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International Monetary Fund: Organization, Functions, and Role in the International Economy

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April 22, 2004

Abstract. IMF member countries agreed on a quota increase in 1997. The U.S. Congress subsequently appropriated additional funding for the IMF in October 1998 in the midst of the Asian financial crises, a decision that engendered considerable debate in light of growing criticism of the IMF and its lending practices. In 2002, the IMF did not request any additional increase in funding. Although appropriations of new funds for the IMF is not pending, Congress exercises oversight authority over U.S. policy at the IMF and over its lending practices. This report supports congressional oversight of the IMF by providing an understanding of its organization, functions, and role in the world economy.new developments require .



# **CRS Report for Congress**

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# The International Monetary Fund: Organization, Functions, and Role in the International Economy

April 22, 2004

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### The International Monetary Fund: Organization, Functions, and Role in the International Economy

#### Summary

The International Monetary Fund (IMF), conceived at the Bretton Woods conference in July 1944, has become the focal point of the international monetary system. Created in 1946 with 46 members, it has grown to include 184 countries. The IMF has six purposes that are outlined in Article I of the IMF Articles of Agreement. They are the promotion of international monetary cooperation; the expansion and balanced growth of international trade; exchange rate stability; the elimination of restrictions on the international flow of capital; insuring confidence by making the general resources of the Fund temporarily available to members; and the orderly adjustment of balance of payment (BOP) imbalances.

At the Bretton Woods conference, the IMF was tasked with coordinating the system of fixed exchange rates to help the international economy recover from two world wars and the instability in the interwar period caused by competitive devaluations and protectionist trade policies. From 1946 until 1973, the IMF managed the 'par value adjustable peg' system. The U.S. dollar was fixed to gold at \$35 per ounce, and all other member countries' currencies were fixed to the dollar at different rates. This system of fixed rates ended in 1973 when the United States removed itself from the gold standard.

Floating exchange rates and more open capital markets in the 1990s created a new agenda for the IMF — the resolution of frequent and volatile international financial crises. The Asian financial crisis of 1997-8 and subsequent crises in Russia and Latin America revealed many weaknesses of the world monetary system.

To better help it achieve its overall goal of promoting a stable international monetary system, the IMF's format has changed dramatically since it was created in 1945. Designed initially to provide short-term balance of payments (BOP) lending and monitor member countries' macroeconomic policies, the IMF has steadily incorporated microeconomic factors such as institutional and structural reforms into its activities. These had been seen previously as the exclusive province of the World Bank and other development agencies. The IMF found that, in order to pursue its core responsibilities in the changed world economy, it needed to pay greater attention to "second generation" reforms, as economists call these sorts of issues.

IMF member countries agreed on a quota increase in 1997. The U.S. Congress subsequently appropriated additional funding for the IMF in October 1998 in the midst of the Asian financial crises, a decision that engendered considerable debate in light of growing criticism of the IMF and its lending practices. In 2002, the IMF did not request any additional increase in funding. Although appropriations of new funds for the IMF is not pending, Congress exercises oversight authority over U.S. policy at the IMF and over its lending practices. This report supports congressional oversight of the IMF by providing an understanding of its organization, functions, and role in the world economy. This report will be updated only if major events and new developments require.

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# The International Monetary Fund: Organization, Functions, and Role in the International Economy

### **Background and Introduction**

#### History of the IMF

The International Monetary Fund was created in 1946, a result of the 1944 international financial conference at Bretton Woods, New Hampshire. It was created in order to prevent a return of the international financial chaos that preceded — and in some ways precipitated — World War II. During the 1930s, many countries pursued "beggar-thy-neighbor" economic policies — restricting purchases from abroad in order to save scarce foreign exchange, cutting the value of their currencies in order to underprice foreign competitors, and hampering international financial flows — in ways that deepened the world depression and accelerated the decline in economic activity. The IMF was designed to limit or prevent this kind of economic behavior.

Technically, the IMF is a specialized agency of the United Nations but it functions virtually independently of UN control. The IMF must obey directives of the U.N. Security Council, but it need not comply with directives from the U.N. General Assembly or other U.N. agencies.

Rather than being organized on a one-country, one-vote basis, as is the United Nations, the IMF has weighted voting. The IMF has 184 member countries, whose voting share depends on the size of their quota or financial commitment to the organization. A country's quota is determined by its size and its level of participation in the world economy. The amount a country can borrow from the IMF is determined by the size of its quota. The United States is the largest single shareholder, with a 17.2% voting share. Together, the nine Executive Directors (EDs) representing the G-7 countries and other advanced countries in Europe have nearly 56% of the vote. Most decisions are reached by simple majority, though a decision is generally expressed by consensus. Some special matters (changes in the Articles of Agreement or approval of new quota increases, for example) require an 85% affirmative vote. No country can block or veto loans or other operational policy decisions by the IMF. However, because the U.S. vote exceeds 15%, no quota increases, amendments or other major actions can go into effect without its consent. The same can be said for other major blocks of IMF member countries.

#### The IMF's Mandate

As set forth in its Articles of Agreement, the purposes of the IMF are (1) to promote international cooperation on international monetary problems, (2) to facilitate the expansion and balanced growth of international trade, promoting high levels of employment and real income and the development of productive resources in all member countries, (3) to promote exchange rate stability and to avoid competitive exchange rate depreciation, (4) to help establish a multilateral system of payments among countries for current transactions and to help eliminate foreign exchange restrictions which hamper world trade, (5) to make loans to member countries on a temporary basis with adequate safeguards for repayment, "thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity," and (6) to shorten with such loans the duration and to lessen the degree of disequilibrium in the international balances of payments of members.

The International Monetary Fund is an international financial institution (IFI) which deals mainly with balance of payments (BOP), exchange rate, and international monetary concerns. Originally, the IMF focused primarily on macroeconomic issues. It monitored the macroeconomic and exchange rate policies of member countries and it helped countries overcome BOP crises with short-term loans conditioned on their making improvements in their macroeconomic performance. Institutional and microeconomic issues were generally considered the province of the World Bank and the other multilateral development banks (MDBs). In recent years, however, the Fund has found that these issues have a much larger impact on countries' abilities to pursue effective macroeconomic and exchange rate policies. Increasingly, it has included them among the subjects which need to be addressed in the context of its loan programs. It has also given increased attention to institutional and microeconomic issues in its consultations with member country governments, its surveillance activities, and the technical assistance it offers to member countries.

The IMF is a monetary institution, not a development agency. Its sister agency, the World Bank, was created at the same time as the IMF in order to provide long-term loans and to stimulate growth and economic development in war-damaged and developing countries. Even so, economic development and growth are core objectives of the IMF, as specified in purposes 2 and 4 above. The founders believed that international monetary stability would facilitate the growth of world trade and that this in turn would generate higher levels of employment, increased income, and expanded growth and development in the countries participating in the post-World War II international economy.

