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AID REQUIREMENT OF IMF CONDITIONALITY

ANALYSIS & RECOMMENDATION

by

Joseph D. Reid, Jr.

Research Associate, Center for Study of Public Choice

& Associate Professor of Economics, George Mason University

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SUMMARY

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This report examines whether AID should continue current practice of requiring that recipients of foreign aid perform in accordance with IMF loan conditions, if relevant. To do so, the report presents first the historical and theoretical foundations of the IMF. It then examines the major controversies surrounding IMF conditional lending. The report concludes that in many cases IMF loan conditions do not encourage economic productivity and efficient international trade. Rather, IMF high conditionality loans encourage growth of unproductive government regulation and employment in recipient countries. These undesirable outcomes are byproducts of the drive by the IMF to retain power and influence in a world of flexible exchange rates, that is, in a world where no IMF is needed. In response, at the least, the report recommends that AID examine each case on its merits before AID requires acceptance of IMF conditions. The report favors more that AID give no encouragement to growth of IMF power.

Essentially, the historical justification for the IMF is that use of fixed exchange rates in open international trade necessitates reserves of foreign exchange to finance temporary imbalances between foreign payments and receipts. In the 19th century, needed exchange had been provided through commercial

banks. But after the shocks of the Depression and World War II, neither commercial bankers or governments trusted that commercial banks could provide international financial services sufficient to revive free trade. So the IMF was established to be an expert source of international liquidity. When justified, it would provide foreign exchange to bridge transitory imbalances (in the form of low conditionality loans). If imbalances in foreign exchange were not transitory, it would accompany foreign exchange with expert economic guidance to reestablish free trade at stable rates of exchange (in the form of high conditionality loans).

Common conditions imposed by the IMF on errant economies are devalue, disinflate, and deflate. Although workable means to restore overvalued exchange rates to a sustainable equilibrium, they impose disproportionate costs on private sector producers, and directly and indirectly extend the authority of the government. The solution is not that the IMF conditions be abandoned, so that IMF credits become a permanent subsidy to imports of developing countries, as the left advocates. Rather, the solution is that the IMF be abandoned, via the adoption of flexible exchange rates or other currencies by developing economies, which would prompt the substitution of citizens for governments as the borrowers of international purchasing power. Only this solution will stimulate the prosperity and freedom of developing societies. Thus, only this solution is worthy of government support.

AID REQUIREMENT OF IMF CONDITIONALITY

ANALYSIS & RECOMMENDATION

This paper is prompted by the current spate of attacks on and defenses of what might be termed the development establishment. Institutional representatives of the development establishment include the International Monetary Fund, the World Bank, the Food and Agricultural Organization of the United Nations, other alphabet international agencies, and the international sections of the largest commercial banks (Chase and Citicorp, in particular). The particular focus of this paper, the International Monetary Fund, is under attack from left and right, and is defended by an establishment (which in large part designed the IMF and continues to advise it). The attack of the left is that the IMF promotes the hegemony of exploitive capitalism. The attack of the right is that the IMF hinders growth of the private sector. The defense is that the IMF has worked well and will work better. This paper most agrees with the right. The paper concludes that the IMF is unneeded, and in any event will get worse rather than better. Therefore, the paper recommends that AID stop supporting the IMF and IMF policies and loan terms.

I. Theoretical Foundation of IMF Practices & Responsibilities

The problem faced at Bretton Woods, how to effectuate international trade efficiently, is not unlike the problem faced by any country of how to effectuate its internal trade. Internationally and domestically there are gains from trade: trade widens

the market for successful producers and thereby lets them enjoy scale economies in production that cheapen the supply cost of their product; trade permits the products of geographically specific resources to be widely consumed, and thereby raises the earnings of specific resources while it raises the enjoyment or cheapens the cost of new (foreign) purchasers; and trade tends to equalize input prices, so that world production is made more efficient and the need for labor to emigrate to gain higher income is reduced.

But trade only expands if those who give up products for trade get something valued back. That is, trade must be paid for. One mechanism for payment is barter. If traded goods are bartered, so that traded goods given up are paid for by different goods taken in trade, then a double coincidence of wants between producers must be found. Experience shows that such double coincidence is costly to find.[1] Alternatively, promises could be received by producers in return for their products: domestic tradesmen or foreign exporters could provide their wares in exchange for agreements to pay something of acceptable value at some future time. To the extent that promises were accepted, cartage and storage would be reduced below the level required by simultaneous barter, but these still would be of sufficient cost to keep trade at a fraction of its efficient scope. And the vulnerability to fraud of trade on promises might destroy the whole system of exchange.

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1. The many episodes of trade collapse after currency repudiations in defeated powers after wars, including the collapse of trade in Germany after the Second World War, offer vivid testimony to the high cost of barter.

A less personal medium of exchange could be agreed to. If easy to transport and stable in value, this medium of exchange could be kept at little cost between the time of sale of product and purchase of benefit. To be stable in value, however, holders must be confident of getting back something equal in value to what they surrendered to get the medium. Confidence could be got from endorsements and testimonials; this is exactly what cosigners of checks and bills of exchange give. But that seems a costly way, unless at the most only a few endorsers emerge as dominant suppliers of confidence; if many emerge, they necessarily give confidence over but a small share of the market.

