The IMF and Economic Policy

Module Introduction and Overview

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1 Introduction to the Module

Welcome to this module looking at *The International Monetary Fund and Economic Policy*. The module covers an extensive range of issues and, in the next eight weeks, you will study a wide spectrum of topics associated with the relationship between the IMF and macroeconomic stabilisation. Because the subject matter is vast, I have tried to focus on some of the key themes and provide some indications as to where this subject matter can be studied in greater detail if or when you have time to do so.

Economies are vastly complex. They involve many policy instruments, many policymakers dealing with different aspects of economic management and many affected agents, including government, businesses, workers, the unemployed, the poor and many others.

Standard textbook analyses of macroeconomic policy focus on a number of models. Central to these models lies the concept of *equilibrium*, with much of policymakers' efforts hinging on their ability to bring economic aggregates, such as savings and investment, into balance, or equilibrium. In most macroeconomic models – especially the mainstream models sometimes called 'neo-classical' models – a central mechanism, which brings savings and investment into equilibrium, is *prices*.

If there is disequilibrium, prices – including the price of labour (real wages), the price of capital (including real interest rates) and the price of foreign exchange (real exchange rate) – adjust to restore equilibrium. In other models, including 'structuralist' models, which you will also study in this module, other mechanisms are considered more relevant and effective in bringing about equilibrium among macroeconomic variables.

In all instances, however, attention focuses on the mechanisms, including the policy tools, that can enable an economy to adjust from its current position, which is assumed to be in disequilibrium, to one in which a variety of macroeconomic variables come into and remain in equilibrium.

Macroeconomic stabilisation policies focus on trying to find the best adjustment process, or path, to bring about such equilibrium. This seems simple enough. But a range of complexities lies ahead. In this module, you will learn to recognise these complexities, and you will examine what answers are provided, among different models of and approaches to stabilisation policy, in helping to bring about equilibrium. To help in this process, you will study a number of case studies, intended both to illustrate the complexities inherent in stabilisation policy and to demonstrate which among many competing approaches may be more useful in a particular case.

Key questions in studying stabilisation policy

A series of key questions can help to frame this inquiry as to the best approach to stabilisation policy. As you proceed through the eight units of the module, you will learn how stabilisation theories and practices can help answer these questions. There are at least four key initial questions, which arise in any study of stabilisation policies and these will be taken up in detail in the first half of this module.

The first key question is:

- Who pursues stabilisation policies?

In fact, all countries actively pursue stabilisation policies and programmes on an ongoing basis, as part of a process of orderly management of their economic systems. But for the purpose of this module, you will be particularly concerned with those countries for which the effort to stabilise their economies has assumed a significant priority over other objectives – such as the longer-term economic and social development of the country, for example. Usually this occurs because the extent of instability in macroeconomic variables has become so acute that it is necessary to focus in the short term on stabilising the fluctuations in these variables, before being able to address the longer-term economic challenges.

A second, related question focuses on the issue:

- Do countries pursue their stabilisation policies on their own, or do they receive assistance in doing so?

In fact, at any one time, there are two different categories of countries. One concerns those that pursue their stabilisation programmes without external assistance. This group would include, for example, the large industrial countries, which have generally achieved macroeconomic stability and whose main objective in stabilisation policy is to maintain the economy on a stable path. This group of countries also includes some that have not achieved macroeconomic stability, but which have opted not to seek external assistance in stabilising their economies.

A second group of countries comprises those that seek external assistance, usually in the form of external financial resources, to help them to stabilise their economies. These countries use such resources to correct imbalances in their economies, such as balance of payments deficits, or fiscal deficits. In many cases, the external financial resources are obtained from a variety of private sector sources. But when these international private sector sources of external financing are not available, the countries turn to multilateral institutions, including the IMF and the World Bank, requesting these organisations to provide the external foreign exchange needed to help overcome the macroeconomic instabilities encountered. In this module particular attention is focused on this category of countries. As you will see as you progress through this module, the number of countries in this category has tended to grow over time.

After focusing on the institutional structure of the IMF and the Fund's approach to stabilisation in the first units, you will be able to ask a third important question:

- What are the best mechanisms to achieve macroeconomic stabilisation?