The founders also expected (purposes 5 and 6) that the IMF would be a means through which countries could remedy their domestic economic problems without resorting to the kinds of "beggar-thy-neighbor" practices which sought to shift the burden of adjustment onto other countries. Countries with chronic balance of payments deficits could get short-term IMF loans to help them weather a balance of payments crisis. It was generally presumed that BOP deficits, inflation, unemployment and low levels of economic activity were the result of inappropriate domestic economic policies. Better policies and adjustments in the exchange rate for the country's currency were deemed to be the appropriate response to this situation. It was expected that IMF assistance would help countries shorten the depth and duration of their economic problems and help contain or prevent the spread of monetary instability to other countries.

As the largest single contributor (\$50.4 billion cumulatively) to the IMF, the United States has a leading role in shaping the IMF's lending, surveillance, and advisory operations. Both House and Senate committees frequently hold hearings on IMF activities in developing countries and on IMF reform. Other countries are also concerned that steps should be taken to make the IMF more effective.

#### The Role of Congress in Making IMF Policy

The President has the ultimate authority under U.S. law to direct U.S. policy and instruct the U.S. representatives at the IMF, and the multilateral development banks (MDBs). The President, in turn, has generally delegated authority to the Secretary of the Treasury. The Treasury's Under Secretary for International Affairs and his staff manage day-to-day U.S. participation. With the advice and consent of the Senate, the President names individuals to represent the United States on the executive boards of the MDBs. The Executive Board deals with operations and must approve any loan or policy decision.

The Secretary of the Treasury serves as the U.S. representative on the World Bank Board of Governors, where each country has its own representative. The Board of Governors is the highest level decision making body of the World Bank. In both the World Bank Executive Board and Board of Governors countries have voting shares comparable to their financial contributions. At the World Bank, the United States has a 16% vote in the principal loan window.

Congress must give its consent by law before the United States may agree to participate in any new funding agreements. The Senate has advise and consent authority over all persons nominated to represent the United States at the IMF and the multilateral development banks. On many occasions, Congress has enacted legislation specifying what U.S. policy shall be in the international financial institutions (IFIs) and how the U.S. executive directors at these institutions shall vote and the objectives they shall pursue. For example, the Anti-Terrorism and Effective Death Penalty Act of 1996 (P.L. 104-132) instructs the Treasury Department to oppose any loan or other use of IFI funds to or for any country for which the Secretary of State has determined is a state-sponsor of terrorism. Congress has also frequently made specific suggestions to the Administration through Sense of Congress resolutions or language in committee reports accompanying legislation suggesting specific goals and priorities the United States ought to emphasize in the IFIs. Since the World Bank and the other multilateral institutions are not agencies of the U.S. government, but rather international institutions, their activities and policies are not subject to U.S. law.

#### The IMF's Organizational Structure

Figure 1 shows the organizational structure of the IMF (as of March 2004). The Board of Governors (BOG) is the highest authority in the IMF. All countries are represented on the BOG (usually at the Finance Minister level or equivalent). The BOG usually meets annually in the fall. A committee of the BOG, the International Monetary and Financial Committee (IMFC) meets twice annually to consider major policy issues affecting the international monetary system and make recommendations to the BOG. The Development Committee, a joint committee of the Boards of Governors of the IMF and World Bank, also meets at the same time to consider development policy issues and other matters affecting developing countries. The two committees generally issue communiques at the close of their meetings, summarizing their findings and recommendations. These often serve as policy guidance to the IMF and Bank, pending final action by the BOG, and as a means for airing views and for coordinating or harmonizing country policies on issues of international concern.

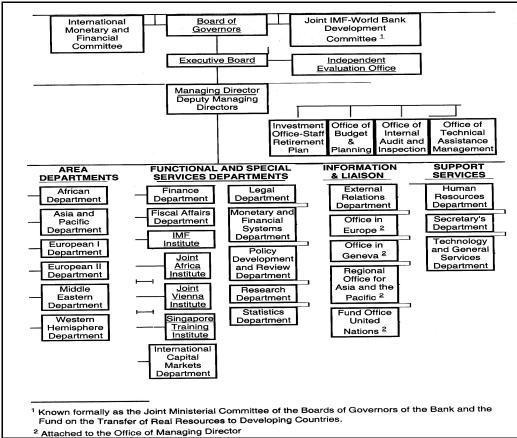


Figure 1. IMF Organization Chart

Source: IMF

Day-to-day authority over operational policy, lending, and other matters is vested in the Board of Executive Directors (BED), a 24 member body that meets three or more times a week to oversee and supervise the activities of the IMF. The five largest shareholders are the United States, Japan, Germany, Britain and France; all appoint their own representatives on the Board. The remaining members are elected (for two year terms) by groups of countries, generally on the basis of geographical or historical affinity. A few countries — Saudi Arabia, China and Russia — have enough votes to elect their own executive directors (EDs). Most countries are represented on the BED, however, by EDs who also represent five to twenty other countries. The EDs each have voting authority equal in size to the combined vote of the member countries that appointed or elected them. They must cast their votes as a unit. The executive board has several committees which examine policy and budget issues and other important matters.

The IMF executive board selects the Managing Director of the IMF, who serves as its chairman and as chief executive officer of the IMF.<sup>1</sup> The Managing Director manages the ongoing operations of the Fund (under the policy direction of the executive board), supervises some 2,800 staff members, and oversees the preparation of policy papers, loan proposals, and other documents which go before the executive board for its approval. Most of the material which comes to the executive board is prepared by IMF management or staff. However, some documents and recommendations are prepared by executive directors themselves or by the governments they represent. The Managing Director is elected for a five-year renewable term of office. The executive board also approves the selection of the Managing Director's principal assistants, the First Deputy Managing Director and two other Deputy Managing Directors. By tradition, the European countries have the right to nominate persons who might be elected as IMF Managing Director. (The U.S. has a similar prerogative at the World Bank.) The First Deputy Managing Director of the IMF is typically a U.S. citizen. Recent controversies have prompted the board to consider possible ways the Managing Director might be selected on the basis of merit, rather than by geography or political connections.

### The IMF's Main Functions and Activities

The IMF has three principal functions and activities: (1) surveillance of financial and monetary conditions in its member countries and of the world economy, (2) financial assistance to help countries overcome major balance of payments problems, and (3) technical assistance and advisory services to member countries.

#### Surveillance

**Oversight.** IMF members agree, as a condition of membership (Article IV), that they will "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." In

<sup>&</sup>lt;sup>1</sup>For further discussion of this issue, see CRS Report RS21810, *International Monetary Fund: Selecting a New Managing Director (2004)*, April 13, 2004.

particular, they agree to pursue economic and financial policies that will produce orderly economic growth with reasonable price stability, to avoid erratic disruptions in the international monetary system, not to manipulate their exchange rates in order to attain unfair competitive advantage or shift economic burdens to other countries, and to follow exchange rate policies compatible with these commitments.

