in Uganda, and the 1996 ESAF in Tanzania. In most cases where IMF targets were not achieved, new programs were introduced after the break.

The author summarized some of the reasons behind this failure “for example” the difference of opinions on IMF policies among the national government members and interest groups like the case in Tanzania, Zambia, and Bangladesh and the discrepancy between the national governments and IMF itself regarding some conditions.

According to Youssef, J. & Zaki, C. (2021), in their empirical analysis, concluded that the majority of IMF loans have an insignificant or even negative effect on the trend component of GDP, which means that these loans don’t contribute in making a long-term economic growth, rather their effect is mainly on the short-term.
Thus, IMF loans suffer greatly from time inconsistency problem.

Also, the IMF suffers from the problem of adverse selection, in which the allocation of financial aid tends to be more directed to the countries with poor economic indicators and bad policies.

According to (Dreher, 2009), there are some limitations concerning the conditionality such as the problem of Moral hazard; in which the borrowing country abuses the IMF fund by increasing its level of debt, knowing that IMF will continue its lending programs to postpone the probability of default.

It has been argued that the IMF is politically polarized, which results in; the politically weak countries having to accept tighter conditionality than more weighty ones (Dreher et al. 2009).

Some literature argues that the borrowing governments usually misuse the fund provided by the IMF by engaging in political business matters before their election to help increase their popularity in their own countries (Dreher and Vaubel, 2004).

Moreover, when we mention the conditionality, we should illustrate an important term, which is (ownership); in the most used definition, the policies are owned when they originate from borrowing country policymakers, and if the policies are exactly what the national government would have chosen to implement regardless of the intervention of IMF.
Therefore, the conditionality undermines national democracy, because the pre-conditions loans aren't owned by the nationally elected governments, rather they are prescribed by another authority.

According to (Conway, 2005), the IMF conditions aren't exogenous to the recipient countries, rather they depend on the bargaining power of the national governments or the ones who deal with them such as national politicians and interest groups. While there is evidence that the number of IMF conditions is being reduced globally, there is no evidence that there is conditions reduction for low-income countries despite their extreme need for the fund. Thus, the integrity and fairness of these conditions are highly questioned.

Policy Recommendations:

As previously mentioned, there is a criticism in literature regarding the IMF conditions as being ineffective, since there exists a selection bias toward who requests financial assistance and in most cases the low-income countries and emerging market economies are those who most probably depend on the IMF money. As a result, it is recommended that donors should set a fixed amount of money to the competing countries for this money as a reward. The distribution of this reward will depend on each country's performance relative to its competitors. This will help donors evaluate the good policies of the competing countries. In consequence, such a system will give more incentive to donors and countries as well to establish a better system that gives the longer term aid in a more efficient way. However, the longer term aid as a development aid should not be given by the IMF, since the IMF is not targeting a development goal in its core objective but a macroeconomic stabilization in the form of supporting countries in a liquidity crisis.

Moreover, in order to increase the ownership of the policies by the national governments, the IMF should try reducing the number of the preconditions aid (ex-ante), and focus more on rewarding the good adherence to the primary goals of these conditions (ex-post). This practice will allow the recipient country to design its most appropriate authentic policies, which will increase the probability of being implemented successfully.

In addition, To reduce the ex-post moral hazard problem, policies should be clear, simple, and published to the public. Periodic assessment reviews should be published also involving the performance of the program and the reasons behind non-compliance or failure if happened, however, to reduce the ex-ante moral hazard problems, which happen in case the governments overestimate the reform costs to get more fund, in this situation ex-ante conditions are important only if there is a potential improvement could happen.

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