Impersonal, yet not so different from promises, currencies could be used as media of exchange. In general, the recipient of a currency can be confident that its giver gave up something of value to its previous holder in order to get the currency. Thus, in some abstract sense, there is a real good or service waiting to be purchased with this currency.[2] But this surety does not always follow. If the giver of the currency is its producer, its recipient does not have that confidence. Governments have been known to depreciate their currencies in order to gain real resources and products. Producers of real media, such as gold mines, have shaved or adulterated their product. So, currencies are not unlike promises, promises in the case of currencies endorsed by the known mechanism of issue (production process) and the degree of confidence in its continuation (tradition), or by

2. J.M. Ostroy, "The Informational Efficiency of Monetary Exchange," The American Economic Review, 63 (September 1973), pp. 597-610, models such transaction economies.

continuous monitoring and reporting and directing of its production. These last three responsibilities implicitly were institutionalized into the International Monetary Fund, in order to permit the expansion of trade using local currencies at the first level of transactions.

II. Historical Background

The agreed to responsibility of the International Monetary Fund (IMF) "is to oversee a distribution of [financial] capital in support of policies that will ease the [balance of payments] adjustment problems of member countries over time."[3] At its founding, at the end of World War II, the rationale was reasonable. Goods and services traded internationally must be paid for, just as must goods and services traded internally. Furthermore, no signatory nation would abandon its own currency and substitute another's currency for its domestic transactions. The loss of political prestige and (it was thought at the time) macroeconomic control implicit in substitution of another's currency for ones own money was too great to contemplate. Hence, for political and economic reasons, it was accepted at Bretton Woods that national currencies would be the immediate media of exchange. This decision made for an important difference between international and internal payments: to pay the exporter something of value, the importer's payments must be made in the

3. C. David Finch, "Adjustment Policies and Conditionality," p. 76 in John Williamson, ed., IMF Conditionality (Washington, D.C.: Institute for International Economics, 1983).

exporter's currency or an acceptable substitute, not necessarily the purchaser's own currency. This raised the fear that financing trade would be arduous.

The reasons for thinking so were several. International banking facilities were scant and frightened, having suffered the vicissitudes of protectionism through the thirties and the disruptions of the War. Thus, existent private banking talents and resources were anticipated to be inadequate to finance trade. Nor was it anticipated that the needed financial capabilities would be provided by the invisible hand of unregulated free markets. Attribution of the thirties' depression to the excesses of financial markets and beggar-thy-neighbor trade policies warned Bretton Woods' participants away from a laissez faire approach to trade. On the other hand, the participants did have recent experience with the perils and problems of managing trade. The inefficiencies and black markets brought forward by wartime controlled prices previewed what incorrect exchange rates would produce: shortages of foreign exchange for official transactions. So means to achieve and keep adequate foreign exchange and "correct" exchange rates were wanted.

The simple means to achieve adequate foreign exchange supplies, flexible exchange rates, was not trusted, however. The havoc wreaked in the late twenties and thirties by rapidly fluctuating currency, equity, and land prices indirectly, and by manipulated foreign exchange rates directly, convinced nigh all that freely fluctuating exchange rates would not encourage a rapid and sound expansion of international trade, but would instead stimulate destabilizing speculations against national

currencies. Accordingly, the signatories of the Bretton Woods agreement committed themselves to fixed exchange rates.

"Fixed" exchange rates did not mean never-changing, at that time. Nor was a literal return to the gold standard deemed feasible or desirable. Finance of even existing trade with current gold stocks would have required massive reductions of prices everywhere, have given windfall profits formally to the richest country, the United States, and have denied the world the benefits of scientifically managed international exchange. Britain's post World War I stagnation to sustain an overvalued pound was remembered sufficiently well that deflations were dreaded, although fluctuations in real exchange rates were anticipated as likely to be necessary (if not to be applauded). So it was thought that exchange rates should not be changed, except in response to future true and continuing changes in real economic circumstances, such as an unexpected discovery or exhaustion of a major natural resource, or the sudden advance or retreat of foreign competitors on an important economic sector. In particular, exchange rates should not to be depreciated unfairly in order to win foreign markets. All in all, trade in a stable international marketplace was seen to be a desirable, but at the same time a difficult goal to achieve.

Responding to economic theories and political perceptions dominant in 1945, Bretton Woods took several steps to stabilize and expand international trade. It established a dollar exchange with U.S. responsibility to preserve the value of the dollar. This signaled the premier place of the United States in postwar finance, while it preserved the scope for scientific management

of exchange reserves and dedicated monetary gold supplies to international finance. It outlawed many anticipated means of manipulating exchange rates, such as by non-tariff restrictions on trade or different exchange rates on current account trade. And it established the International Monetary Fund to finance trade using local currencies.