The IMF Articles of Agreement require (Article IV) that it "oversee the international monetary system in order to ensure its effective operation" and to "oversee the compliance of each member with its obligations" to the Fund. In particular, "the Fund shall exercise firm surveillance over the exchange rate policies of member countries and shall adopt specific principles for the guidance of all members with respect to those policies." Countries are required to provide the IMF with information and to consult with the IMF upon its request. The IMF staff generally meets each year with each member country for "Article IV consultations" regarding its current fiscal and monetary policies, the state of its economy, its exchange rate situation, and other relevant concerns. The IMF secutive board along with the staff's observations and recommendations about possible improvements in the country's economic policies and practices.

Access to Information. The information in these reports about their economic conditions, performance and policies is the property of the countries concerned and may not be disclosed without their consent. In recent years, however, the IMF has successfully persuaded most countries to allow publication of their Article IV consultation reports, loan documents, and other information about their economic policies and conditions. The IMF makes these available to the public on its country information page, available at [http://www.imf.org]. Most countries now also publish on their IMF country page considerable information (often the verbatim text of their letters of understanding with the IMF) concerning the stabilization programs they plan to pursue in connection with an IMF loan. These are generally the product of close discussions between IMF staff and country officials. The IMF executive board will not normally approve a loan unless the condition embodied in these plans is acceptable to it. The IMF executive board must approve the disbursements at each stage of these loan programs. Its published remarks often give the reader considerable insight into the borrower's performance and its degree of compliance with loan "conditionality."

In exercising its oversight and surveillance function, the IMF also publishes numerous reports each year on economic conditions and trends in the world economy. These include, for example, its *World Economic Outlook* (which provides each year an overview of conditions in the world economy) and *International Financial Statistics* (a monthly compilation of detailed economic data on all countries.) The Fund is required (Article VIII, Section 7) to publish an annual report on its operations, transactions, and resources and it is authorized to publish "such other reports as it deems desirable for carrying out its purposes." These are available through its publications page, also available at the IMF website.

This authority does not extend, however, to the publication of information about the internal conditions in member countries. Countries are required (Article VIII, Section 5) to provide the IMF with information about their economic and monetary conditions and international economic and financial relationships. However, this information is generally deemed to be the property of the country which provided it and their consent is required for its release. The Fund may not publish reports involving changes in the fundamental structure of the economic organization of members (Article XII, Section 8) without their consent. It may communicate its views informally to any member country about any relevant issue. A 70% vote of the executive board is required, however, before any report can be published on economic, monetary or balance of payments conditions in a country if the country in question does not want it released. It does not appear that the IMF executive board has ever exercised this authority.

**Crisis Prevention.** Some analysts are concerned that IMF surveillance is not sufficient in preventing financial crises. In a recent report, the U.S. General Accounting Office (GAO) asserted that the IMF's surveillance mechanisms, including the Fund's biannual World Economic Reports (WEOs) and its Early Warning Systems (EWS) have not performed well in predicting crises.<sup>2</sup> In a reply to the report, First Deputy Managing Director Anne Kreuger noted that it is difficult for the IMF to publicly predict crises. If the Fund publicly reported a country's economic weaknesses, this alone might precipitate the very economic crises everybody wishes to avoid. Some argue that the IMF should formally separate its surveillance activities from its lending operations in an attempt to get around this problem.<sup>3</sup> It is difficult to see how this would solve the problem, however, since its surveillance functions are generally the means by which the IMF gets inside information about economic conditions in member countries. The IMF would violate its rules if it released information of this sort without a country's consent and it would likely make the acquisition of accurate information about economic conditions in member countries more difficult in the future. Moreover, if a fire wall were erected between the two functions, the IMF staff responsible for its loan program would not have ready access to the information derived from surveillance as conditions became more serious in a prospective borrower country.

The IMF's lending function only comes into play when a country applies for assistance to deal with a pending or current economic crisis. Countries often postpone this step until the crisis is almost upon them, since it is often seen as an admission of failure by the government. The IMF has sought for years to encourage countries to come to it for aid before their economic problems reach crisis proportions. However, it has no capacity for requiring them to do so.<sup>4</sup> Similarly, the

<sup>&</sup>lt;sup>2</sup>International Financial Crises: Challenges Remain in IMF's Ability to Anticipate, Prevent, and Resolve Financial Crises. GAO - 03 - 734.

<sup>&</sup>lt;sup>3</sup>*Preventing Financial Crises: The Case for Independent IMF Surveillance*, Remarks by Edward Balls at the Institute for International Economics, Washington, DC, March 6, 2003.

<sup>&</sup>lt;sup>4</sup> The IMF's recent experience with Contingent Credit Lines is a case in point. The CCL program was created in early 1999 to help bolster countries that might be hit — for no reason of their own — by "contagion" effects in the international financial crisis. This is where investors decide to pull their money out of a whole category of countries because problems emerge in one or two of them. The CCL allowed qualified countries to sign up for immediate access to substantial sums to help insure them against such situations. (continued...)

IMF cannot require countries to address economic problems — even those which are of broad international concern, such as Japan's chronic balance of payments surplus or the United States' chronic BOP deficit — if those countries have sufficient resources and they choose not to apply to it for assistance.

Some critics say that the IMF should solve this by neither doing surveillance nor lending. Instead, private lending would determine whether or not to provide capital based on confidence, economic policies, and appropriate risk premium. This is, in effect, another version of the argument that the IMF makes things worse in the world economy and that commercial financial markets would be more efficient and effective in their approach. The argument assumes that countries will share with private lenders the same types of information they currently share with the IMF and that private lenders would be willing to lend to countries in deep financial crisis on terms that they can afford. It presumes that countries will run their economies better and will be more willing to adopt economic reforms if they have no recourse to an organization like the IMF. It also assumes that the world economy will not suffer if some countries are cut off from credit during financial crises because they cannot or will not meet whatever terms their private creditors demand.

Those who oppose this view and support the IMF argue that the history of the world economy during the nineteenth and the twentieth century up to 1945 give much evidence which contradicts the assumptions stated above.

