

Unmasking the IMF:

The Post-Financial Crisis Imperative for Reform



About Jubilee USA Network

Jubilee USA Network is an alliance of more than 75 religious denominations and faith communities, human rights, environmental, labor, and community groups working for the definitive cancellation of crushing debts to fight poverty and injustice in Asia, Africa, and Latin America.

Jubilee USA Network | 212 East Capitol St NE
20003 | www.jubileeusa.org | 202-783-3566

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Summary

The global financial crisis in late 2008, on the heels of the global food and fuel crisis, had grave and far-reaching repercussions across the globe, particularly for low-income countries (LICs). In April 2009, G-20 leaders designated the International Monetary Fund (IMF) as the central vehicle for global economic recovery and tripled the Fund's lending capacity from US\$250 billion to US\$750 billion.¹ By 2014, the IMF's concessional lending capacity to LICs will be ten times higher than it was before the crisis.² Further, the IMF intends to seek another capital increase of \$250 billion from the G20 in the coming months.³

When the U.S. government allocated an additional \$100 billion in IMF resources in June 2009, civil society and humanitarian organizations expressed deep concern due to the Fund's checkered record in predicting and responding to crises (including the most recent global financial crisis), and the harsh austerity and pro-cyclical measures that accompany IMF lending. In fact, the IMF's negative reputation had led many countries to avoid engagement with the Fund altogether.

In response, the IMF has gone to great lengths to demonstrate its commitment to change. The Fund says it learned from the mistakes it made during the East Asian crisis and has reformed its programs to provide greater flexibility for LICs to adopt counter-cyclical, expansionary policies. Likewise, the Fund has reduced its use of controversial conditionalities such as public wage freezes or privatization. New crisis lending facilities, such as the Flexible Credit Line (for middle income countries) and the Precautionary Credit Line, ostensibly have little or no conditionality attached. Using some resources from IMF gold sales, concessional lending to LICs has increased dramatically. Finally, the Fund is in the process of reforming its governance structure to reflect the changing global economy.

Despite the IMF's claims, analysis of Fund policies demonstrates that much of the reform is marginal and does not represent a solid departure from past IMF orthodoxy. IMF policies continue to constrain public spending and impede recovery.

Specifically post-crisis analysis finds:

1. Pro-cyclical fiscal and monetary policies continue to appear in IMF programs for many LICs. In the select countries where the IMF did allow fiscal and monetary breathing space for a time, the Fund is now advising premature tightening in most cases.
2. Where explicit conditions to freeze public wages or reduce health and education spending do not appear, continued focus on tight fiscal targets and onerous reserve requirements often result in public spending reductions in these areas.
3. The "rigorous qualification criteria" attached to new crisis lending facilities, such as the Flexible Credit Line and the recent Precautionary Credit Line, amount to ex-ante conditionality.
4. Increased IMF lending to LICs threatens to undermine those countries' long-term debt sustainability and counter the positive effects of debt relief initiatives. Despite windfall profits far above projected levels from the sale of its gold reserves, the Fund has not committed to using that extra revenue for increased debt relief and grants for LICs.
5. The much-heralded voice and vote reform at the Fund is a small step in the right direction but will not make the institution more accountable to the low-income countries that are most affected by Fund policies.

Without genuine reform of the IMF's strict fiscal and austerity requirements, lending procedures, and structures of accountability, the institution's expanded crisis role may actually keep low-income countries from recovering, push them into greater debt, and hinder long-term development.

The U.S. government should use its voice and vote within the IMF to promote the following reforms:

- (1) Allow for pro-poor macroeconomic policies and social spending during the crisis and beyond in IMF programs.
- (2) Stop adding to the debt burdens of LICs.
- (3) Restructure IMF governance and decision-making processes to make them more accountable to the countries and populations most affected by Fund policies.

The Post-Crisis Reality for Low-Income Countries

While LICs had no hand in creating the global food, fuel, and financial crises, LICs have been severely impacted. In 2008, private investment flows to developing countries fell by more than 40 percent and portfolio investment virtually ceased.⁴ Worker remittances declined dramatically, terms of trade deteriorated, and aid flows came under threat. According to Development Finance International, the financial crisis caused a budget hole of \$65 billion in lost revenue for low-income country governments.⁵ As a result the World Bank now estimates that 64 million more people are living in extreme poverty in 2010.⁶

Like middle-income and developed countries, LICs need fiscal and monetary space to increase government expenditure and credit availability in order to boost domestic demand, economic activity, and local employment. This support is especially critical in LICs where few safety nets exist for the most vulnerable.

