CHAPTER II

THE INTERNATIONAL MONETARY FUND (IMF) ESTABLISHMENT AND CONTRIBUTION

This chapter describes about International Monetary Fund (IMF) objectives, origin, conditionality and country quota in the IMF, and IMF decision making process.

A. The Establishment of International Monetary Fund (IMF)

The idea of establishing a global financial institution such as IMF was driven by several events. Those are namely the Great Depression and World War II. In the beginning of 20th century, the Great Depression occured and it made the whole global economy suffered and this happened in 1930s while the world was also having a great war. Since the global economic system rapidly fell apart, it led to a big effect on international trade. Thus, many countries were experiencing the reduction in standard of living as a result to a huge unemployment.

During World War II, the Anglo-American were putting their focuses on increasing demand and creating an international institution that could take care of international finances, cooperation, and international trade (McQuillan, 2017). At that moment, the United Nations became the platform or the place where these non-communist countries gathered and held meetings in order to talk about global issues until July 1944. They created a conference in New Hampshire.

The Bretton Woods system was originally drafted and proposed by Harry Dexter White, an American economist and a senior United States Treasury department official, and John Maynard Keynes, a British economist. Both men agreed that the economic problems of life in times of war could only be avoided through international economic cooperation in the future (Bernstein, 1984). According to White, through the establishment of mechanism or stabilization it would create a currency stability in the world and avoid the recurrence of devaluations. Keynes (1994) proposed the idea of international clearing union which supposed to solve the problem of a shortage of cash flows. His original plan later became the core of the International Monetary Fund establishment (Skidelsky, 2005, p. 15).

The Bretton Woods conference mainly discussed about the projects that enabled the International Bank for Reconstruction and Development (IBRD) to use long-term funds that urgently need such external assistance and the International Monetary Fund (IMF) to fund international short-term imbalances payment to stabilize the exchange rate that formulated the project. In the Bretton Woods exchange rate method, all currencies are linked to the dollar, the dollar is associated with gold. To avoid speculation about currency equality, capital flows are very limited (Buttonwood, 2014).

The United States policy makers in the interwar period gained lessons and provided information to institutions created at the meeting. Officials such as President Franklin D. Roosevelt and Secretary of State Colder Hull supported the belief that free trade promotes international prosperity as well as international peace. The experience of the 1930s certainly suggested much. Policies adopted by the government to combat the Great Depression, High Tariff Barrier, Competitive Currency devaluation, and Discriminatory Trade Blocks contributed in creating an unstable international environment without improving economic conditions. Utilizing this experience, international leaders concluded that economic cooperation is the only way to achieve domestic and international peace and prosperity (State, 2009).

Figure 1 The International Monetary Fund Logo

The IMF officially existed in December 1945 and the first 29 countries signed this agreement. It started in March 1, 1947. In order to join the membership in IMF, the country has to be a prospective controlled member country with their foreign affairs, and must be prepared and trained to fulfill the obligations of membership according to the IMF Article of Agreement. Under these obligations, the member shall apply the exchange rate policy of the economic, financial and related policies in accordance with the Article. Furthermore, the country also has to provide requested economic and financial information to the IMF (Primorac, 1991, p. 34).

In the late 1950s and 1960s, as a request for independent membership of several African countries was made, IMF members began to expand. However, the Cold

War was limiting the number of members in the fund. Therefore, most of the countries of the Soviet bloc did not participate (IMF, 2017).

B. The Objectives and Functions of International Monetary Fund

The founder of IMF was seeking to build a framework for economic cooperation that would avoid the repetition of the catastrophic economic policies that contributed to the Great Depression of the 1930s and the ensuing global conflict. Since then, IMF was able to create a dramatic change globally, bringing widespread prosperity and lifting millions out of poverty. In general, the main objective of the IMF is to bring the global public good of financial stability.

There are six objectives of IMF according to Article 1 from the Articles of Agreement (IMF, 2016, p. 2):

1. to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems
2. 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
3. to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation

4. 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
5. 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
6. in accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members

Each objective of IMF above shows the ability and the willingness of IMF in preventing each of its country member and even the global economy from huge economic crisis (Great Depression) and tend to lift up the number of prosperity internationally. Thus, through these objectives, it could be described that IMF has some important functions.

Essentially, the main function of IMF is to supervise or to monitor the international monetary system. However, there are three principal functions and activities of IMF which will be delivered more detail and show how this international governmental organization runs (Sanford & Weiss, 2004):

1. Surveillance

Through the Article IV agreement, IMF individuals consent to team up with the Fund and members to guarantee the coordination of trade courses of action, and to advance a steady arrangement of trade rates. IMF is seeking after a monetary and budgetary strategies that will deliver deliberate financial development with sensible value dependability to keep it away from whimsical interruptions in the global money related framework, not to control their trade rates to achieve unjustifiable upper hand or move monetary weights to different nations, and to take after swapping scale approaches good with these responsibilities.

According to Article IV, “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.” In this way, countries are required to give the IMF data and to counsel with the IMF upon its demand (IMF, 2016). The IMF's reports on its yearly Article IV agreement with every nation are exhibited to the IMF official board alongside the staff's perceptions and suggestions about conceivable changes in the nation's financial approaches and practices.