III. IMF Practices

To stabilize and expand international trade using local currencies with fixed exchange rates, the IMF undertook several tasks. The simplest task was to provide foreign currencies appropriate for the needs of trade to countries in transitory deficit and to recycle surplus foreign currencies from countries in transitory surplus. Such deficits and balancing surpluses of foreign exchange are anticipated, even under flexible exchange rates, because one of the benefits of money is to allow sales to be temporally separated from purchases. A shortage of wanted foreign currency, then, might not signify inadequate goods to sell at incorrect prices, but a (randomly) bad or inadvertent sequence of transactions which promises to balance when completed, but at this moment does not. Engaged in such a sequence, countries <u>temporarily</u> in surplus hold barren assets, foreign exchange unwanted for purchase of foreign products. Countries <u>temporarily</u> in deficit need briefly just those exchange stores to

4. See Plessner and Reid, "The Precautionary Demand for Money," <u>Journal of Monetary Economics</u>,6 (1980), pp. 419-32, for a model of fluctuating transactions balances of media of exchange in sequential probabalistic execution of trades.

accomplish the mechanics of financing trade.[4]

To keep trade flowing smoothly, the IMF operates just as does an overdraft facility for individual bank customers. Countries which just like individuals have spent more than they conveniently can pay on the spot from immediately accessible funds, follow individuals and reach for credit. When an exchange shortage restrains the imports of countries, they reach for low conditionality IMF credits or unrestrictive commercial loans to gain wanted foreign exchange.[5] For countries without credit, as for customers, the alternatives are either disruption of purchasing (to rebuild balances of wanted media of exchange) or price reductions via devaluation of exchange rates (to entice foreigners to provide wanted foreign exchange) or depreciation of specific prices to fire sale levels, in order to raise cash quickly. Because these alternatives (to reiterate) were not thought conducive to stable and efficient international trade, the IMF offers high conditionality loans.

Here a picture of a deserving borrower is helpful. Perhaps the ideal borrower is typified by an agricultural products exporter-manufactures importer which has had due to weather a brief delay in its obviously bountiful harvests. The real resources to justify sustained foreign purchases are clearly visible--the crops. The immediate shortage of foreign exchange is caused by an exogenous source--weather--rather than by mal-

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5. The mechanics of an IMF low conditionality loan are that the borrower's own currency is exchanged for desired foreign currencies or reserves.

6. More precisely, the shortage of foreign exchange is

functioning government or other institutions in the country.[6] The remedy--better weather--is on the horizon. This country's request for foreign exchange would be granted routinely by the IMF, with the lowest of conditions, say that it please replenish its draw of exchange upon harvest. The mechanism would be a low conditionality loan from the IMF to the country.

Of course, everybody always can find a use for more purchasing power. Countries are no exception. This is the rational argument for the IMF policy to review all requests for financial assistance. Ideally, IMF review--of data prepared by the country requesting assistance and by IMF employees--determines if only transitory assistance is needed to sustain the country's ability to import at desired levels, or if other corrective steps are needed to keep trade viable. Such review might uncover a borrower undeserving of a low conditionality loan: a country facing a permanent rather than a transitory shortage of foreign exchange, if its present economic policies continue. The foreign exchange deficit need not be the country's fault. For instance, the OPEC run up in the price of oil generally worsened the terms of trade of oil importers and transformed prior balance into deficit in international payments of many countries in the mid-seventies. Nonetheless, if the monopoly prices were to be paid (which they were, in fact), steps to conform the economies of oil importers to higher oil prices were necessary. Requirement to take conforming steps underlay conditions of IMF loans to oil importers.

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caused by the regularity of import purchases and the irregularity of export sales (only at harvest). Note that this borrower will be in surplus, and thus be looking to lend reserves from harvest to harvest, on average.

Trade deficits are not often the result of such exogenous shocks, however. More often, a persisting imbalance of payments does stem from a country's economic policies. In such cases, IMF loan conditions seek to change of these deficit causing policies.

IV. Controversies

Controversies abound currently about the aims and the content of IMF practices. Indeed, the IMF and academic collaborators made semi-official response to these controversies in a recent published conference.[7] Although the sense of the conference was that the IMF has done well and will do better, especially if its financial resources and missions grow, the participants did not address the most basic question about the IMF: Is it still needed? Nor did they give the current criticisms full due. So let me here consider the current criticisms each in turn, and then consider what the future of the IMF and the degree of support of IMF aims given by AID should be.

A. High Conditionality Loans

Current dissatisfactions with IMF conditions imposed on high conditionality borrowers stem from three roots: the arrogance of IMF representatives; the inflexibility of IMF conditions; and the inappropriateness of IMF conditions. First, consider the arrogance alleged of IMF representatives.

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7. See John Williamson, ed., IMF Conditionality.

1. IMF Representatives

The typical supplicant to the IMF is in a crisis and in a hurry. The country is running a balance of trade deficit that continued will exhaust its reserves and foreign exchange borrowing power quickly. Unless the country is in very bad economic shape, cooperation rather than confrontation is the strategy most likely to speed IMF processing of loan application and minimize

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8. When the deficit country is in very bad shape, in contrast, there might be little lost from a complete repudiation of foreign debts and temporary disruption of trade. The reason is that the present value of maintaining current trade and international respectability might lie well above the present cost.