#### **Financial Assistance**

When its member countries experience balance of payments (BOP) difficulties, either through capital account or current account crises, the IMF can make loans designed to help them stabilize their international payments situation and adopt policy changes sufficient to reverse their situation and overcome their problems. In some cases, the IMF makes short-term loans to help prevent countries' economies from spiraling into financial crisis and to facilitate renewed inflows of private sector capital. Many financial crises in developing countries in recent years were the result of a lack of confidence by the international financial markets and the "sudden stop" or reversal of capital inflows to developing countries which often occurs at the outset of a crisis. In other cases, the IMF makes loans to help countries deal with BOP crises but the loan repayment period is longer and the conditionality includes

<sup>&</sup>lt;sup>4</sup>(...continued)

Nobody borrowed from it and it was closed in November 2003. In retrospect, it seems that countries feared that their application for a CCL would be perceived by the market as a sign of weakness rather than strength and this would put them at greater risk than before. Similar factors seem to discourage countries from applying dearly for IMF assistance as soon as they begin experiencing economic problems. Ironically, arrangements of this sort seem to have been helpful if countries open a line of credit but *promise that they will not borrow* from the IMF unless their economic circumstances deteriorate. Between 1987 and March 2004, 59 "precautionary" arrangements of this type were approved by the IMF. Evidently, the market sees precautionary arrangements as a type of insurance rather than a signal that there might be undisclosed sources of risk which might be of concern. See, for example, *The IMF's Contingent Credit Lines (CCL), a Factsheet.* March 2004. Available from the IMF web page at [http://www.imf.org/external/np/exr/fact/ccl.htm].

problems which are more deeply rooted and require more time than is usually possible in the IMF's usual timeline.

The IMF is required by its Articles to ensure that countries' use of its resources will be temporary and that loans will be repaid. To insure this end, as well as to guarantee oft-needed economic reforms, the Fund splits the disbursement of its loans into tranches and requires that specified economic conditions must be met for the continued disbursement of IMF funds. The IMF has redesigned its conditionality guidelines to better tailor its lending arrangements to the specific financial needs of each recipient country.<sup>5</sup> The IMF's area departments, which interact with borrower countries and prepare loan agreements, may well have a different perspective on this question than do the IMF's functional departments which must approve a prospective loan agreement before it goes to the executive board. On one hand, the IMF wants to tailor its loan programs to the particular situation in the borrower country. On the other hand, the IMF also needs to have a consistent approach and policies which are equally applicable in all parts of the world.

Officially, the amount a country is able to borrow from the IMF is related to the country's quota, its ownership and contribution share in the IMF. In most instances, countries may borrow several multiples of their quota in response to particular circumstances. The conditionality and performance standards attached to a loan become more rigorous and demanding as its size (relative to the borrower's quota) increases. In many cases, deemed exceptional by the IMF executive board at the time, countries have received loans from the IMF which are much larger than the normal guidelines would allow. In December 1997, for example, the IMF made a \$21 billion IMF loan to South Korea, which was 1939% of its IMF quota.

The IMF has several loan programs.<sup>6</sup> (See Appendix 1 for details.) Most are funded with money drawn from the quotas subscribed by member country governments and charge market-based repayment terms. Quotas are, in effect, lines of credit which IMF member countries extend to the IMF in case it needs money to finance its operations. The IMF generally draws only upon the quota resources subscribed by the countries with strong currencies. The IMF charges its borrowing countries interest ("rate of charge") at a rate slightly higher than the market rate for short-term loans in major currency markets. The IMF pays interest ("rate of remuneration") to the countries, when it uses their quota resources, at this blended market rate. In some instances, particularly for loans with long repayment periods or for loans which are particularly large, compared to the size of the borrower's economy, the borrower may be required to pay a higher interest rate (surcharge) and the IMF may borrow money on market terms to supplement its quota resources.

The IMF makes loans to its poorest member countries on highly concessional repayment terms through its Poverty Reduction and Growth Facility (PRGF). These also aim to help countries overcome BOP problems, but their conditionality puts less emphasis than is usual for IMF loans on austerity and more on economic growth. The

<sup>&</sup>lt;sup>5</sup>See CRS Report RS21357, New IMF Conditionality Guidelines, November 19, 2002.

<sup>&</sup>lt;sup>6</sup> IMF. *How Does the IMF Lend, A Factsheet,* April 2003. Available through the IMF web cite at [http://www.imf.org]. Type title in inquiry box.

IMF does not use its regular quota resources to fund these loans. Rather, PRGF loans are funded with money borrowed in world capital markets and contributions from donors countries offset the interest cost of these loans. Hence, the IMF can charge its PRGF borrowers an interest rate (one-half of one percent) — similar to the rate the World Bank charges its poorest borrowers — to cover the cost of making and administering PRGF loans.

#### **Technical Assistance**

The IMF's technical assistance and advisory programs have become increasingly important in recent years. Indeed, some analysts now believe that this is IMF's most important function. While the specific types of reform vary from case to case, IMF technical assistance operations focus primarily on its core areas of expertise (principally financial and macroeconomic policy management). Any member country may request that the IMF provide it with technical assistance. Though it is a separate program, the IMF wants to make technical assistance a more integral part of its Article IV consultations and lending programs.

The IMF's Technical Assistance department plays a key role in the implementation of the IMF's development-oriented strategy. Many sub-departments are reporting increased demand for assistance in areas such as government transparency, compliance with international standards and codes, strengthening domestic financial systems and poverty reduction. Demand has been especially great in the areas of fiscal policy and administration of technical assistance. In addition to helping countries design appropriate fiscal policies, the latter areas help them build the institutions needed to support and implement them.<sup>7</sup>

### The IMF's Role in the International Economy

#### From Fixed to Floating Rates

The world financial system created at the 1944 Bretton Woods conference was a fixed-parity ("fixed but adjustable") exchange rate system. In effect, the United States defined the value of its dollar in terms of gold and other countries defined their currencies in terms of the U.S. dollar. Central banks were supposed to stabilize the value of their national currencies through their domestic monetary policies and use of foreign exchange reserves. With the prior consent of the IMF, countries could devalue their currencies if their existing par value proved unsustainable. The main issue facing the IMF during this period was convertibility: whether countries' currencies could be used freely in world markets or whether countries would maintain currency controls restricting the outflow of foreign exchange and specifying that their currencies could only be exchanged for other currencies within their territory. Currency controls of this sort placed serious limitations on world trade. A major success of the IMF and its members during its first two decades was the

<sup>&</sup>lt;sup>7</sup>FY2000 Annual Report on Technical Assistance, Supplementary Paper: Recent Developments. Pg. 4.

gradual spread of convertibility to include most of the world's major economies and most largest trading nations.

In 1971, the United States severed the link between the dollar and gold. Henceforth, the dollar was worth a dollar, rather than any fixed quantity of gold or other materials. The "gold window" at the U.S. Treasury was closed and, despite prior official assurances, foreign governments could no longer exchange dollars for their equivalent value in gold. This action by the United States produced great uncertainty in world currency markets. It was not clear how the currency of one country should relate in value to the currency of another. Some countries defined the value of their currency in terms of gold, others linked their currency to some other major currency, and others simply decided to let the value of their currency rise or fall ("float") in world currency markets.