I. Continued Pro-cyclical Policies in Post-Crisis Lending

The IMF's insistence on a strict program of "fiscal balance" (low deficits) and "price stability" (low inflation) for borrowing countries has undermined investment in basic infrastructure, industry, and educational capacity over the past 30 years. The effort to keep inflation artificially low (typically below 5%) means high interest rates on new loans and restrictions on domestic money supply, keeping essential start-up capital out of the hands of nascent small-business and domestic industries.⁷ These rigid policies slow down the domestic economy when stimulus is desperately needed.

In March 2009, the IMF announced that it had learned from the East Asian crisis of 1997-98 when its emergency lending was tied to pro-cyclical policies. These restrictions led borrowing countries into deeper crisis, causing massive job losses and an economic recession. The Fund claims that it has reformed its programs to allow LICs to adopt expansionary policies.⁸

While the Fund did permit slightly higher deficits for select⁹ LIC's during the brunt of the crisis (2008-2009), the breathing space provided was marginal at best.

The Center for Economic and Policy Research (CEPR) found that in most countries, the IMF simultaneously called for tighter monetary policy that blunted the attempted stimulus.¹⁰ Out of 41 post-crisis country agreements surveyed, CEPR found that 31 contained pro-cyclical macroeconomic policies. A substantial minority of the programs (15 of 41) included pro-cyclical fiscal and monetary policies. An April 2010 study by academics at the School of Oriental and African Studies (SOAS) found that, in a representative set of 13 LIC IMF agreements,

High interest rates and restrictions on domestic money supply keep essential start-up capital out of the hands of domestic businesses.

projected fiscal expansion for 2009 amounted to only 1.5 percent of GDP on average.¹¹

For countries allowed slightly expansionary economic policy during the height of the crisis, the Fund is already advising expenditure reductions in the public budget.

In the IMF agreements SOAS surveyed, an average fiscal tightening of 0.5 percent of GDP was projected for 2010. Eight of the 13 countries face tighter fiscal constraints in 2010 than in 2009.¹²

A July 2010 study from Oxfam International found that while the IMF protected some social sector spending at the start of the economic crisis, it is now advising countries to cut back. In 2010, LIC deficits are set to halve, and not because of recovery or increased revenue. Half of African countries (and 75 per cent of other LICs) with an IMF program are cutting spending in 2010, even though most need a massive increase if they are to reach the MDGs by 2015.¹³

A United Nations Children's Fund (UNICEF) review of IMF country reports (Article IV agreements and loan documents) from March 2009 to March 2010 for both low- and middle-income countries found that in two-thirds of the 86 countries reviewed, the IMF recommended cutting total public expenditures in 2010. In all but a few countries, the Fund recommends further fiscal adjustment in 2011.¹⁴ The study was later retracted due to pressure from the IMF.¹⁵

Deep impoverishment already constituted a perpetual economic crisis for dozens of countries around the world. The global economic downturn has only worsened this situation.

II. Evidence of Continued Restrictions on Critical Public Spending

In May 2009, responding to criticism of the harsh conditionalities that reduce critical public spending in poor countries, the Fund announced that it would discontinue the use of “structural performance criteria” for all countries, including low-income

There is a strong likelihood that the premature exit from stimulus spending will choke off recovery. Expanded fiscal space is critical to enable long-term development.

Restrictions on Public Sector Wages, Hiring, and Spending

In Burundi, public sector workers have demanded wage increases in response to soaring food and oil prices. Moreover, government authorities believe that wage bill cuts would hurt their ability to disarm and integrate former militants. Nonetheless, the IMF has used its influence to ensure that the government implements reductions in its wage bill, through attrition and a hiring freeze. The government has also had to cut petroleum support and reinstate a 20 per cent fuel tax.¹⁶

As **Jamaica** undergoes its third year of economic decline, the country's Stand-by Arrangement requires a public sector salary freeze, a wage bill reduction, consumption taxes and fees for public services, and several privatizations. Due to Jamaica's loan agreement with the IMF, teachers and other public sector workers have not received negotiated reimbursements of salary arrears.¹⁷

Ghana's original agreement with the IMF called for a raise in utility prices, a wage freeze and a lower than budgeted salary increase for health workers in 2009.¹⁸

In October 2009, the **Maldives** implemented a drastic wage cut of 14 per cent as a “prior action” required to become eligible for an IMF Stand-by Arrangement. This reduction will remain in place until 2011.