That present cost has two components. One is the current value of what must be paid back to keep current respectability, generally a large proportion of the prior borrowings. Typically these were consumed at the time or were put into dams or hydroelectric stations or other projects with little current payback relative to (interest and operating) cost. So the payback of these prior loans must come from future income unaugmented by yields from additions to capital stock. The other present cost is deadweight loss from IMF loan conditions: raised taxes, redistributed incomes, and so on. The present value is the efficiency gain from uninterrupted trade (or, more realistically, less interrupted trade, since some trade will withstand bankruptcy proceedings and so on). But if the country is in really bad economic shape, it probably anticipates having little to offer in trade for quite some time, and so it anticipates little direct present value from being permitted to participate as fully as possible in the international sector. The uncooperative country also loses the present value of further loans that would be made to it if IMF blessed, but generally these are but a fraction of the current foreign payments that the "performing" country must make to stay out of default. And, if lucky, the uncooperative country will lose its airliners as they land and are attached overseas (as these airlines customerily run up losses).

This jaundiced light makes understandable the agreeableness of Mexico and the unageeableness of Argentina to IMF conditions, notably, pay back prior borrowings. Mexico sees a low (transport) cost market for its immense oil flow for quite some time into the future, the U.S., if it cooperates with the IMF. To keep access to that lucrative market, it pays. The cost savings of selling its oil to its neighbor more than repays the cost of paying off the necessary portion of its foreign debt. The oil of Argentina is wheat, which for little added cost can be traded to countries

the undesirability of loan conditions.[8] Classically, the deficit country got to this position by maintaining an overvalued exchange rate in the face of rampant inflation of domestic credit, and has worsened its deficit with a state-run exports (agricultural crops) purchasing authority and imports and exchange controls that cripple domestic productivity.

There is no reason to doubt that IMF representatives respond to this environment of subserviency amidst economic lunacy and chaos by becoming expert and didactic, rather than knowledgeable and assisting. Since IMF technical representatives often are not the brightest or most imaginative, but are better traveled and better paid to a degree to produce envy and jealousy, it is not surprising that the necessity of almost pandering to these arrogant and low quality bureaucrats produces outbursts against the loan conditions which result from the IMF visit.[9]

By insisting that recipients of U.S. foreign aid funds subscribe to IMF conditionality terms, if applicable, it seems that AID is reinforcing the IMF's tendencies to dictate loan terms. Needless to say, such a perception is not totally helpful. It slows economic learning by doing in the affected country, and envelopes the U.S. in the blanket of hostility earned by IMF representatives. These accomplishments do not seem in the inter-

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that do not seek repayment of its foreign borrowings (such as Russia). Thus, the cost of repayment for Argentina is not so clearly offset by the benefit.

9. This was recognized by several participants in the IMF conditionality conference, who noted that often the talents of the IMF representatives were not the top, and called for more interchange and less telling between IMF and country representatives.

est of the U.S. On the other hand, strengthening IMF muscle with U.S. muscle may speed implementation of IMF conditions. If IMF conditions are desirable, then U.S. speeding of their acceptance is in the interest of the U.S. There seems, therefore, no simple obvious conclusion to reach here. Rather, the defensible response to IMF arrogance is that requirement of IMF conditionality for foreign aid assistance should be made after a review of the appropriateness of the conditions. This would improve the conduct and the recommendations of IMF representatives, since lack of approval by the US would be encouraged by country dissatisfaction, which in turn would more surely follow shoddy conduct and poorly reasoned loan conditions.

2. Inflexible conditions

Can something less than detailed review of each set of IMF conditions better their impact? Several IMF policy changes have been proposed to lessen countries' dissatisfactions with the foreign exchange borrowing process. One proposal is to make IMF conditions more flexible. For instance, a typical IMF condition now might read: Over the next six months, domestic credit should grow no more than 25 percent. That is a flat rule, easy to monitor but perhaps more costly to follow than a flexible alternative that might restore trade balance as surely, and at much less cost. A typical contingent IMF condition might be:

Over the next six months, domestic money supply should grow no more than 25% + f(world price level growth) + g(domestic employ-

10. Where f( ) and g( ) are functions determined by the respective values of their arguments.

ment growth).[10]

Making IMF conditions contingent upon independent economic events would make them less risky to the agreeing county, and so it would seem would speed their acceptance and accomplishment. For instance, the above contingent rule would let the country change its rate of monetary expansion in response to changes in the rate of world monetary expansion (as permitted by the f-function), a contingency which reflects that the determinant of the rate of change of exchange rates is the country's relative rate of inflation, not its absolute rate. The country could vary domestic monetary expansion in response to variation of domestic employment growth from that anticipated (as permitted by the g-function), a contingency which reflects that policies to affect external balance often affect internal balance, as well.[11]