Without a fixed anchor of value, the world money supply and consumer prices grew four-fold in the decade following 1971 whereas the world's GDP in constant prices grew by only one-third.<sup>8</sup> Many economists believe that financial strains which predated the U.S. decision to sever the gold-dollar link and the disruptions and financial shocks which followed are still being felt in varying forms today. However, given the differences in national interests and preferences and the changes which have since occurred, most economists doubt that a return to the earlier fixed-parity exchange rate system is now desirable or perhaps even desirable. An 85% majority vote of the IMF membership would be required to establish a fixed — or any other uniform — system of exchange rate procedures (Article IV, Section 4). In many respects, the current flexibility and liquidity of world financial markets can be attributed to the reduction of barriers and other shifts which have occurred since the early 1970s.

Ironically, it was the prior success in achieving the ready convertibility of the major currencies which laid the groundwork for the new system of floating exchange rates. The value of a country's currency was no longer determined at the exchange window of its central bank. Rather, the rate for convertible currencies would be determined second-to-second every day by supply and demand conditions in the world market.

At the time, many agreed that the IMF needed to create a new world financial system to clarify and stabilize the situation, but disagreements among the major countries made this virtually impossible. In 1978, the members of the IMF adopted an amendment to the IMF Articles of Agreement which let member countries decide for themselves what exchange rate system they would use. The amendment severed officially the link between currency and gold. IMF member countries were prohibited from defining the value of their currency in terms of gold and the IMF was prohibited from lending gold or defining its assets in terms of gold. Countries could use any system they wanted (other than using precious metals as a base) for defining the value of their currencies. Prior IMF approval of exchange rate changes would no longer be required.

<sup>&</sup>lt;sup>8</sup>IMF. International Financial Statistics, 1987 Yearbook. Pp. 90-1, 944-5, 114-5, 160-1.

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Most major countries let the value of their currency float in world exchange markets after 1978 (though they might seek to influence that value through changes in their domestic monetary policy or through purchases or sales in currency markets). Other countries defined the value of their currency in terms of a fixed quantity of another country's currency. Particularly for small countries, this helped protect their economies against the pernicious effects of rapid changes in currency values due to specific events(a likely possibility in small economies with floating rates). However, it risked catastrophic financial crashes if (as has been the case many times in the past three decades) the market value and official exchange rates for their currencies diverged and the central bank did not have enough foreign exchange reserves to offset market pressures for devaluation.

#### **Financial Liberalization**

Financial liberalization in the developing countries coincided with a major liquidity boom in the Western countries. The size and scope of capital flows increased dramatically during the 1990s. Instead of a relatively small number of banks lending to foreign governments, as was the case in the 1980s, developing countries turned to the new global capital markets and were raising money through the issuance of sovereign debt and private capital flows. The crises of the late 1990s were influenced as much by this rapid increase in private financial flows and market sentiment as by the underlying macroeconomic fundamentals of the crisis countries.

In recent years, major crises have occurred when governments allowed banks in their country to borrow substantial amounts of short-term money from abroad in order to fund long-term undertakings (a classic debt/asset mismatch). Problems occurred when, in an uncertain situation, the creditors found that a country's central bank lacked sufficient resources to cover all the short-term obligations which were scheduled to come due. In that case, rather than simply rolling over their loans, as had been their standard practice in the past, creditors all sought to get their money out in order to avoid default. This often precipitated a collapse which entangled creditors in the very situation they wished to avoid.

#### Financial Liberalization and IMF Policy

The increased importance of private capital markets, and the debate over its effects on developing country policy making has had a major effect on IMF operations. Instead of being the central figure, as in the old fixed-parity system, the IMF became merely another participant (though arguably the most important one) in the world monetary system. Since 1979, with the possible exception of South Korea in 1998, only developing countries have come to the IMF for assistance in dealing with their international monetary problems. The major countries have dealt with their problems on their own, through changes in their monetary and exchange rate policies and through the G-7. They have not come to the IMF for loans or (generally) technical assistance and policy advice. This has had a major impact on the work of the IMF. It has had to deal increasingly with the particular needs of developing countries where, even though it is not a development agency, the IMF's policies and operations can have a major impact on development prospects. It has forced the IMF to grapple with new issues that were not part of its original mandate. These include

capacity building in countries with weak institutions, development policy concerns, the dissemination of information about economic conditions and policies in member countries, and the creation of standards and guidelines for international financial and monetary practices. In addition, the IMF has had to rethink its crisis prediction and management operations.

The IMF operates on the general principle that the liberalization of trade barriers and reductions in currency restrictions will strengthen the world economy and raise living standards in individual countries. Until recently, it also generally supposed that most BOP crises in countries stemmed mainly from inappropriate fiscal and monetary policies leading to poor macroeconomic performance. The IMF's typical remedy included measures to reduce the borrower country's budget deficit, to raise interest rates, and to adjust downward the international value of the country's currency in order to lay the foundation for future growth. Later experience showed, however, as discussed below, that some crises could be driven by mistakes in public sector policy but that others were caused more by the interaction between structural and institutional problems and private sector activity.

**"Washington Consensus" Reforms.** The term "Washington Consensus" was first used in 1990 to summarize the general policy reforms that many experts agreed were appropriate for developing countries in Latin America and other developing countries.<sup>9</sup> The consensus encapsulated three main ideas: macroeconomic discipline, a market economy, and openness to global trade and foreign direct investment.<sup>10</sup> The IMF, the World Bank and other international lending agencies put strong emphasis on these concepts in their loan programs during much of the 1990s. Appendix 2 illustrates, as "first generation" reforms, some of the major elements of the Washington Consensus approach to policy reform.

After the financial crises of the late 1990s, the term "Washington Consensus" took on a more negative connotation. Some argued that market-friendly economic policies were forced on developing countries by the IMF and by major commercial banks in order to create investment opportunities in developing countries that would benefit investors in the advanced economies.

**"Second Generation" Reforms.** In 1994, the list of "Washington Consensus" reforms was expanded to include the so-called "second generation reforms."<sup>11</sup> The idea of second generation reforms is that without strong national

<sup>&</sup>lt;sup>9</sup>These included fiscal discipline, a redirection of public expenditure priorities towards fields offering high economic returns and the potential to improve income distribution, tax reform (to lower marginal rates and broaden coverage), interest rate liberalization, competitive exchange rates, trade liberalization, and liberalization of inflows for foreign direct investment. See Williamson, John, "What Should the World Bank Think about the Washington Consensus?" *The World Bank Research Observer* 15:2 August 2000.

<sup>&</sup>lt;sup>10</sup> Williamson. "Did the Washington Consensus Fail?" Speech delivered at the Center for Strategic and International Studies, November 6, 2002. Available at http: [http://www.csis.org].

<sup>&</sup>lt;sup>11</sup> This is some overlap between Williamson's original list and Naim's list of second (continued...)

