IMF: Quotas and Conditionality

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The IMF lending seeks to cushion balance of payments adjustment and sends a signal of reassurance to investors to further attract additional resources. In 2002, sixty-nine countries had programs with the IMF, but with a different combination of financing and conditionality (Bird and Rowlands 2004, 117). A number of studies in the past have investigated the factors that determine IMF's financial arrangements.

Barro and Lee extended the previous literature by modelling the IMF as a bureaucratic and political organization. Thus, in addition to the commonly included variables such as the level of international reserves, per capita GDP, the lagged growth rate of GDP, and the country's membership in the OECD, Barro and Lee used additional explanatory variables to measure political connection and influence within the IMF. Newly included variables are as follows: the size of a country's IMF quota, nationality of professional staff, a country's political and economic proximity to major shareholding nations of the IMF (measured by patterns of U.N. voting and bilateral trade flows).

The size of a country's share of IMF quotas determines the country's voting power and the amount of money available for lending. According to Barro and Lee, holding economic conditions constant, a higher country quota raises the size and the likelihood of an IMF loan (Barro and Lee 10). As of 2008, the United States has 17.09 percent of the total quota and consequently, 16.77 percent of the voting weight, followed by Japan (6.02 percent of the votes), Germany (5.88 percent), UK and France (4.86) (Leech and Leech 3). The Board of Governor reviews and allocates quotas based on the country's importance in the world economy, the likelihood of balance of payments crises and its subsequent need for a bailout fund.

Another variable is the share of a country's nationals among the IMF professional staff. In order to avoid conflicts of interest and political bias, item 24 of the

IMF Code of Conduct for Staff rules against "assigning nationals to work on policy issues relating specifically to IMF relations with their home country," except for linguistic or other reasons (10). Nevertheless, the presence of own nationals on the staff enables their home countries to get access to more information, better express their economic, political needs in negotiations, and exert greater powers in selecting programs that are favorable to circumstances facing the country. For a more accurate investigation of political bias, Barro and Lee measured IMF loan program by not only considering the sheer size of the loan, but also the ratio of IMF loans to GDP and conditionalities such as IMF-led stimulus package or stabilization programs.

Barro and Lee found that political-economy variables (political/economic proximity to major shareholding nations of the IMF) are significant in explaining IMF's lending decisions. Considered together, the p-values for the statistical significance of political-economy variables is between 0.003 and 0.014, which lends considerable support to Barro and Lee’s initial hypothesis that these variables would play a significant role in determining a nation’s access to IMF resources.

The Barro and Lee study revealed that IMF lending increases when a country has high political and economic proximity to the United States. A marginal increase in an US-friendly vote raises the ratio of IMF lending to GDP by 0.4 percentage point. Similarly, an increase in trade with the U.S. by one standard deviation has raised the ratio of IMF lending by 0.4 percentage point. The estimated effects of political-economy variables associated with the European countries, on the other hand, were found to be less statistically significant. In particular, Barro and Lee discovered that an increase in the log of the IMF quota by one standard deviation has a large effect on the loan-to-GDP ratio increase (Barro and Lee 17-19).

Due to the presence of political bias in determining a nation's access to IMF resources, emerging market countries have opted to accumulate holdings of international reserves since the late 1990s. Accumulated reserves are considered an insurance against the risk of balance of payments crises as reserves allow countries to adopt slower speeds of adjustment when confronted with financial crises. Reserves can also cushion or mitigate the negative output effects of economic crises and thus minimize the need to turn to the IMF for help.

As Graham Bird points out in *The IMF and the Challenges it Faces*, due to such tendency to accumulate international reserves, the IMF has failed to fulfill its purposes. There is little point in the IMF existing, claims Bird, if its member nations refuse to turn to it for financial assistance. Moreover, the desire to accumulate reserves and run current account balance of payments surpluses contributes to global economic imbalances which then make future crises more likely (147).

The IMF's failure to fulfill its role as an international lender of last resort also arises from the ineffective design of its conditionality attached to its loans. Conditionality was seen as "adequate safeguards" to ensure that countries are able to not only repay the money they borrowed but also to commit themselves to structural reforms (84). There are three different types of IMF conditionality: "Prior Actions" stipulate reforms that a nation must implemented before it can receive any resources from the IMF; "Performance Criteria" require countries to comply with certain quantitative conditions (in regards to structural conditions or key macroeconomic variables such as fiscal deficits and monetary expansion) to receive installments of a loan beyond the first one; "Structural Benchmarks" incorporates supply-side policy conditions that are hard to quantify (83). According to Bird, Structural Benchmarks

were viewed as “a way of creating the economic circumstances in which conventional macroeconomic conditionality would work best” (89). Failure to comply with such conditionalities may result in a disruption of the flow of finance from the IMF.

During the 1980s and 1990s, the IMF expanded its conditionality to include broader aspects of macroeconomic targets and structural reform. This expansion, however, undermined country "ownership." Bird explains in *Reforming IMF Conditionality* that while effective policy implementation relies on governments "owning" the reform measures, conditionality was fundamentally at odds with such a concept. Moreover, many of IMF's policies reflect the political influence of economically advanced countries that were not subject to IMF-imposed conditionality; as a consequence, economic philosophy reflected in conditionality could be inappropriate for emerging market economies (84-85). More importantly, according to Bird, conditionality has gone "well beyond the level required to ensure repayment" (84).