There are clear negatives from making IMF conditions contingent upon future events, however. The degree of policy accomplishment will be more difficult to monitor. Even in the United States, economic data are not quickly produced accurately: revisions in quarterly income, money growth, and employment data continue for up to a year, and often are sizable. Those countries likely to look for high conditionality loans from the IMF are much less likely to have accurate data, and impacts from having the countries produce such data would be to expand further the bureaucracies of the high conditionality borrowing countries, so to produce and obfuscate the data, and of the IMF, so to check

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11. Although the Phillips Curve linkage most apparent in the g-function is one of the least credible examples.

the data. In addition, resources of the private sector would be reemployed from production of valued goods and services to production of data. After all this, the data still would be ambiguous, and thus accomplishment of contingent conditions would be harder to ascertain. Divisive demagoguery and endless debate over the minutae of content and accomplishment of contingencies would be encouraged.[12]

Since what a borrower country truly deserving high conditionality terms needs to do is raise exports relative to imports and to raise capital inflow, and since the most direct steps toward these objectives are politically painful, to devalue and to enlarge and to encourage the private sector, perhaps noncontingent conditions whose degree of accomplishment cannot be hidden and whose accomplishment is directly and unambiguously related to the goal of restoring external balance better aids borrowing countries.

In sum, production of the data necessary to measure compliance with contingent conditions would lower productivity in the economy out of balance, and increase the size and power of its government and of the IMF. None of these accomplishments seems in the interest of the United States, which for world economic health would like to see efficient trade and internal production. In addition, if conditions were contingent, AID would have to determine continuously their content, and thus would find itself held responsible for onerous terms, because the onerous-

12. Witness the debate in this country over the meaningfulness and degree of achievement of contingent monetary targets by the Federal Reserve Board.

ness of terms is determined in large part by the definition of the contingency. In reaction, AID would devote more attention to designing and defending contingent conditions itself. In the end, AID would end up embroiled in controversies with the IMF and its debtors that doubtless would more stimulate the growth of bureaucracies than of economic goods and services. Thus, all things considered, simple noncontingent conditions more likely will move constrained economies in the correct direction toward more and freer internal and international trade. The United States should not support moves to make interpretation of compliance with IMF loan conditions explicitly contingent upon exogenous outcomes.

3. High Conditionality

By design, conditions of IMF balance of payments assistance aim at reduction of balance of payment deficit. Common conditions attached to <u>high conditionality</u> loans from the IMF are: devaluation, or lowering the amounts of foreign currencies got per unit of own currency; reduction of the rate of rise of domestic credit (money supply); and deflation, or slowing the rate of domestic income growth. These steps are put into quantitative target goals believed related to the ultimate goal of reviving sustainable free trade: fall in the rate of exchange between domestic currency and the dollar by X percent within Y months; reduction of domestic credit expansion to an X' percent per annum rate within Y' months; reduction of aggregate income growth by X'' percent within Y'' months. The IMF makes subsequent release of foreign exchange to the borrowing country contingent upon achievement of these target goals. The questions at issue are whether the means

advocated to satisfy these conditions are the best, and whether the conditions contribute toward a desirable change in borrowers' economies?

For discussion, agree that the imbalance of payments needs correcting. Then, if the IMF loan is to facilitate restoration of external balance, it must be accomplished by other steps, steps that change some structural part of the economy. If it is not, then it merely prolongs the period of disequilibrium. The theoretical support for the specific structural reform of devaluation is that it raises the domestic price of imports to citizens and lowers the foreign price of exports to foreigners. By doing so, devaluation should raise exports and reduce imports. To be sure, there are complicating questions of how soon and for how long?[13] But a defensible general conclusion is that, perhaps after an initially adverse impact, a devaluation will improve the balance of payments. Consequently, devaluation is a standard requirement in an IMF high conditionality loan.

Slowing in growth of domestic money supply is required, in order to slow the rate of inflation and the concomitant rise in the price of exports and relative cheapening of imports that accelerates deterioration in the trade balance. Increased taxa-

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13. There is some empirical support for an initial perverse effect from devaluation because of locked in prices or wants. This is discussed at the start of the next section. Then, there is worry that income effects might overcome price effects and render a devaluation permanently perverse in impact upon the balance of payments. And there is the argument of the "monetary approach" that the export stimulating impact of a devaluation will ultimately end, when real monetary balances are restabilized. For a thorough discussion, see Anne O. Krueger, Exchange-Rate Determination (Cambridge: Cambridge University Press, 1983), chap. 3.

tion and other deflationary (judged in a Keynesian macro-model) steps are proposed to reduce further pressure toward deterioration of the external balance. Increased and more effective taxation, in addition, offsets the government's loss in spending power from reduced inflation.

B. Conditionality Considered Further

In aim, IMF high conditionality conditions are to restore and maintain current account balance. They would do so in a simple world where the current account is improved by a fall in income and by a rise in the domestic price of imports relative to exports. Unfortunately, that world is too simple. It admits an incomplete description of influences on the balance of payments, current and future. In the real world, so much more complex than the world envisioned in international trade texts, IMF loan conditions have further impacts which are in neither the interest of the United States nor the assisted country to accept.