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institutions (legal, financial, and bureaucratic), it is difficult, perhaps impossible, to implement "Washington Consensus" macroeconomic reforms. The macroeconomic principles which lie at the heart of much of the IMF's activities may not work as expected if the underlying institutions in borrower countries are weak or dysfunctional. Strong domestic institutions are increasingly necessary for countries to manage large capital flows and are being proved increasingly important for long-term economic growth.<sup>12</sup> Appendix 2 shows the two types of reforms, (first and second generation, or micro and macro-economic) that are often co-dependent.

Many economists decided, in the late 1990s, that these reforms needed to be better incorporated into IMF assistance programs. Simply put, many felt that the IMF could not successfully pursue its core functions and purposes unless the fit between its basic economic concepts and the institutional reality in recipient countries was improved. Analysts find that without strong institutions, a country is more likely to suffer persistent domestic challenges including economic inequality, and intermittent dictatorship.<sup>13</sup> Good national institutions are integral to providing a framework for citizens to conduct their business and for government to create effective policy, collect taxes, and effectively regulate the economy.

Proper diagnosis of the origins of a financial crisis are important. The difficulties of the borrower country may be compounded if the IMF lacks the proper tools or if its tools and policies — which might be appropriate for crises that stem from poor macroeconomic management — are inadequate for crises whose origins are attributable more to weak institutions and poor management of country accounts.

The IMF said, in its assessment of the Asian financial crisis of 1997-8, for example, that the sudden collapse of South Korea, Thailand and Indonesia's currencies was due more to poor debt management policies, unsound banking institutions, and weak bank oversight procedures than to any specific problems with macroeconomic policy.<sup>14</sup> This was, the IMF reported, "a new breed of economic crisis." The Fund responded to the crisis initially with the kinds of tools and policies appropriate for crises caused by unsound macroeconomic policy, though it shifted

<sup>&</sup>lt;sup>11</sup>(...continued)

generation reforms, for example, the protection of property rights. In modern usage, though, the term Washington Consensus has come to be equivalent with liberal, pro-market macroeconomic reforms.

<sup>&</sup>lt;sup>12</sup> See Daron Acemoglu, Simon Johnson, and James Robinson, Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth, Bank of Bangkok, Thailand, August 1, 2002.

<sup>&</sup>lt;sup>13</sup> Jeffrey A. Frankel, *Promoting Better National Institutions: The Role of the IMF*. IMF Staff Papers, Vol. 50, Special Issue 2003.

<sup>&</sup>lt;sup>14</sup> IMF. *Recovery from the Asian Crisis and the Role of the IMF*, prepared by IMF staff. IMF Issue Brief number 00/0-5, June 2002, available from the IMF website at [http://www.imf.org/external/np/exr/ib/2000/062300.htm#II]. There is a considerable academic literature on this subject. For example, see Eichengreen, Capital Flows and Crises, cited above.

gears quickly and added institutional and structural reforms to the agenda as nature of the problem became apparent. The Fund presumed initially that its macroeconomic programs would be sufficient, together with large financing packages, to restore confidence. Growth was expected to slow, but to remain positive. Neither the IMF nor other observers expected the deep recessions that occurred. The effects of structural and institutional reform are felt much more slowly in an economy than are those of macroeconomic policy change.

In all three countries, monetary policy had to be tightened vigorously to halt the collapse of their exchange rates. According to the IMF, the tightening went 'well beyond what might have been warranted by fundamentals' in order to prevent the currency collapse from turning into rampant inflation. Structural and institutional factors were major contributors to the depth of the crisis. Meanwhile, fiscal policy in the three countries was also tightened, on the mistaken assumption that government overspending was part of the problem. In retrospect, the IMF acknowledged, this was not true, particularly for Indonesia and South Korea. IMF staff reported that, if fiscal policy had been eased more quickly, the subsequent recessions in the countries would have been less severe.

The IMF and other observers drew several conclusions from the Asian crisis. They concluded, for example, that when institutional and structural issues are the problem crisis prevention is the preferable strategy. "The course of the crisis clearly showed," the IMF reported, "the difficulty of stopping such developments once they have started." More emphasis should be put on surveillance, particularly identifying and remedying weaknesses in countries' exchange rate and financial systems before a crisis occurs. Greater transparency of economic and financial data was also essential, they found, to strengthen market discipline and avoid adverse surprises. Further effort to restructure countries' financial and corporate sectors were needed and the legal commercial framework for their economies needed to be updated. Care also need be taken regarding the pace and sequencing of capital account liberalization, particularly when the soundness of domestic financial institutions is doubtful, so that short-term capital flows do not make a country's economy more vulnerable to instability.

#### IMF Activity in the Poorest Countries

Between 1976 and 1980, the IMF sold 50 million ounces of gold from its stockpile, partly at official prices and partly at market prices, to raise money to help low-income countries. Until that time, the IMF had no low-cost facility to help poor countries who had difficulty with its standard market-rate terms. The proceeds were accumulated into the Gold Trust Fund, which lent SDR 3 billion (\$3.8 billion) to poor countries between 1977 and 1981 on highly concessional repayment terms. Some of the repayments from these loans were placed in the new Structural Adjustment Facility (SAF), which lent another SDR 1.8 billion (\$2.4 billion) on the same basis between 1986 and 1995. Later reconstituted as the Enhanced Structural Adjustment Facility (ESAF), this program became the centerpiece of the IMF's strategy for helping low-income countries. Using repayments from Trust Fund and

SAF loans as well as new contributions from donors, the ESAF lent SDR 7.6 billion (\$10.7 billion) to 56 low-income countries between 1987 and 1999.<sup>15</sup>

Many critics complained, however, that the ESAF was lending to poor countries with the same type of conditionality it applied for its regular loans. These countries could not afford to use budget cuts and austerity as devices for turning around chronic balance of payments deficits. Instead, they argued, the IMF needed to put more emphasis in its concessional loan program on growth, poverty alleviation, and structural change in the economies of its low-income borrower countries.

In 1999, the IMF and the World Bank approved a new joint approach for their poverty reduction efforts in the least-developed and developing countries.<sup>16</sup> The basic format of the ESAF was altered. Reconstituted as the Poverty Reduction and Growth Facility (PRGF), the program was supposed to integrate the objectives of poverty reduction and growth more fully into its macroeconomic concerns. The IMF says, in its PRGF factsheet, that its concessional loan program and the concessional aid program of the World Bank are now built around a Poverty Reduction Strategy Paper (PRSP). The PRSP is prepared by the borrower government with input from members of civil society and the international financial institutions. As of March 2004, 77 countries were eligible for PRGF funding.