In **Togo**, the IMF objected to increases in minimum wages and subsidies to subsistence farmers.¹⁹

An August 2010 loan agreement requires that **Ukraine** reduce its fiscal deficit from 8.5 to 3.5 per cent of GDP by 2010. Ukraine must achieve these cuts through wage freezes and pension cutbacks, despite the fact that the IMF anticipates no reduction in unemployment for several months.²⁰

As **Pakistan's** people suffer the impacts of massive flooding, the IMF has required the government to end energy subsidies, up fuel and electricity tariffs, and increase regressive excise and sales taxes.²¹

In order for **Romania** to obtain a desperately needed bail-out loan, the IMF mandated that the government slash 2010 public sector wages by 25 per cent and pensions and transfer payments by 15 per cent. In late September 2010, 12,000 Romanians protested in Bucharest to demand that authorities return salaries to 2009 levels and stop the layoff of public workers.²²

countries. By avoiding the necessity of a formal waiver for governments that fail to meet these criteria, the Fund claimed that these countries would face less stigma in international markets. The Fund also asserts its current policies require far fewer structural conditions, such as public sector wage caps. Indeed, since the crisis, many Fund programs actually encourage governments to increase poverty reduction expenditures, such as in health and education.

The IMF's mandatory deficit and reserve targets leave LICs with little choice but to divert government revenue and foreign aid away from needed public expenditure.

Closer examination reveals that the IMF's claims to have halted structural conditionalities are overblown. The Fund itself has stated that "structural reforms will continue to be part of IMF-supported programs when they are seen as critical to a country's recovery."²³

Restrictions on public spending remain prevalent in post-crisis programs.

Forthcoming analysis from the Center for Economic and Policy Research (CEPR) finds that 29 of 48 2010 IMF Extended Credit Facility (ECF) and Stand-By Arrangements (SBA) contain wage bill restraints,²⁴ as well as policy requirements that directly harm the working poor. These include utility subsidy cuts, regressive taxation, and national industry privatization. Moreover, 12 of 41 2009 LIC loan agreements included cuts to energy and utility subsidies.²⁵

Even for loan programs that have not explicitly required a reduction in social spending, the IMF's macroeconomic policy conditions have forced low-income countries to reduce critical public expenditures. The IMF's mandatory deficit and reserve targets leave LICs with little choice but to divert government revenue and foreign aid away from needed public expenditure.

According to a 2007 study by the IMF's Independent Evaluation Organization (IEO) of loan programs in

29 sub-Saharan African countries from 1999-2005, Fund-supported macroeconomic policies required that impoverished countries divert annual aid increases into currency reserves instead of using it for people in dire need. On average, \$7 out of every \$10 in new aid was channeled into currency reserve accounts and or used for debt repayment.²⁶ The IEO also highlighted the arbitrary nature of IMF reserve requirements, as the Fund failed to ground them in specific analysis of adequate precautionary levels for the countries in question.

Despite internal and external criticism, the IMF continues to promote reserve accumulation for precautionary purposes. In 2010, the IMF's Global Financial Stability Report recommended flexible exchange rates and reserves accumulation to mitigate the risks of capital inflow fluctuations.²⁷

While the current system encourages countries to maintain reserves as insurance against sudden capital flows, higher reserve requirements for LICs may discourage both donors and recipients from seeking more ambitious aid levels or increasing levels of public investment as a percentage of GDP.²⁸ This greatly impedes progress toward the MDGs and countries' ability to invest in the capacity building necessary for people-centered development. Instead, the IMF should assist LICs facing these potential fluctuations by supporting the use of capital controls and providing insurance without conditions to reduce countries' need to accumulate high reserves.

III. New Crisis "Insurance" Facilities Require Ex-Ante Conditionality

In January 2009, the IMF announced a new Flexible Credit Line, to ensure that finance would be quickly available for countries facing liquidity crises. The ostensible goal of this new instrument was to create a "safety net" so that countries facing balance of payments shortfalls could institute counter-cyclical policies without having to implement typical IMF conditionalities.

In reality, however, countries only qualify for the new FCL if they have already implemented macroeconomic reforms to the satisfaction of the IMF. The FCL's "rigorous qualification criteria"²⁹

closely follow the Fund's typically tight fiscal and monetary policy requirements. These criteria include low inflation rates, a "comfortable reserve position," and a "track record of access to international capital markets at favorable terms."³⁰

So far, only three countries – Colombia, Mexico, and Poland – have qualified for and accessed the FCL, though none of them have drawn down the credit line.³¹ The strict qualification criteria mean that the FCL will very likely not be available to any low-income countries in crisis.