This is a particularly complex question. A useful entry point in trying to provide a satisfactory response to this question is to examine the variety of models of macroeconomic stabilisation, which you will do in later units, which focus on the fourth question:

- How successful are stabilisation policies in practice?

2 The Module Author

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3 Study Resources

In addition to the module study guide, you will be asked to study a selection of key readings.

Module readings

The module readings seek to give you a wide sample of the literature on stabilisation. Two types of literature are used: firstly, a range of articles on the theoretical aspects of stabilisation policy and, secondly, several articles and book chapters on country studies. These readings focus on three different types of countries:

- those that have experienced large-scale macroeconomic and financial sector instability
- countries that were affiliates of the former Soviet Union, which have been in transition from a broadly state-controlled to a broadly market-influenced economic system
- low-income developing countries.

As you progress through the various units of the module, I will ask you to read specific articles from the module readings, the material you will study will be needed for both your assignments and the module examination.

During your module, you will be asked to read a variety of key readings in addition to the unit texts. At each step in this process, I have suggested that in reading through this material, you take notes on specific aspects of the material you are reading. These notes do not form part of the prescribed assignments that you must complete during the module, but they may be useful to you in structuring your thoughts as you progress through the reading material. I would encourage you, as a regular practice, to take notes as you read, as this will enable you to illustrate your assignments with specific and practical examples and will also help you cover some of the material needed for your end of module examination, in a systematic and structured way.

4 Module Overview

There are eight units in this module, each to be studied over the period of a week. Each unit focuses on one specific sub-theme associated with the module and seeks to guide you through what is effectively a very extensive and topical literature on macroeconomic policy and stabilisation, and the role of the IMF. The module has been prepared on the assumption that you do not have an extensive knowledge of economics, but it should still be challenging even if you do.

The module relies to a significant extent on country case studies, both to illustrate key theoretical issues and to help distinguish between the various approaches to stabilisation in developing countries. The case study approach is particularly useful because the range of theoretical issues that would normally feature in any module on economic stabilisation is extensive, and country circumstances differ considerably. As you will note during the study of this module, no single theoretical model provides a best-fit application of theory to the circumstances of a particular country.

Unit 1 Macroeconomic Stabilisation and the Role of the IMF

1.1 Introduction
1.2 The Character of the International Monetary Fund
1.3 The Articles of Agreement
1.4 Three Key Functions Performed by the IMF
1.5 Organisational Structure of the IMF
1.6 The Executive Board, Constituency System and Advisory Organs
1.7 The Departmental Structure of the IMF
1.8 The Process Followed in Negotiating a Financing Arrangement with the IMF
1.9 Types of IMF Lending
1.10 Types of IMF Conditionality
1.11 Conclusion

Unit 2 The IMF's Approach to Stabilisation

2.1 Introduction
2.2 Trends in the Use of IMF-Supported Stabilisation Programmes
2.3 Special Drawing Rights (SDRs)
2.4 A Model to the Rescue? Mundell-Fleming

Unit 8 Challenges for Low-Income Countries

- 8.1 Introduction
- 8.2 Quotas and Voting Shares of Low-Income Countries
- 8.3 Access Limits
- 8.4 Additional Challenges for Developing Countries
- 8.5 Social Safety Nets
- 8.6 Conclusion

Because you will be focusing on this category of countries, your study, as the module title suggests, will focus centrally on the work, functions and policy approaches of the International Monetary Fund. Indeed, in Units 1 and 2, you will be focusing exclusively on the IMF. The reason for this is that, globally, the IMF's approach to stabilisation has become the dominant and most frequently used model of stabilisation policy. And in recent years, for an increasing number of countries that have been pursuing stabilisation programmes, their approach has been closely tied to the IMF's approach to stabilisation.

Unit 1 Macroeconomic Stabilisation and the Role of the IMF

In Unit 1, you will examine several of the key institutional characteristics of the IMF, including its mandate, its ownership and decision-making structure and its organisational structure. In this unit, you will also examine the various functions performed by the IMF, as well as the range of financing facilities offered by the organisation to its various members. You will consider issues directly related to the IMF's approach to stabilisation policy, including the process through which the Fund's approach to stabilisation is implemented. This is not apparent at first glance, for the IMF is an international, multilateral organisation. It lends to its country members and it is these members, not the IMF, that implement stabilisation programmes. As you will observe, however, the IMF's approach to stabilisation is given effect through the process of setting conditions on the use of IMF resources, known as its policy on 'conditionality'.