The PRGF has significantly expanded the scope and range of IMF assistance in its poorest countries. Distinguishing features of the PRGF are as follows: greater country "ownership" of the reform process through increased government input; broader country participation among civil society and the poor; and IMF lending is embedded in a broader, poverty-reduction framework (the PRSPs). PRGF loans allow countries to create budgets that reorient government spending towards the social sectors, and basic infrastructure, include tax reforms favoring the poor; ensure greater flexibility in fiscal targets; and have a more selective use of structural conditionality.<sup>17</sup>

Eligibility for the PRGF is principally based on a country's per capita income, drawing on the cutoff point for eligibility to World Bank concessional lending (currently the 2001 cutoff - per capita gross national income of \$875). PRGF loans carry an annual interest rate of 0.5% with repayments made semiannually, beginning  $5\frac{1}{2}$  years and ending 10 years after the disbursement.<sup>18</sup> Eligible countries may

<sup>&</sup>lt;sup>15</sup> IMF. Gold in the IMF, A Factsheet, April 2004; IMF Concessional Financing through the ESAF, April 2004; "Experience Under the IMF's Enhanced Structural Adjustment Facility," *Finance and Development*, September 1997, pp. 32-5. All are available through the IMF website, [http://www.imf.org]. Type title in the inquiry box.

<sup>&</sup>lt;sup>16</sup> IMF. *The Poverty Reduction and Growth Facility (PRGF), a Factsheet*, April 2004. Available through the IMF website at [http://www.imf.org]. Type title in inquiry box.

<sup>&</sup>lt;sup>17</sup>See Key Features of IMF Poverty Reduction and Growth Facility (PRGF) Supported Programs. IMF Policy and Development Review Department, August 16, 2000. Available from the IMF website, [http://www.imf.org]. Type title (Key Features etc.) in inquiry box.

<sup>&</sup>lt;sup>18</sup> This can be compared with World Bank's IDA loans, which carry no interest charge (but do carry a <sup>3</sup>/<sub>4</sub> of 1% service charge on the disbursed balance) with repayment over 30 to 35 (continued...)

borrow up to a maximum of 140% of their IMF quota under a three-year PRGF arrangement. The borrowing percentage may be increased to 185 percent due to exceptional circumstances.

A study of the PRGF done by IMF staff in 2002 and 2003 found that the programs supported by PRGF lending are more pro-poor and pro-growth than those previously funded by ESAF.<sup>19</sup> However, some critics maintain that the balance needs to be shifted further. They claim, for example, that the terms of PRGF loans are not much different from those previously required for ESAF loans. They say these are too hard for poor countries, still putting too much emphasis on improvements in macroeconomic policy and requirements for structural reform and diverting resources and attention from poverty-alleviation activities. Supporters argue, by contrast, that poverty can best be alleviated by economic growth and that effective economic policy and better institutions are crucial to that goal. They note that the guidelines of the PRGF were changed from those of the ESAF to give more explicit emphasis to growth and poverty alleviation than was the case before and they argue that the balance has been well shifted in that direction.

In FY2003, approximately \$1.76 billion was disbursed under the PRGF, an increase from \$1.36 billion in FY2002, and \$.81 billion in FY2001. PRGF loans are administered by the IMF through the PRGF and PRGF-HIPC Trusts. The trusts borrow resources from central banks, national governments, and official institutions generally at market-related interest rates, and lend them on a pass-through, concessional basis to eligible countries. Interest costs are subsidized by donor contributions. In 1999, the IMF "sold" 14 million ounces of its gold stockpile, through an off-market sale/buyback arrangement, to help fund its participation in the HIPC program. This enabled it to shift \$3.8 billion from its general account to a special investment account whose income is dedicated to the HIPC program. Along with contributions from bilateral donors, this has been able to fund the bulk of the IMF's share of the HIPC program. Funds were also transferred by the IMF from some special reserve accounts to help defray PRGF-HIPC expenses.

Another aspect of the PRGF program is the IMF's involvement with the Heavily Indebted Poor Countries (HIPC) debt reduction initiative. The IMF and World Bank have initiated this joint initiative to reduce to the stock of debt for the poorest countries through debt forgiveness. The goal of the HIPC program is to reduce the debt stock of its beneficiary countries to a "sustainable" level (generally defined as 150% of export income). Because most of this debt was borrowed on concessional repayment terms, the annual cost of servicing the debt is only a small fraction of the total. For the 27 countries which had qualified for debt relief at the end of 2003,

 $<sup>^{18}</sup>$ (...continued)

years (including a 10 year grace period on payments of principle). There is no specified ceiling on the amount IDA may lend to a particular country.

<sup>&</sup>lt;sup>19</sup> IMF. Review of the Poverty Reduction and Growth Facility: Issues and Option, February 14, 2002; Aligning the Poverty Reduction and Growth Facility (PRGF) and the Poverty Reduction Strategy Papers (PRSP) Approach: Issues and Options, April 25, 2003. Available by clicking titles in the sidebar on the PRGF Factsheet page, referenced above.

annual debt service fell from \$3.7 billion (18% of export revenue) in 1998 to \$2.45 billion (9.7% of export revenue) in 2003.<sup>20</sup>

There are many links between the HIPC program to IMF supervision and lending activities. A requirement of eligibility is the completion of a PRSP. Indeed, the Bank and Fund seem to be using the PRSP process as an adjunct element of the HIPC debt cancellation process, to help encourage further policy and institutional reform in HIPC candidate countries. Moreover, HIPC countries must be under an IMF program, and must "establish a track record of reform and sound policies."<sup>21</sup> Finally, an IMF program must be in place for a HIPC country to receive debt relief from the Paris Club group of official creditors.<sup>22</sup>

#### IMF Activity in Institution Building

Analysts have found that countries with good financial systems and the requisite microeconomic institutions are more likely to use capital effectively and encourage development through economic growth and trade.<sup>23</sup> By contrast, there is little evidence that poorly functioning financial systems have many desirable effects, though they can be useful to privileged or well-connected groups. Nevertheless, the process of reforming financial institutions in a country can be painful. Additional inputs of capital or steps to contain risk may be required, costs (including excess employment and overcapacity) may need to be reduced, and the special beneficiaries of the existing system may need to be persuaded or forced to accept change. In many instances, the costs of reform may be more evident than are the future benefits, so resistance may be strong. This may be particularly true if prevailing interest rates need to be raised to market levels. The interest groups who believe themselves injured will likely resist the reforms more vigorously than will the less well organized and perhaps unknowing persons who will be the main beneficiaries of reform.

The Financial Sector Assessment Program (FSAP) is an example of how the IMF is increasing its activity in domestic financial surveillance and financial sector institution building. Created by the IMF and World Bank in 1999 to study and assess the financial sectors of their members, the program has three primary components: (1) an assessment of the stability of the financial system; (2) an assessment of the extent to which relevant international financial sector standards, codes, and good practices are observed; and (3) an assessment of the financial sector's reform and

<sup>&</sup>lt;sup>20</sup> International Monetary Fund and International Development Association. *Heavily Indebted Poor Countries (HIPCs) Initiative, Status of Implementation*, September 12, 2003. Available at [http://www.worldbank.org/hipc].