Reforms to conditionality would not only help to ensure that the IMF focus only on its core areas of expertise, guaranteeing effective economic reforms and policy implementation, but also modify the preferences of excess reserve holding nations to "reconsider their attitude to borrowing from the IMF" (147). The IMF introduced a "streamlining" initiative in 2000 to include only "structural conditions that were deemed critical to" the nation's development and economic growth to foster stronger ownership and encourage more effective policy implementation (81).

I would now like to draw upon Graham Bird's work *Reforming IMF Conditionality* to assess whether streamlining has achieved its objectives or not. Comparing the 2001-2004 post-streamlining period with the 1997-2000 pre-

streamlining period, the IEO (Independent Evaluation Office) has published an evaluation of structural conditionality which concluded that "there is no evidence of a reduction in the number of structural conditions following the introduction of the streamlining initiative" (92). The IEO has revealed that the average number of structural conditions has remained at about 17 per program despite the streamlining initiative. In fact, in certain sectors, the IEO has found an increase in conditionality as a "direct consequence" of streamlining.

As Bird implies, it appears that the streamlining initiative has "refocused rather than reduced" the number of structural conditionality in areas where the IMF believed such structural conditions were necessary. However, the IEO has discovered that many of the conditions do not seem to be critical to the program objectives and called for the need to articulate why "conditions, either core or non-core, were critical" and how these conditions relate to program objectives. Moreover, according to the IEO, approximately half of the structural conditions (excluding prior actions) were not met. Compliance was generally lower in areas that required deeper content (96).

Another problem arising from politically biased quota allocations system includes insufficient help for low-income countries. While the quota system is said to reflect how much the country can afford to contribute to the Fund, in practice, quota shares are determined by a politically biased mathematical formula. In 1946, the U.S. determined the original quotas according to "a political formula designed to ensure that the big four wartime allies would retain control under its leadership" (Leech and Leech 5). Raymond Mikesell, the economist who was in charge of creating a mathematical formula, later confessed that he was specifically asked to "come up with a formula that would 'give the la rgest quota to the U.S,'" followed by the UK, its colonies, the Soviet

Union, and China (5). At that time, Mikesell had to make the formula look as scientific as possible to hide the fact that the quota allocations process was more political than scientific (6). A country like Palau only has 0.01 percent of the voting weight. While some may argue that it is only fair that we base the allocation of voting powers strictly upon the level of each nation's contribution to IMF's resources, the design of allocation system that is intent on deliberately assigning excessive shares to certain nations makes it harder for the IMF to cushion against economic shocks that take place in less powerful, emerging and developing nations.

Recent reforms have thus attempted to modify quota shares and increase the number of votes to grant more voting power and voice to low-income, less powerful nations. According to Bird, these attempts were presented as efforts to change the balance of power in favor of emerging and developing nations (Bird and Rowlands 2010, 149). He questions, however, the extent to which such reforms have succeeded in eliminating political bias in favor of advanced economies. For instance, it is unclear whether the G20's commitment to choose the IMF's Managing Director on merit rather than stay with the convention of having a European national as Managing Director and a US national as First Deputy Managing Director has contributed to making IMF more transparent and accountable to its member nations. As Bird points out, the IMF and its policies would carry more legitimacy if its governance is representative of its membership, including emerging and developing economies.

In order to meet the needs of low income countries by granting quicker access to IMF resources, in September 2008, the IMF modified its Exogenous Shocks Facility by incorporating a "rapid access" component that allows a country to quickly draw up to 25% of its quota. With the "rapid access" component in place, countries only need to

commit to suggested policies to address the shock. Also, for emerging market economies, the IMF launched the Short Term Liquidity Facility to minimize the conditions; under STLF, the IMF will impose only the measures "absolutely necessary to get past the crisis" (Bird 2009, 98). According to Bird, the series of measures adopted to benefit low income nations has been more effective in vaguely defined reforms under the aforementioned streamlining initiative in 2000/02 (99). The conditionality imposed against emerging and developing economies distinguished between what was necessary in the short term in the immediate aftermath of financial crises and what was apropriate in the longer term as economic recovery took place. Towards the end of 2008, the IMF was able to reach a consensus on a series of reforms as the financial crises created a sense of urgency and an environment that fosters cooperation and change. However, as the economy began to recover, "reform fatigue" set in and the IMF still suffers from a lack of agreed structural reform (100).

To further its catalytic role, the IMF should look closely at the financing needs of developing countries and develop alternative financing mechanisms for a stronger, more reliable catalytic effect (Bird and Rowlands 129-130). Bird suggests that the IMF help expand the financing role of regional monetary funds and supports the idea of direct borrowing from capital markets in times of crises instead of relying exclusively on wealthier member nations. Heavy reliance upon wealthier nations will widen the bifurcation between the countries that provide resources to the IMF and countries that draw from it (Bird and Rowlands 2010, 150). Quota system, unfortunately, will not be appropriate in such a bifurcated system; according to Bird and Rowlands, determining the distribution of voting rights will take place at the expense of a fair allocation of subscriptions.

To bridge the gap between rhetoric and reality, it is important that reforms are grounded upon secure theoretical or empirical basis. Striking balance in the design of economic policies and conditionality and determining the desirable amount of IMF lending and intervention requires systemic evidence and analysis. Moreover, in order to garner strong institutional commitment to reform among its member nations, the IMF should explore ways in which it can modify its member nations' preferences by creating incentives. Finally, since the governance and the operation of the Fund are heavily influenced by politics, the IMF must try to relax the political constraints and overcome political resistance to reform (Bird and Rowlands 2010, 152).

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