Unit 2 The IMF's Approach to Stabilisation

In Unit 2, you will examine a range of issues pertaining to the way the IMF conducts its work – in particular, its lending operations. First, you will study some of the major trends in IMF lending since the establishment of the institution over sixty years ago. You will also examine in detail the Mundell-Fleming model, which was developed in the early 1960s and has come to represent a standard analytical tool for the evaluation of macroeconomic policy options in small open economies. The model offers important insights into the types of policy choices available to policymakers in developing countries, and it also yields a number of important recommendations as to which types of policies are more appropriate in differing circumstances.

In Unit 2, you will also examine the specific approach to stabilisation pursued by the IMF. This approach is known as the 'financial programming approach'. The financial programming approach is based on a number of assumptions regarding the process by which an economy adjusts from a state of disequilibrium. I will first identify these assumptions, then outline in detail the various elements of the financial programming model itself. This model is used by the IMF on each occasion that its members ask for financial support. Finally in Unit 2, you will apply the information you have studied by examining a specific, actual country case study of an IMF stabilisation programme.

Unit 3 Alternative Approaches to Stabilisation

In Unit 3, you will further your inquiry as to what are the best mechanisms for achieving macroeconomic stabilisation in a number of logical steps. First, you will examine some alternate approaches to the financial programming model – in particular, 'structuralist' models of stabilisation policy. Second, you will study some of the key differences in the assumptions used, between the IMF's financial programming approach and the alternate approaches to stabilisation. And finally, you will examine some empirical evidence about the success of IMF stabilisation programmes.

By the end of Unit 3, you will have examined the theoretical bases for both the IMF's approach to stabilisation and some alternative models of stabilisation policy. While these alternative models differ from the IMF approach in their behavioural assumptions about how an economy adjusts to an unexpected disequilibrium – such as an unexpected macroeconomic shock – the models nevertheless share one particular characteristic: they focus largely on macroeconomic variables and on the tools that policymakers typically use, including monetary and fiscal policies, as well as exchange rate policies, to bring about stabilisation. More particularly, they do not take detailed account of the sources of macroeconomic stability that can arise from weaknesses in the financial system.

Indeed, until the late 1990s, neither the IMF nor alternative stabilisation models devoted much attention to the financial system as a source of instability. From the mid-1990s, however, a series of crises in emerging market economies – in particular, in Mexico, East Asia and Russia – highlighted the fact that the financial system can represent a major source of disequilibrium, leading to macroeconomic crisis. And the responses offered by the IMF to these events highlighted that the traditional approaches to addressing instability were ineffective in responding to the new set of challenges arising from financial sector weaknesses. A new set of policies was required to address these new challenges. More recently, the global financial crisis, which began in the market for mortgage finance in the USA in 2007 and which quickly spread to the US financial system and then in 2008 to the financial systems of many industrial countries, has brought much closer attention to the importance of the financial sector and of financial stability, in contributing to macroeconomic stability.

Unit 4 Stabilisation and the Financial Sector

In Unit 4, you will therefore focus your attention on stabilisation and the financial sector. You will briefly examine a range of financial crises, firstly in emerging market economies, particularly in Indonesia, Korea and Brazil – all of which took place between 1994 and 2000; and secondly more recently in the US, the UK and Western Europe, which have taken place since 2007. You will then consider the significant costs associated with banking and financial sector crises, and examine the variety of responses to these crises by the IMF and by other international financial agencies. These efforts have focused on three sets of objectives:

- first, finding ways to help avoid or prevent crises from occurring in national financial systems
- second, where these national crises nevertheless occur, in trying to find ways to manage these crises effectively
- third, finding ways to avoid and prevent regional and global financial crises, which emerge when the effects of crises in one or more national financial systems spread beyond national borders and threaten financial systems and, subsequently, the economies of other countries.