For instance, consider further the influence of devaluation on the balance of payments. There is argument that the first impact of devaluation is to worsen the balance of payments. The reasoning is that domestic demand for imports and foreign demand for exports do not react immediately to the real price change implicit in a devaluation, so that the impact of the devaluation is to increase proportionately the export of foreign exchange to pay for imports, and to decrease proportionately the import of

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14. A common explanation of this anticipated (and perhaps seen) J-curve phenomenon is that contracts to use imports and supply exports are locked in for a period, so that the changed (by devaluation) domestic prices of tradeables cannot be responded to quickly. See Stephen P. Magee, "Currency Contracts, Pass Through, and Devaluation," Brookings Papers on Economic

foreign exchange in pay for exports.[14]

This means that it is private entrepreneurs who are hurt inordinately by the devaluation. It is private entrepreneurs who are buying imported inputs and selling traded goods, and who do not have the ability to raise prices as easily as the government can raise taxes. It is private entrepreneurs that pay to large extent the taxes raised so that the government can continue its consumption of imports. It is private entrepreneurs who must queue, petition, submit to regulation, and bribe to get needed foreign exchange, and then in inadequate amounts released with delays that drive up the real cost of doing business for the private sector. It is private entrepreneurs who must shift their attention from the production processes that they have mastered to international currency transactions that they have not and (given the monopoly of the government) can not, with consequent reductions in market share and employment.

Thus, a most important side product of government sponsored, IMF assisted devaluation is that who you know in the government gains importance and how well you produce loses importance in determining the payoff from work In consequence, private sector activity declines in importance as a source of employment and as a generator of success. The understanding and respect of the public for private employments are diminished, while the best minds are redirected from production of valuable goods into transfer and rent-seeking.

Activity 1 (1973) pp. 303-325. Tullock suggests an alternative interpretation of the J- curve data: that speculators are dumping the soon-to-be and just-devalued currency in anticipation of devaluation.

Disinflation and deflation impose further burden on private entrepreneurs. To the extent that inflation was anticipated in borrowing and wage agreements, the disinflation raises real costs to entrepreneurs, in the form of contractual repayments that must be made from diminishing nominal revenues. Deflation reduces growth of demand for domestic products, as well as saddles private entrepreneurs with cost-raising additional taxes. To meet loan and tax obligations, and in response to labor's rising real cost, entrepreneurs sell off or scale back productive activities, and so accelerate the growth of public employment relative to private. Entrepreneurs contend with workers that anticipated wages cannot be paid, with polarization of social relations as a likely outcome, as workers in their confusions begin to subscribe to demagoguery. The general public, meanwhile, perceives the instability and lack of opportunity that characterizes the private sector, and further endorses public careers for its children and increased government controls to restore stability in the meanwhile.

Thus, an IMF rescue program can be a perverse program, indeed. The government which by mismanagement and waste put the country into its fix is given a reprieve, IMF credits, so that it need not confess its culpability in the calamity nor retrench. To be sure, the government is forced to accept conditions which slow its progress toward ruin <u>along the path it followed to crisis</u>. But these conditions open alternative paths. The conditions and credits assure its immediate growth relative to the private sector, and its absolute growth in tax and regulatory powers. For the longer run, the populace is educated that in a crisis govern-

ment grows and that private employment is inconstant and shrinking. The populace is taught that notary publics, not engineers, get ahead, and that making deals rather than making truly valued things is the prestigious activity, in sum. If, as is so popular currently, the IMF brings millions in commercial banks' assistance behind it, local politicians are encouraged to exploit xenophobia and anti-Americanism in order to hide further the true impact of the government on the economy.[15]

For the borrowing government, IMF assistance transforms the crisis from an imperative that it mend its ways, to an event that in the short run increases its influence and, properly gamed, in the long run holds promise of being resorted to again. These do not seem to be accomplishments that will benefit the United States, the cause of free and efficient international trade, or the causes of social and economic freedom. Accordingly, AID should not as a matter of routine require IMF conditionality before release of foreign aid funds

C. Argument of the Left

Spokesmen from the left raise a different argument against IMF conditionality: it is too harsh and imperialistic. Charlotte Payer is representative. She argues that IMF conditions to raise taxes hurt the poor who pay and reward the rich who illegally do not. IMF conditions to reduce food subsidies, she alleges, penalize the mass of urban poor, who at world prices can buy less food. IMF conditions to reduce import and exchange controls expose domestic producers to the cutthroat competitive practices

15. Is Mexico a current illustration?

of multinational corporations; these, she adds, do not have the country's interest at heart, but instead press to produce efficiently rather than humanely. IMF loan conditions, in the view of the left, in the short run produce economic hardship and in the long run suck the country into an international imperialist conspiracy bent on taking economic control from citizens and giving it to multinational capitalists. "The IMF is not the real villain.... They are the multinational corporations and capitalist governments which are the natural enemies of Third World independence...."[16]

These arguments are of little merit, although their political popularity requires that they be dealt with at length. The left makes two logical fallacies. First, left-imperialism arguments presume that jobs are naturally scarce and that general poverty is inescapable in developing countries. Only physical resources, such as copper mines and rivers suitable for hydroelectric projects, are valuable resources in developing countries. Accordingly, these few resources must be shared as widely as possible through exploitation with labor intensive production processes, no matter how inefficient. Further, these resources must be husbanded as long as possible, for when they are exhausted, nothing will take their place.[17] These few resources, then, provide the discussion space for the left to

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16. Charlotte Payer, The Debt Trap (New York: Monthly Review Press, 1974), p. xiii.

