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Preparation Paper/Study Guide:

International Monetary Fund (IMF)

"The Sovereign Debt Crisis: Europe and the IMF"

Historical Background

The Gold Standard

The late 19th and 20th centuries were characterized by a highly integrated world economy.

From approximately 1870 to 1914 It was supported by an international financial arrangement known as the "*gold standard*" where each country defined the value of its currency in terms of gold. At this time gold was a commonly used as an official capital reserve. Since the value of each currency was defined in terms of gold as a common denominator, exchange rates of different currencies were fixed.

In 1914 the countries involved in conflict of the World War I suspended the convertibility of their currencies into gold, which led to the break down of the old financial system. Attempts to return to the gold standard failed.

The Gold-Exchange Standard

A new attempt to rebuild the pre-World War I gold standard in 1922 succeeded but due to the gold shortage at this point of history it differed form the previous one. Countries that were not important financial venters did not hold gold as official reserves but instead other currencies which were "gold-convertible". This new financial system was known as the "*gold-exchange standard*" which aimed to set major rates at their pre-war levels.

At a system-wide level each major rate was set to gold ignoring the implied rates among the various currencies, which led to a pile of center countries which were directly tied to to gold and, so called, periphery countries holding these center-country currencies as reserves. More and more countries joined this system until 1930 nearly all were operating under this system.

However this designed system contained inventive problems for periphery countries. Suppose a periphery country expected that the currency it held as a reserve was going to be devalued against gold it would be in the countries interest to sell it's reserve before the devaluation took place not only to preserve value of it's total reserves but also to obtain additional value. This puts even greater pressure on the center currency.
This happened in 1931 when Britain was forced to cut the pound's tie to gold, leading many other countries following suit, due to the fact that the pound was set at an overvalued rate at the founding of the "gold-exchange standard" a year earlier.

This problems led to the disaggregation of the "gold-exchange standard" until by 1937 no countries remained on it.

Throughout the 1930s a system of separate currency areas evolved with a combination of both fixed and floating rates. The lack of international financial coordination helped contribute to the economic crisis of the decade. International economists have even seen the "gold-exchange standard" as the major contributor to the Great Depression.

At the worst of times countries even engaged in a game of competitive devaluation.

The Bretton Woods System

During the World War II the United States of America and Great Britain began to plan for the post-war economic system and hoped to avoid the same mistakes made after World War I. So after the Great Depression there was a need for an organization to create a new system for exchange rate stability. The affects of World War II urged the need for reconstruction in well-developed nations on the one hand and on the other development in the lesser development nations.

In the 1940s a proposal for a monetary system by Harry Dexter White (USA) and John Keynes (UK) led to the foundation of the International Monetary Fund (IMF). It's goal was to establish the value of each currency, eliminate restrictions and certain practices on trade and assistance for post-war reconstruction.
In 1944 at the Bretton Woods Conference white largely got his way and the conference produced a plan that became known as the Bretton Woods System.
The essence of the system was an adjustable gold peg which pegged the US dollar to gold at $35 per ounce. Other countries were to peg either to the US dollar or directly to gold. In the end this resulted in the US dollar as the base currency of the new international financial system.

The Bretton Woods System became the foundation of the International Monetary Fund.

The Operation of the IMF

The Organization

The IMF is an international financial organization comprised of 183 member countries.

The Major decision-making body is its Board of Governors where each member state appoints a Governor and an Alternate Governor and meets annually.

Day-to-day operations are in the hands of Executive Board composed of 22 Executive Directors which are appointed by largest IMF quota holders.

The Articles of Agreement of the International Monetary Fund were adopted at the United Nations Monetary and Financial Conference in Bretton Woods (New Hampshire) on the 22nd July in 1944 and entered into force on the 27th December in 1945.

The essential article is number I, declaring the purposes of the IMF:

(I) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Quota System – IMF Funding

The most important feature of the IMF is its quota system which determine both the amount of money members can borrow form the IMF and also their relative voting power.

This means, a higher member's quota results in greater voting power and a greater amount it can borrow from the IMF. It is the main funding of the IMF.

A Members' quota is their subscription to the IMF which is based on their relative size in the world economy. One fourth of it's quota hast do be payed in a widely-accepted reserve currency (US dollar, British pound, Euro, or Yen) whilst the remaining three-quarters of the quota can be in its own national currency.

Activities

The IMF engages in four areas of activity:

1. Economic surveillance or monitoring
2. Dispensing of policy advice
3. Technical assistance
4. Lending money (which is perhaps the most important)

If an IMF member faces balance of payments difficulties it can automatically borrow one fourth of it's quota in the form of a reserve tranche. Which means when the IMF lends to a member country, what actually happens is domestic country purchases international reserves from the IMF using its own domestic currency reserves.

The result ist that the member cuntry is then obliged to repay IMF by repurchasing its own domestic currency reserves with international reserve assets.

This kind of lending is known as “purchase-repurchase” arrangement.

Credit

Originally the first credit tranche was one fourth of a members' quota which is more or less automatic. In 1970s credit trances were increased to 37.5% of the quota.

Further credit tranches (second through fourth) require that the member adopt policies (conditionality) that will solve balance pf payments problem at hand.

The credit tranches effectively limits a member state's credit to 150 percent of its quota but as the IMF evolved, it created a number of special credit facilities that extend potential credit beyond the 150%-level.

Drawings on IMF by its members have do be repaid (with interest) whilst a five-year limit was established.

Ideal Role of the Fund

The following scenario describes the ideal role of the IMF:

- Development of a country requires an inflow of private foreign savings
- Inflow would cover a current account deficit often caused by import of capital goods
- Occasionally, this private foreign savings disappears which results in a balance of payment crisis
- in this instances the IMF steps in and the member draws on its reserve and credit tranches under the condition of repaying credit tranche debts within a five-year period.