2. Financial Assistance

At the point when IMF member states are having battles in Balance of Payment (BoP), through the capital record or current record emergencies, the IMF may give credits to enable them to balance out the circumstance and take international payment changes in strategy that are adequate to turn around their circumstance and conquer their issues.

The IMF must make its material accessible to guarantee that countries utilize their assets. It will be transitory and that the advance will be reimbursed. To accomplish this objective, the guarantee of the fundamental financial changes, the store separates the dispensing of credits in segments and requires satisfaction of particular monetary conditions proceeded with payment of IMF reserves (Sanford & Weiss, 2004).

3. Technical Assistance

The IMF's Technical Assistance division assumes a key part in the usage of the IMF's advancement arranged system. Many sub-offices are revealing expanded interest for help with zones, for example, government straightforwardness, consistence with global benchmarks and codes, fortifying local money related frameworks and neediness decrease. Request has been particularly incredible in the ranges of financial strategy and organization of specialized help. Notwithstanding helping countries configuration fitting financial strategies, the last regions enable them to construct the establishments expected to help and actualize them.

C. Conditionality

When a country is in need of financial assistance from the IMF, its government must agree in adjusting its economic regulations to cope with the struggles which conduct it to look financial aid from the international community. The loans conditionality also attends to confirm that the country will be able to reimburse the Fund. Thus, the resources can be prepared for those members who are in need. The Fund is on its way concerning about the monetary and money related issues of individual nations, and also with the working of the worldwide fiscal framework. Its exercises are centered on advancing arrangements, procedures through which its individuals can accomplish adjust of installments practicality on individual basis and cooperate to guarantee a steady worldwide monetary framework and maintainable financial development of the world economy (Stone, 2008, p. 598).

Conditionality in IMF intended to overlay both the design of IMF supported programs. Those are the macroeconomic and structural policies. Moreover, the particular means used to supervise improvement the objectives elaborated by the country which cooperated with the IMF. Conditionality will help countries in solving balance of payments problems without applying to quantify the loss to national or international welfare. Together, the measures are implied to maintain IMF resources through the guarantee of the country's balance of payments which will be potentially strong to permit it in reimbursing the loan. All conditionality within an IMF supported program has to be "macro-critical" means that both critical to the achievement of macroeconomic program objectives and significant for the execution of particular provisions within IMF's Articles of Agreement (Drazen, 2002).

The financing features settlement in the IMF are mostly made in installments that are connected to evincible actions of policy. This action meant to make sure the development in the implementation of its program and to decrease loss or risks to the IMF's resources. The program analyses will offer a structure for the IMF's Executive Board to evaluate occasionally if the IMF's supported program on the right track and if amendments are notable in realizing the program's final goals. However, this conditionality is seen as the core to IMF lending, purposed to confirm a borrowing country that if it takes certain well-specified actions, perpetual financing will be forthcoming. Hence, it is seen as allowing the country to invest in longer-term policy adjustment by making them sure that if they do so, IMF financing will not be deducted.

Consenting to IMF contingency is a burden on a nation despite the fact that the two may have similar targets outer feasibility, value soundness, managed high development, lessened foundational hazard, etc. Certainly, the contract in the credit assertion required by the IMF is much more perplexing and has unexpected attributes in comparison to pledges in less difficult private money related exchange (Khan & Sharma, 2003, p. 233).

The IMF's conditionality associated with the loans are known for the macroeconomic conditions in order to decrease the budget deficits, devaluation, and decrease domestic credit expansion, and structural conditions like freeing the prices that were being controlled and interest rates, reducing trade barriers, and making privatization for state enterprises (Easterly, 2003, p. 364).

These are some general conditionality for the debtor country to fulfill before finally receiving the financial assistance from the IMF (White, 2013):

- balance of payments deficits reduction through currency devaluation
- budget deficit reduction through higher taxes and lower government spending, also known as austerity
- restructuring foreign debts
- monetary policy to finance government deficits (usually in the form of loans from central banks)
- eliminating food subsidies

- raising the price of public services
- cutting wages
- decrementing domestic credit

Moreover, long-term adjustment policies usually include:

- liberalization of markets to guarantee a price mechanism
- privatization, or divestiture, of all or part of state-owned enterprises
- creating new financial institutions
- improving governance and fighting corruption
- enhancing the rights of foreign investors
- focusing economic output on direct export and resource extraction
- increasing the stability of investment (by supplementing foreign direct. investment with the opening of domestic stock markets)

D. Country Quota and Decision Making Process in the IMF

In the IMF, conditions could be different based on their relative power in the international economy measured by the country member's current account transactions and Gross Domestic Product (GDP) (IMF, 2017). This can be called as the country's quota. The country's quota could determine the amount of allowance that the debtor country could get from the IMF. The bigger they invest, the bigger financial aid they can get. The quota will also show how powerful the country is in the IMF since the quota will indicate the voting power in the making of IMF decision.