<sup>&</sup>lt;sup>21</sup>International Monetary Fund, *Debt Relief under the Heavily Indebted Poor Countries* (*HIPC*) *Initiative: A Factsheet*, August 2002. Available at [http://www.worldbank.org/hipc]. See also CRS Report RL30214, Debt Reduction: Initiatives for the Most Heavily Indebted Poor Countries. Larry Nowels, February 1, 2000.

<sup>&</sup>lt;sup>22</sup> See CRS Report RS21482, *The Paris Club*, Martin A. Weiss, April 3, 2003.

<sup>&</sup>lt;sup>23</sup>Rousseau, Peter L. and Sylla, Richard., Financial Systems, Economic Growth, and Globalization, *Working Paper 8323, NBER Working Paper Series*, June 2001.

development needs. This includes their national institutional setting and legal and regulatory restrictions.

The IMF and the World Bank have endorsed 11 international standards and codes, of which the IMF created three (those relating to the timely and accurate dissemination of financial data, fiscal transparency, and monetary and financial policy transparency.) The IMF also prepares and publishes Reports on the Observance of Standards and Codes (ROSCs) that summerize a country's adherence to the internationally endorsed financial codes and standards. The IMF cannot publish a ROSC without a country's permission, yet a country's not allowing publication would suggest non-compliance. Moreover, financial market participants often take adherence to standards and codes as a proxy for sound economic governance when making investment decisions.<sup>24</sup> The ROSCs and broader FSAP reports form the basis of Financial System Stability Assessments (FSSAs). The FSSAs consider issues relevant to IMF surveillance, including the financial sector's ability to absorb macroeconomic shocks and other risks to macroeconomic stability. While the FSAP is still in an experimental phase, at some point the FSAP reports might become part of the Article IV consultation, an annual assessment of member's countries' economies.

<sup>&</sup>lt;sup>24</sup> Layna Mosley, "Attempting Global Standards: National Government, International Finance, and the IMF's Data Regime," *Review of International Political Economy*, May 2003.

#### Appendix 1. IMF Loan Programs ("Facilities")

The IMF has several loan programs or "facilities" through which it provides assistance. Low income countries may borrow on concessional repayment terms from the Poverty Reduction and Growth Facility (PRGF). Generally, these are "IDA-only" countries, that is, countries that can borrow from the World Bank only from its concessional loan window, the International Development Association (IDA). Their annual income levels are generally around \$865 per capita. Non-concessional assistance is provided through four facilities. Another, the Contingent Credit Lines (CCL) was created in 1999, but — never being used — it was terminated in 2003. Emergency loans at standard rates are also sometimes made to post-conflict countries or those that have suffered natural disaster. These are repayable in 3¼-to-5 years.

For the **PRGF**, borrowers are charged an interest rate of 0.5% and loans are repayable over a period of between 5  $\frac{1}{2}$  and 10 years. Loans are based on a Poverty Reduction Strategy Paper, which is supposed to be prepared by the borrower country in cooperation with civil society and its development partners, in particular the World Bank. In practice, the World Bank has a major role in preparing these papers.

IMF non-concessional loans carry an interest rate ("rate of charge") which is based on the IMF's SDR interest rate. The SDR rate is calculated weekly based on a weighted average for short-term debt in money markets in the United States, United Kingdom, Japan and the Euro zone. There is a markup, depending on the status of the country, and in some cases there is also an interest rate premium ("surcharge.") In March 2004, the rate was 1.61%, about double the reference rate for rate for dollar-based loans but only about one-third the rate for loans in pound sterling.

**Stand-By Arrangements (SBA)** are the IMF's standard loan program and its most commonly used facility. Designed to address short-term BOP problems, these are lines of credit which may be used as needed during a specific period of time (generally 12 to 18 months). Repayment is expected within 2¼ to 4 years after each disbursement is made. Surcharges are applied to loans which represent high multiples of the borrower country's quota.

The **Extended Fund Facility (EFF)** was created in 1975 to help countries address long-term BOP problems which required major restructuring of their economies. Credit is generally kept available for a longer period (3 years) and repayment is expected within  $4\frac{1}{2}$  to 7 years of disbursement. Surcharges also apply.

The **Supplemental Reserve Facility** (**SRF**) was created in 1997 to provide short-term financing on a large scale. The IMF used this facility to fund the large loans it made to emerging market economies during the international financial crises of the 1990s. Countries are expected to repay within 2 to 2<sup>1</sup>/<sub>2</sub> years of disbursement. SRF loans carry a substantial surcharge of 3- to-5%.

The **Compensatory Financing Facility** (**CFF**) was created in the 1960s to help countries experiencing a sudden loss of export income or a sudden rise in imported cereal prices due to fluctuating world prices. SBA repayment terms apply. Its purpose was adjusted several times, most recently in 2000. The IMF executive board recommended in 2004 that the CFF — unused in recent years — might be terminated.

	First Generation	Second Generation
Priorities	<ul> <li>Reduce inflation</li> <li>Restore growth</li> </ul>	<ul> <li>Improve social conditions</li> <li>Increase international</li> <li>competitiveness</li> <li>Maintain macroeconomic stability</li> </ul>
Reform Strategy	<ul> <li>Change macroeconomic rules</li> <li>Reduce size and scope of state</li> <li>Dismantle protectionism and statism</li> </ul>	<ul> <li>Create and rehabilitate institutions</li> <li>Boost competitiveness of the private sector</li> <li>Reform production, financing, and delivery of health care, education, and other public services</li> <li>Create "economic institutions of capitalism"</li> <li>Build new "international economic insertion"</li> </ul>
Typical Instruments	<ul> <li>Drastic budget cuts and tax reform</li> <li>Price liberalization</li> <li>Trade and foreign investment</li> <li>liberalization</li> <li>Private Sector Deregulation</li> <li>Creation of "Social Emergency</li> <li>Fund" bypassing social ministries</li> <li>"Easier" privatization</li> </ul>	<ul> <li>Reform of labor legislation and practices</li> <li>Civil service reform</li> <li>Restructuring of government, especially social ministries</li> <li>Overhaul of administration of justice</li> <li>Upgrade of regulatory capacities</li> <li>Improvement of tax collection capabilities</li> <li>Sectoral conversion and restructuring</li> <li>"Complex" privatizations</li> <li>Building of export promotion capacities</li> <li>Restructuring relations between states and federal government</li> </ul>

### Appendix 2. First and Second Generation Economic Reforms

**Source:** Moises Naim, "Fads and Fashion in Economic Reforms: Washington Consensus on Washington Confusion?," Paper presented at the IMF Conference on Second Generation Reforms, Washington, D.C., October 26, 1999.