The role of the IMF in the Crisis

August 2007 marked the first phase of the global financial crisis, with the initiation of liquidity operations by the European Central Bank. The global crisis entered a more acute phase in September 2008 with the collapse of Lehman Brothers. The severe global financial crisis in late 2008 and early 2009 shook Europe as much as the United States, creating the worst recession since the Great Depression of the 1930s.

The IMF was mobilized on many fronts to support its member countries, increasing its lending, using its cross-country experience to advise on policy solutions, and introducing reforms to modernize its operations and become more responsive to member countries’ needs.

As the apex of the crisis shifted to Europe, the IMF's work in Europe intensified, particularly since mid-2010 as a result of the sovereign debt crisis in the euro area.

During the global financial crisis, a number of emerging European countries started requesting financial support from the IMF to help them overcome their fiscal and external imbalances. In 2010-12, three members of the euro area—Greece, Portugal, and Ireland—requested access to IMF resources.

The fund was drawn into the crisis when France and Germany were unable to agree on a purely European solution to Greece's short-term debt needs.

In late 2011, in order to help stop the debt crisis from spiraling out of control the fund decided to take firm steps by announcing that it would offer credit to countries in relatively good fiscal shape facing liquidity problems, to help, in its words, "crisis bystanders."

In April 2012, the IMF announced that it had raised at least $430 billion in extra lending capacity to be used if the euro zone crisis worsens or global financial conditions deteriorate, and by August the IMF had arrangements with 10 countries in Europe with commitments amounting to €124.06 billion or $186.97 billion , meaning that of the IMF's total disbursing and precautionary commitments, about 62 percent where destined to Europe as a whole.

With a seemingly endless series of euro zone crises, and the fund calling for the euro area to move swiftly toward a toward a fiscal union including issuance of joint euro zone debt European officials started pushing for a banking union that would watch over and bind together the currency group's faltering financial institutions.

In facing the issue of potential steps forward the fund also said it would like euro zone bailout funds to be lent directly to struggling banks — rather than through national governments — and appealed to the European Central Bank to take more aggressive measures to quell volatile financial markets, such as increasing the money supply or resuming the purchase of the bonds of stressed sovereigns such as Spain, but with interbank cooperation at perhaps its lowest level since the creation of the euro currency union, a broader solution is needed.

Working to establish a common banking supervisor for euro zone countries, with a front row role played by the European Central Bank, the only institution with the firepower to credibly rescue a wobbly financial sector.

Future challenges

The IMF has recommended that Europe focus on structural reforms to boost economic growth, such as product and services market reforms, as well as labor market and pension changes. The fund has also urged eurozone members to make a more determined, collective response to the crisis by taking concrete steps toward a complete monetary union, including a unified banking system and more fiscal integration.

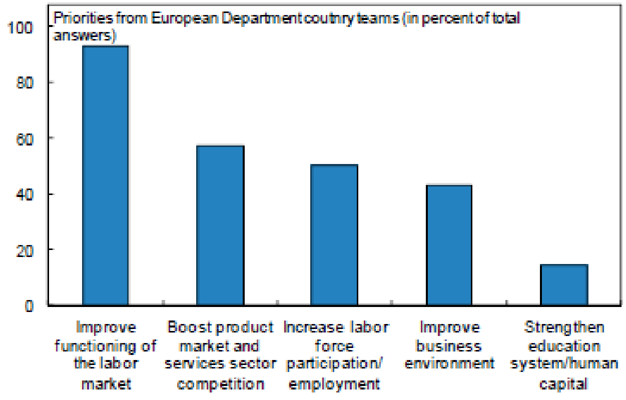
Risks have been reduced by a strengthening of the euro area's anti-crisis firewall, lending by the European Central Bank, and the introduction of the new fiscal compact. But with the recession continuing, and unemployment high and on the rise in many countries, policymakers need to do more, both long-term and short-term solutions are needed.

Structural reforms, product and services market reforms, as well as labor market and pension changes, should be implemented without delay.

Access to IMF resources for Europe is being provided, amongst others through the following:

- Stand-By Arrangements (SBA);
- Flexible Credit Line (FCL);
- Precautionary and Liquidity Line (PLL);
- Extended Fund Facility (EFF);

Figure 10. Priorities for Structural Reforms in Country-Specific Recommendations



Source: IMF European Department country teams.

Our committee

"While multilateral institutions were important in the past, they are even more important for our future" – *Christine Lagarde*

A revival of growth seems key to reversing the vicious cycle of poor confidence, flagging growth, fiscal weakness, and bank vulnerability. The Union would benefit from increasing its common pools of resources, whilst always bearing in mind that structural reforms need to tackle many of the pre-crisis or "older" challenges. While some policies are applicable at the euro area level, granularity is necessary, as there is no one-size-fits-all strategy.

What can the IMF and its international members do to face the challenges of the European debt crisis, a crisis with global effects?

For further reading

General information on the IMF

http://www.imf.org/external/np/exr/facts/glance.htm

The IMF and Europe: main site and fact sheets of interest

http://www.imf.org/external/region/eur/index.aspx
http://www.imf.org/external/np/exr/facts/pdf/europe.pdf
http://www.imf.org/external/pubs/ft/survey/so/2012/POL061812A.htm

IMF and the Crisis in Europe

http://www.imf.org/external/pubs/ft/survey/so/2012/NEW101212A.htm
http://www.imf.org/external/pubs/ft/sdn/2012/sdn1207.pdf
http://www.imf.org/external/pubs/ft/survey/so/2012/CAR101412A.htm