The IMF

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Today’s Plan

- Housekeeping
- Reading quiz
- From last class:
  - How deficits become crises
- For today:
  - The IMF
Housekeeping

• Brief Note: Why I assigned readings that are generally pro-IMF
Reading Quiz (1)

• Which of the following are true?
  • a. The IMF stands for the International Monetary Fund
  • b. The IMF requires collateral from a country in order to make the loan
  • c. If predetermined conditions are not met by the aided country, the IMF can withhold funds
  • d. Was created at the end of the Vietnam war
  • e. a & c
  • f. All of the above
Quiz

What way does the IMF help ensure stability in the international system?

• A. Keep track of the global economy and the economies of member countries

• B. Give practical help to member countries

• C. Lend to countries with balance of payments difficulties

• D. All of the Above
Reading Quiz (2)

• Which of the following is/are (a) critique(s) of the IMF mentioned in the reading?
  • a. IMF conditionality has traditionally included too much austerity
  • b. The IMF doesn’t force private lenders to take large enough losses
  • c. The IMF doesn’t sufficiently represent the interests of borrowing countries
  • d. a&b
  • e. a & c
  • f. All of the above
Checking understanding: The current account

Which of the following improve a country’s current account balance (i.e. reduce a current account deficit)?

A. Increasing government spending
B. Increasing investment
C. Increasing household savings
D. A and B
E. B and C
Borrowing Abroad: The Temporary Fix

• Balance of Payments = (X-M) - net foreign assets
  • Exports - Imports = (Savings - Investment) + (Taxes - Government Consumption)

• If you have a current account deficit:
  • You can borrow money from abroad to cover it
  • Sell off assets to foreigners

• If you have a current account surplus:
  • Loan money to other countries
  • Use the surplus to buy assets (e.g. real estate, companies) in other countries.

• This only works for so long. As the debt grows, will or can the borrowing country repay?
Over-borrowing and Debt Crises

• Step 1: The debt is growing, questions arise about the country’s willingness or ability to pay it all back.
• Step 2: Cautious investors pull back or demand higher interest to cover the higher risk.
• Step 3: Higher interest payments make the current account deficit worse, debt rises more.
• Step 4: More investors pull back, interest rates rise more, debt gets bigger, and so on...
Checking Understanding

• How long can a country keep borrowing to cover a current account deficit?
  
  A. Forever
  B. Until debt reaches the size of GDP
  C. Until lenders get scared that the country can’t afford to pay back its loans
Checking Understanding

• How do debt crises start?

A. As lenders get scared, interest rates fall, causing the country to borrow more

B. As lenders get scared, interest rates rise, making the existing debt even harder to pay back

C. Currency crises usually start with a default by the government
Types of Crises are Interchangable...

• Debt crisis: Interest rates are spiking, government default is imminent

• Currency crisis (aka Balance of Payments Crisis): Government is low on reserves, currency is losing value

• As long as a government can borrow foreign currency, it can use those loans to prop up its currency

• As long as a government can print money, it can pay off its debts
  • So a currency is a debt crisis, and a debt crisis is a currency crisis
What the IMF does in a crisis

• The IMF is a “lender of last resort”
• When a government can’t borrow, the IMF steps in with a subsidized loan
  • IMF doesn’t take collateral
  • It imposes “conditions” on loans

• Conditions: Designed to fix the problems that created the crisis in the first place
  • Austerity: raise taxes, cut government spending, tight monetary policy
  • Also, sell off state-owned assets
IMF: The Big Picture

• Part of the Bretton Woods system
  • Goal = keep currencies stable, prevent economic collapses, and promote trade.

• Three functions:
  • Surveillance: Collecting data, giving governments advice
  • Technical Assistance: Guidance and training to poor countries to help them manage their economies
  • Lending: Loans to countries facing balance of payments crises or otherwise w/o access to other credit
    • Smooth out shocks, avoid defaults
    • “Concessional” loans available for poor countries
IMF: The Big Picture

- The money the IMF lends out comes from contributions made by member countries
- Your vote share is determined by your contribution
  - Only 5% of the votes are “basic votes”
- Is this fair, or should poor countries have more of a voice?
  - A. Its fair.
  - B. Its unfair. “Basic Votes” should be a greater share of the total.
IMF Critiques

• Forcing too much austerity:
  • Shouldn’t crush growth just to get rid of current account deficits a wee bit sooner
  • Counter: You can’t spend more than you take in – criticizing the IMF is just shooting the messenger

• Creating moral hazard:
  • The IMF lets private lenders off too easily (and thereby incentives future reckless lending)
  • Counter: Private creditors still take some losses even when the IMF bails out
IMF Critiques (2)

• Forcing pro-cyclical fiscal policies:
  • It is ideal to run deficits during recessions and surpluses during good times
  • Counter: Its too late for that. More deficits when you’re already in crisis just drives up risk and interest rates.

• Encouraging countries to open themselves up to foreign capital too much.
  • Financial openness -> volatility -> crises
  • Counter: The problem isn’t openness per se, its the combo of financial openness and too little trade (Latin America), or openness plus poor regulation.
    • Also: Gains from openness are large
Iceland's Journey
Crisis by Crisis

- Latin American debt crisis (1980s)
  - Forced an end to Import Substituting Industrialization
  - Caused a lot of pain, but also produced some success
- The asian financial crisis (late 1990s)
  - Financial openness had a lot to do with causing it
  - IMF response has been widely criticized
- Iceland is the success story
- The Eurozone crisis is a big test
  - The IMF has been advocating debt forgiveness as part of the package for Greece
  - Germany and other creditor countries don’t want that
We’ll talk lots more about the Eurozone crisis after break but…

• Many Eurozone members are still running current account deficits
  • Greece, Spain, Portugal, etc
• They would love some inflation in the Euro
• But these countries owe a lot of money to Germany
  • So the Germans don’t want inflation