G20 2010 co-chair South Korea, which sought to help other countries avoid its bitter experience in the East Asian financial crisis, joined other member countries in pushing to expand IMF "insurance" facilities. In September 2010, the Fund expanded the duration and size of the FCL and created a Precautionary Credit Line (PCL), which would be made available for countries meeting most of the criteria for IMF macroeconomic policy targets but that may have one or two areas where the IMF believes the country "needs improvement."

Protective capital controls and insurance would reduce LICs' needs to accumulate reserves.

In addition to the ex-ante conditionality reflected in the qualification criteria, the PCLs include ex-post conditions to bring those countries into line with the Fund's macroeconomic vision. So far, the PCL is purely theoretical, since the IMF has not identified any countries that qualify. Thus, while the FCL and PCL were created to make the Fund more relevant in a post-crisis world, the ex-ante conditionalities required by these lending facilities do not represent a departure from past IMF policy imposition.

IV. IMF Lending to LICs Threatens Debt Sustainability

In the wake of the economic crisis, G20 governments proposed that the IMF substantially increase support to low-income countries (LICs). Indeed the Fund increased its lending to LICs in 2009 to \$3.8 billion

(compared to \$1.2 billion in 2008). In September 2010, the IMF announced that it had raised \$8 billion for concessional lending to LICs, keeping the institution on track to provide up to \$17 billion by 2014.³²

The flexible and precautionary credit lines involve ex-ante conditionality.

While low-income countries need support, anti-poverty organizations and some governments urged the IMF to provide debt relief and grants to LICs instead of new loans. Further, they called for the institution to use internal resources, particularly proceeds from the scheduled sale of 403.3 tons of gold, to finance increased support to LICs.

Despite huge profits from the ongoing sale of IMF gold, the IMF has slated the vast majority of the proceeds for its own administrative budget. The failure to tap existing gold resources to fund its commitments forced the Fund to rely on contributions from member countries. This reliance on additional bilateral contributions raises concerns that donors will channel already scarce aid resources through the IMF to finance its modest support for LICs. Meanwhile nearly two-thirds of the IMF's gold sales are complete – raising nearly \$3 billion in windfall profits so far due to the higher-than-expected price of gold.³³ The IMF has yet to commit any additional money to help low-income countries, and refuses to discuss the issue until all the gold is sold.

A more fundamental concern is the damaging impact of adding new debt to low-income countries in the wake of a crisis not of their making. After repeated public calls for deeper debt relief and non-debt creating assistance, the IMF announced with much fanfare in July 2009 that it would provide "interest relief" for two years to LICs. This was a welcome step, but does not come close to meeting the need for non-debt creating assistance for LICs. In the end, this initiative is worth only \$55 – 70 million for LICs over 2 years – just \$500,000 annually per country that qualifies.³⁴ Interest rates will rise on zero-interest loans in 2011 and the rest of IMF support for LICs adds to their debt.³⁵

There is a significant danger that the new borrowing that has resulted from a lack of sufficient international grant support for LICs will force low-income countries to prioritize debt repayment over essential social services and lead to renewed debt crises throughout the developing world. Borrowing by developing countries is set to increase due to reduced international financing for grants and debt waivers, the long-term effects of export shocks, diminished international private investment, and continuing balance-of-payments imbalances and/or structural deficits. The IMF itself reported that “the debt sustainability outlook has clearly deteriorated” for LICs, even taking into account the Fund’s optimistic assumptions that countries’ economies will recover quickly and that their growth will immediately return to pre-crisis levels.³⁶

Despite raising nearly \$3 billion more than expected from IMF gold sales, the Fund has not yet committed any additional money to help low-income countries.

Despite a looming potential debt crisis, the G20 directed the IMF and World Bank to make their Debt Sustainability Framework (DSF) more “flexible.” These tweaks to the DSF were oriented toward allowing countries to increase borrowing rather than addressing longstanding concerns about the performance of the DSF as a tool to maintain debt at sustainable levels. Short-sighted reforms of a fundamentally flawed framework also fail to address the underlying need for expanded debt relief and non-debt-creating assistance.