The key questions posed in Units 1–4 are helpful in understanding stabilisation policies in theory. But what of the practice and implementation of stabilisation policies? You will consider this set of issues in the second half of this module, in Units 5–8.

Unit 5 Stabilisation Policy and the Financial Sector – Institutional Responses to Recent Crises

In Unit 5, you will focus on a particular set of issues that arose following the emerging market and industrial country crises of the late-1990s and since 2007, respectively – the issue of how the IMF itself reacted to the evidence that the role of the financial sector had previously been significantly underestimated as a source of macroeconomic instability. Since the late-1990s and more recently since the global financial crisis in 2007–08, the work of the IMF has undergone very significant change. In Unit 5, you will trace some of the major shifts in its approach to stabilisation. In the closing part of Unit 5, you will also examine how other institutions have emerged, with some responsibility for the stability of the international financial system, and how they have reacted in response to these crises.

Unit 6 Stabilisation and the Financial Sector – Some Challenges and Controversies

In Unit 6, you will continue focusing on the role of the financial sector in stabilisation policy, by working through a number of country case studies to examine a few particular controversies that have arisen in the past decade. Because the IMF occupies so central a position in the design of stabilisation programmes and because that institution has come to rank as a major lender during periods of financial crisis, these controversies have inevitably been associated with its approach to lending during periods of financial crises. In this unit, you will examine three particular sets of issues:

- appropriate timing and sequencing of capital account liberalisation

- approaches to the introduction and retention of capital controls
- approaches to stabilisation in the context of financial crisis.

All of these issues have generated significant and ongoing discussion in global policy forums in which international financial issues are discussed, and all of these issues continue to be grappled with – particularly by small, open economies such as those that were affected by the emerging market crises of the late 1990s and subsequently.

Unit 7 Stabilisation and Low-Income Countries

In Units 7 and 8, you will turn to the case of a different set of economies – those that are poor, of which many are seeking to stabilise in the context of enormous and unsustainable indebtedness and a lack of adequate external financial resources. These countries proceed in the context of a severe and protracted disequilibrium in their external accounts.

Unit 7 will examine five particular issues regarding the IMF's approach to stabilisation in these countries. These include the specific financing instruments used by the IMF in low-income countries, as well as the evaluative tools used by the institution to assess the level of poverty in these countries, the nature of their indebtedness and the major international debt relief programmes that have been developed to help low-income countries address unsustainable levels of debt. In Unit 7, you will also consider some of the specific challenges for countries trying to stabilise in the context of an immediate past conflict and, finally, you will examine the role of IMF technical assistance in low-income countries.

Unit 8 Challenges for Low-Income Countries

In Unit 8, you will study two important issues, both of which have assumed increasing importance to low-income countries in the past two decades. The first issue focuses on the voice, level of influence and representation arrangements for developing countries in the IMF. It is often argued that one of the reasons why many IMF stabilisation programmes in low-income countries fail to achieve their objectives is the poor and unbalanced influence of these countries on the institution. The first part of Unit 8 examines this set of controversies. The second and final part of this unit focuses on a second set of challenges – how to develop social safety nets to help mitigate the effects of such programmes, particularly on the poor. You will examine a particularly useful model by Ravi Kanbur, which helps to explain the variety of implications that stabilisation programmes can have on the poor.

By the time you have completed your study of all eight units of this module, you will be in a position to understand the role, function and operations of the IMF, its approach to stabilisation, and the major criticisms and controversies that its approach has elicited. You will also be able to identify the influence of the financial sector in precipitating instability, and you will have a strong appreciation of the particular circumstances of low-income countries seeking to stabilise their economies.

5 Learning Outcomes

When you have completed your study of this module, you will be able to:

- identify who pursues stabilisation policies, and why
- distinguish between countries that seek to stabilise on their own, and those that seek help in doing so
- outline and discuss the role, function and operations of the IMF and its approach to stabilisation
- discuss the influence of the financial sector in precipitating instability
- explain the prevalent stabilisation theories and assess their appropriateness in differing circumstances
- identify and discuss the major criticisms and controversies that the IMF's approach has elicited
- explain the particular problems and prescribed remedies for low-income countries seeking to stabilise their economies.