The Fund's liquidity has the same balance to the amount of the contributed capital and the member's quota. Gold, currencies and Special Drawing Rights (SDRs) can be contributed by the IMF's member to determine its quota. It is claimed by the IMF that it will comply the fundamental of nondiscrimination in setting both member's quotas and voting shares.

Table 1 Sample of IMF executive directors and voting power

Member Country	Votes by country (250 votes per member +1 for each SDR contributed to IMF funds)	Percent of Total Fund Votes
United States	341743	17.11
Japan	133378	6.14
Germany	130332	6
France	107635	4.95
United Kingdom	107635	4.95
Russia	59704	2.75
Saudi Arabia	70105	3.23
China	63942	2.94
Egypt and 12 other Arab countries	64008	2.95
23 African Countries	25169	1.16
Other	1103651	52.18

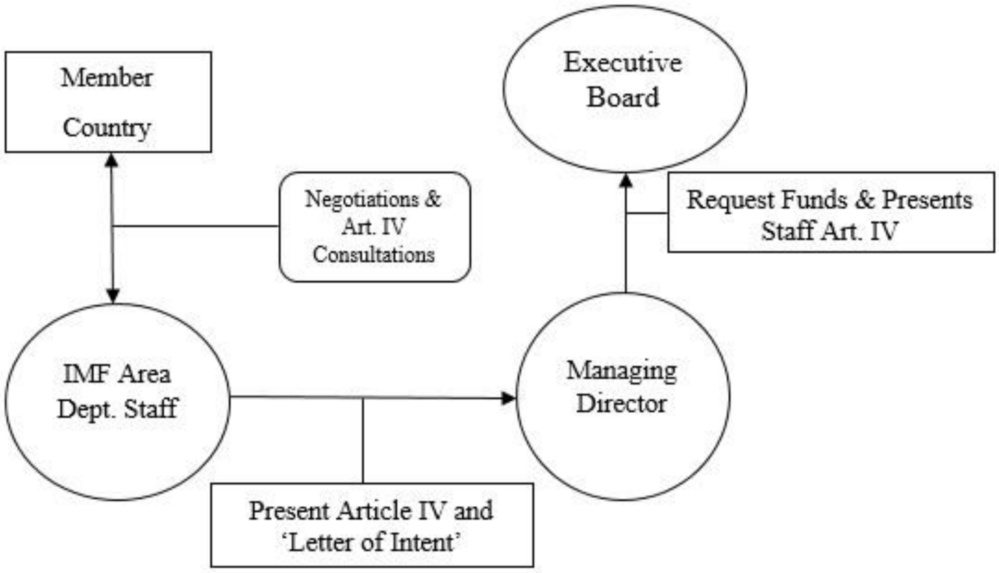
Source: (IMF, 2016).

The IMF Executive Board's decisions are based on the amount of voting which represent a member's quota. The member has 250 basic votes each and an extra vote for every 100,000 SDRs contributed to its quota. It can be seen that the United States supplies the largest amount of contribution or subscription to IMF funds among any other states, and hence it takes hold of the biggest voting strength (17.11%). There is a distinctive gap in voting power between the United States' and another member states. In order to prove the range in voting power, through the judging of Sub-Saharan and other African countries which indicated only by one Executive Director or one representative and merged the voting power up to 1.16% of total fund votes.

The IMF Articles of Agreement stipulates that choices including endorsement of individuals' assertions and relating conditions require a larger part of IMF votes (IMF, 2016). Critics of the Fund, in this way, have recommended that the skewed circulation of vote’s guarantees industrialized nations' strength in all parts of basic leadership, particularly in the outline of credit conditions. Suitably, poor and indebted countries which substantially use the funds’ resources are having a minor voice in the decision making of IMF.

In order for a country to ask an assistance, the member country has to negotiate due to the terms and conditions of its agreement with the IMF staff. Then, the IMF staff will organize the annual reports, based on Article IV Consultations which carry preconditions that need to be fulfilled before initiation of an agreement.

Figure 2 IMF Decision Making Process



Source: (Momani, 2004)

For each country, the preconditions can differ since it was adjusted on a country-by-country basis, even though the IMF acknowledge that resemblance occurs. The IMF staff will examine if the agreements' preconditions have been met as part of the yearly Article IV Consultations. Once the member expresses the detailed prior conditions from the staff based on the Article IV reports, later it can finally see financial assistance from the IMF funding using a Letter of Intent. Throughout the parley, there will be types of conditions which will be designated by the IMF staff, also showed as 'policy understandings' that are required to comply the Fund's stipulation (Riesenhuber, 2001). Both the member state and the IMF staff work tightly together to design a Letter of Intent that will be submitted by the member to the Managing Director. Then the Managing Director will assign if the

Letter of Intent is suitable, yet it is still under the consideration of advice from the IMF staff.

The Managing Director brings out the IMF staff's proposals and the member's Letter of Intent to the Executive Board, and demands funds on the importance of the member. The Managing Director encourages the Executive Board to accede the Letter of Intent since the proposed agreement is based on Staff recommendations (IMF, 2009). The IMF Annual Report (1998) stated that "The Executive Board carries out its work largely on the basis of papers prepared by the IMF agreement and staff". Finally, the final decision will be taken by the Executive Board members though voting system based on countries quota.