According to a study by the Center for Global Development, impoverished countries that have recently received or are set to receive debt relief under the Multilateral Debt Relief Initiative (MDRI) are now re-accumulating unsustainable debt burdens, in part due to large volumes of post-crisis lending by the IMF and other Multilateral Development Banks (MDBs).³⁷ The Democratic Republic of Congo (DRC), for instance, received \$276 million in new loans from the IMF in 2009, despite a highly unsustainable debt-to-GDP ratio of 120 percent. This new lending cancels out the benefits of the \$320 million that the Fund has committed in future debt

relief to the DRC through MDRI before that debt relief is even implemented.³⁸

The IMF’s Post-Catastrophe Debt Relief Trust, created in June 2010, made it possible for the Fund to provide non-debt creating assistance to Haiti in the wake of a catastrophic earthquake.³⁹ This is a positive step forward, though so far the Trust Fund’s criteria are so narrow that it is unlikely to be useful for other countries whose debt burdens increase after natural disasters or other shocks.

V. The IMF Remains Unaccountable to Countries Most Affected by IMF Policies

Given the power that the IMF wields over most low-income countries, the Fund has long been criticized for an unjust governance structure in which high-income countries hold a majority of voting shares and the U.S. Treasury maintains veto power over important decisions. At its 2006 Annual meetings in Singapore, the Fund instituted voting share reforms, which made only slight changes to the percentages of voting shares.⁴⁰

The G20 has placed continued IMF governance reform on its agenda, directing the institution to increase the quota shares of emerging and developing countries by at least 5 percent while protecting the voting share of the poorest member states. At the April 2010 Spring Meetings, the IMF Managing Director announced his intent to implement a new quota formula, approved by the IMF Board of Governors in 2008, which both the G20 and the Fund claim will fulfill those requirements.

Unfortunately, as even the G20’s working group on IMF reform recognized, the 2008 quota formula is inadequate to meet the goals put forward by the G20.⁴¹ Moreover, analysis by the Center for Economic and Policy Research indicates that, after implementation of the 2008 quota formula, high-income countries will still hold a majority, and emerging economies and the rest of the world will gain only 0.6 and 0.9 voting percentage points respectively.⁴² It is difficult to imagine a Fund that is truly accountable to the countries most affected by its policies without much more substantive voice and vote reform as well as greater institutional transparency and diversity of the Executive Board.

In the wake of the global economic crisis, the G20 provided the IMF with a new lease on life. Now, the IMF has announced its intent to seek an additional \$250 billion in resources. By vociferously claiming that the institution has learned from past mistakes in regard to harmful conditionalities, engaged in governance reform, and created new “insurance”

facilities, the Fund hopes to create an appearance of substantial change. Closer scrutiny, however, suggests that many of these changes are marginal and may be short-lived. It is critical, therefore, that the U.S. government exercise its oversight over how the IMF utilizes U.S. taxpayer dollars.

Recommendations for Continued IMF Reform

The U.S. government must use its leadership role within the institution to promote the following reforms:

1) Allow for pro-poor macroeconomic policies and social spending:

- Immediately work with LIC governments to ensure that countries with IMF programs (and others where the IMF provides policy advice) can actively use fiscal policy and spending increases to support public investment, build essential economic and social infrastructure, promote human and economic development and tackle climate change.
- Encourage more expansionary monetary options that better enable domestic firms and consumers to access affordable credit for expanding production, employment, and contributions to the domestic tax base.
- Lower reserve requirements to allow more aid and concessional loan money to build local capacity. In order to protect against sudden capital fluctuations, the US government should support capital controls for LICs.
- Safeguard public sector wages and subsidies to help the poorest access basic necessities such as food, water, and fuel.

2) Stop adding to the debt burdens of LICs

- Use IMF gold sales to provide grants for low-income countries facing major exogenous shocks, such as natural disasters and the global financial crisis.
- Undertake substantive reforms of the Debt Sustainability Framework, so that it centers on what developing countries need to achieve the MDGs.

3) Make IMF governance and decision-making more accountable to countries most affected by Fund policies.

- Undertake governance reform so that LICs have a meaningful voice within the institution. The IMF should adopt a double-majority voting system as an interim step toward the inclusion of population size in determining voting shares.
- Continue to push for more IMF transparency, including publishing minutes and transcripts from Board meetings, circulating draft documents in relevant languages to facilitate country constituency input, and ceasing the use of confidential “side letters” that stipulate policy conditions.
- Require parliamentary approval of new IMF loans in borrowing countries, in order to promote the principle of transparency, democratic governance and country-ownership of development strategies and to avoid irresponsible borrowing practices.

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Jubilee USA Member Organizations

ActionAid International USA	Maryknoll Office for Global Concerns
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Conference of Major Superiors of Men	Presbyterian Church USA
Drop the Debt Pittsburgh	Presbyterian Washington Office
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