17. This is the "Small Is Beautiful" argument: labor intensive means of production are not favored in developing countries because labor there is cheap, but because labor there must and always will be cheap, and wrong production processes must be used to give labor a false sense of worth and a claim to income.

convince the world to make the citizens of developing nations into wards of the world. A first step in the program of the left is to redirect IMF loan conditions from pushing developing nations toward free trade, for that holds no income promise for the naturally poor of the Third World. Rather, IMF loans must be retargeted toward sheltering protected production.

There is in the vision of the left no chance that these citizens can manage their own affairs now so as to ensure a bountiful future, and so there is no reason to encourage self-management or freedom or economic efficiency. Indeed, economic efficiency would accelerate the exhaustion of the too few physical resources, and by stimulating consumption unprepare the citizens for their future. Government (management) by coercive technocrats is, if not applauded, at least tolerated, for the left appreciates that only a few have the vision and the discipline to know that without permanent charity and an accommodating willingness to consume only the barest of necessities, citizens of developing countries necessarily will starve.

The world-view of the left is that the number of jobs and the total of incomes from jobs are constant, and are disproportionately distributed in favor of currently developed nations. In this view, jobs and incomes are, so to speak, a random draw irremediably determined by time and place of birth. But the fact of America gives lie to the pessimism of the left. America was the first nation to develop under modern conditions: no divine rulers and cheap international trade. No divine rulers meant that government had to gain the tolerance of the governed through its policies, rather than through appeal to the supernatural. Cheap

trade meant that Americans could specialize in production without having to specialize in consumption. And of course, Americans did specialize. Americans harvested their physical resource, land, extensively, and traded foodstuffs and timber and such for manufactured goods and developmental capital. When local governments adopted excessive rates of taxation and inflation, their citizens were not suckled by an IMF-like conditioned loan.[18] To escape economic lunacy by governments, Americans moved away or reformed offending governments. Reform of economic policies was more drastic and doubtless more hard on the citizenry in the short run. But in the long run it promoted a continuous search for economic efficiency that raised American incomes to the highest in the world. And while wages rose, the number of jobs expanded--so rapidly that huge immigrations came to fill the jobs. And immigrants still come, although the natural resources that set in motion the first immigrations, New England farmland and Great Lakes ore deposits were exhausted long ago. The success of immigrants from varied countries in varied regions of America documents that there is no ethnic prerequisite for ability to progress. The changing nature of jobs, from farming to manufacturing to services and thinking, shows that there in no physical endowment prerequisite for ability to progress.

Economic theory codifies the American experience. It is

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18. The mid-seventies "bailout" of New York City was an IMF-like loan. Like an IMF loan, it slowed and redirected the economic decline of New York City. Also like an IMF loan, it expanded the rent-seeking sector at the expense of the public sector--with a notable success with Chrysler. These suggest that it is only America's past that illustrates the benefits of economic efficiency; America's present illustrates the growth of rent-seeking.

where resources are distributed most unevenly that free trade and investment have the highest payoff. A country with abundant supplies of untrained labor can in the short run raise wages dramatically by encouraging the importation of managerial techniques and physical capital that make labor more productive, and in the long run further increase wages by encouraging citizens to acquire human and physical capital. That encouragement is given when ownership to the fruits of labor and capital are secure at law, and are only influenced by capabilities for seizing opportunities <u>un</u>influenced by access to government. That is, when it looks like that participation in the economy is a fair gamble with much chance of reward. Then citizens are encouraged to save and to produce, rather than to scheme against the public interest.

Clearly, the jobs-scarcity pessimism of the left is wrong. It is precisely in a developing country that opportunities are most abundant for labor to improve its lot. Only sustained governmental mismanagement--in the form of bars to free internal and external trade, prohibitions on import and use of managerial and physical capital, and confiscatory taxes--can turn an undeveloped country into a non-developing country. To the extent that IMF credits and conditions sustain government mismanagement, they ought not to be encouraged.

V. Other Issues

A IMF Expansion

In addition to extending its credits and authority helter skelter in the developing world, recently the IMF has sought (and won) expansion of its lending ability, has encouraged use of credits in first rather than last resort, has sponsored consortia of commercial banks, and has begun to rationalize the making of what essentially are project loans made traditionally by the World Bank. The reason for this burst of innovation is clear: flexible exchange rates obviate the need for the IMF. Exchange speculators and fluctuating rates now manage the imbalances in foreign exchange experienced by trading partners. For its continued existence, the IMF needs to open new markets.[19]

To employ its staff and place its funds, it must seek new recipients. What better recipients than the perennially needy, the mismanaged state-dominated developing economies. These economies typically are so mismanaged that they can absorb without trace immense amounts of foreign exchange and technical expertise. Defensible suggestions for economic reform are easy to make, and therefore are not risky; for instance, abolish the agricultural marketing board and let farmers earn world prices for their crops is a step toward efficiency that no outside reviewers will quarrel with. And a half-step (as it will be, after negotiation with the government) toward freeing up the

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19. That the IMF is branching into its traditional market seems to be the conclusion reached by the World Bank, which in counterattack has begun to make foreign exchange loans for balance of payments purposes.

economy may relieve political unrest and slow the sinking of the economy, but it will not stop it. Internationally sponsored projects in these countries experience cost overruns and production shortfalls continuously.; Hence, such are guarantors of future assistance need.

The aim of the new policies drive of the IMF, in short, is survival. But the accomplishment of these new policies does not on balance stimulate efficiency in international or domestic trade. Because they expand the size and to the most talented the attractiveness of government employment, these new policies are not a priori in the interest of the US. Consequently, there is no justification for encouraging IMF success and expansion by requiring agreement to IMF conditionality terms as a precondition for disbursement of foreign aid funds.

B. Financial Crisis

There is truth that repudiation of commercial banking debts by any of several Latin American borrowers would bankrupt several huge American and European banks. This would severely penalize bank owners. But it would not necessarily penalize American companies or citizens, or (besides a few days inconvenience) the world economy. The reason is that American banking authorities have the ability to replace lost dollar liquidity instantly.[20] Since the dollar is in fact the international currency, such replacement replenishes international liquidity. Indeed, a spectacular failure would put the international banking community on

20. The FDIC insures all bank deposits up to $100,000 by law and above that by custom, and the Federal Reserve Board can print currency as wanted.

notice that to hold hope of repayment, loans must be made for productive projects.[21] This would redirect commercial lenders from governments to private borrowers, which would encourage growth of the private sector at expense or the public sector. So, the conclusion remains that AID's muscle would find better use in encouragement of internal and external opening of developing economies, which in turn would be served by phasing out the now superfluous IMF and its tortuously negotiated and resented conditionality.

C. Can Flexible Exchange Rates Work?

Yes is the short answer. Nothing else will is the long answer. The advantage of currency, a medium of exchange, is that offers can be made and accepted after reckoning the exchange against general benefit. Thus a large sale of a specific good has the benefit per unit times the (large) number of units sold, while the small sale has the same benefit per unit times the (small) number of units sold. There are no diseconomies of scale with currency. In contrast, to trade good for good requires one either to like or to carry the good taken in trade. Generally, liking diminishes and carrying cost rises per unit as a person gets more of one good. Thus, without currency, we expect less trade, and therefore less benefit from production.[22]

But currency fulfills its role of letting trading calcula-

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21. Unlike the takeover by the FDIC of Continental Bank, which by silence and by generous insurance payoffs is keeping depositors and other bankers unalarmed.

22. This is a rephrasing of the double coincidence indictment of barter presented early in the paper.

tions be reckoned in general benefit only if it is predictable in value. So the issue is what means will keep at least one currency useable for international exchanges? A gold standard probably would not, because of potential fluctuations in supply. A more inclusive multiple-commodity standard might have more a stable supply cost, but its real cost would be great, and its complexity would preclude trust and thus acceptance by traders.[23] Fixed exchange rates administered and enforced by an international agency will not succeed. That is what the world had from 1945 until the end of the seventies. The temptation of governments to bend exchange rate obligations proved too great over that period. Now that there are more countries of more equal political and economic weight, the bending of obligations would come faster.

Flexible exchange rates give countries less obfuscation behind which to hide systematic manipulations of their currencies. The potential competition between yen and dollar to be the international currency promises to offset political pressures for accelerating inflation in each of the countries, and thus give the world two media of foreign exchange most of the time, and one all the time. Thus, I think that a flexible exchange system will work. I know that the alternatives will not. Flexible exchange rates, to repeat, render unnecessary an IMF.

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23. Witness the difficulty adherents such as Robert Hall and Leland Yeager are having trying to convince economists how this abstract concept would work.

VI. Conclusion

My argument, then, is that IMF conditionality misapplied lets governments escape the consequences of wasteful and inappropriate policies that without IMF reprieve would force reform. A government cannot subsidize imports and punish exports with an overvalued exchange rate if it has no foreign exchange. A government cannot reduce the size of the private sector and expand its own size and scope if it has no source of income. A government cannot keep the support of its citizens if it is clear that the economic policies of the government bring penury and ruin.

The IMF in its desire to remain influential extends financial support to governments that have forfeited valid claim for that support. By extending credits where it should not, the IMF sustains and perpetuates economic policies that promise further poverty and waste, and legitimates the authors (governors) and means (state economic controls and industries) of impoverishment. By substituting credits for taxes and sustenance raised domestically, the IMF removes citizens' peaceful means of self-reform, which is their withdrawal of economic support for their government. High conditionality IMF credits to such governments surely are not in the interest of the citizens of the recipients, nor in the interests of the citizens of the United States.