



drishti

IMF Bailouts: Are They Really Effective?

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The article "[IMF bailouts: Are They Really Effective?](#)" that appeared in The Hindu Business Line on 30th May, 2019. It talks about the nature and impact of IMF bailouts for the member countries.

Pakistan is an IMF addict. The country has already spent 22 of the past 30 years in a dozen different IMF bailout programs. Again it finds itself in a macro-economic mess, that made it plead with **International Monetary Fund (IMF)** for a \$6-billion bailout package, conditional on macro-economic adjustments by the government.

The repeated cycle of bailouts and inability to reform structural economic problems by Pakistan, questions the effectiveness of IMF bailouts.

What is the role of the IMF?

- IMF plays a central role in the management of the balance of payments crisis and international financial crises.
- Countries contribute funds to a pool through a quota system from which countries experiencing the balance of payments problems can borrow money.
- As of 2016, the fund had SDR 477 billion (Special Drawing Rights: the currency of IMF).

What is the Balance of Payment crisis?

- The balance of payments includes all external visible and non-visible transactions of a country.
- It comprises of:
 - Current Account (Balance trade + Balance of invisible)
 - Capital Account (net flows of capital investments from the domestic economy and foreign economy in forms of FDI, FII etc.)
 - Forex reserves
 - Reserve Tranche position: The difference between a member's quota and the IMF's holdings of its currency.

What is the Effectiveness of IMF bailouts?

- Two contrasting cases can be discussed in this context
 - Tequila Crisis of Latin America of 1994
 - East Asian crisis 1997
- **Tequila Crisis of Latin America of 1994**
 - It is the effect of the Mexican economic crisis on the South American economy.
 - **It happened due to the Tequila effect.**
 - **The Tequila Effect: Due to a sudden devaluation of the Mexican peso, which caused other currencies in the region (the Southern Cone and Brazil) to decline as well.**
 - The IMF has extended multiple bailouts to these countries to tackle hyperinflation, speculative capital outflows and plummeting growth in lieu of austerity measures.
 - After a phase of temporary recovery, these economies continued to plunge in and out of crises.
 - This happened because the majority of countries had military rulers which got elected on the basis of populist economic commitments
 - **Populist economic policies: Policies that are Good politics but Bad economics.**
 - Clearly, these countries are marred with poor fiscal prudence and economic mismanagement.
 - This led to the failure of IMF bailout packages.
- **East Asian Crisis 1997**
 - The crisis originated in Thailand following a stark devaluation of Thai baht,
 - It was the result of overheating in the economy, stock market bubbles, external deficits etc.
 - Also the slump in global export demand in the EU, Japan etc. negatively impacted South-East Asian exports.
 - All these led to a reversal of market sentiment, massive capital flight and bank-runs triggering a currency crisis
 - The IMF stepped in to bail out South-East Asian economies, in lieu of reforms. Within a few years, these economies restored growth to pre-crisis levels, as the East Asian crisis was more of irrational self speculation by South-East Asia economies than major fundamental flaws in macro-economic management.
- **India's 1991 Balance of Payment crisis:**
 - India was also bailed out by IMF, but India not only repaid IMF loans very soon but went on to become one of the fastest growing economies.

IMF bailouts are therefore not insurance against economic crisis, they are just like a painkiller, its effectiveness depends on certain **factors influencing macro-economic fundamentals**. For example:

- Economic policy must be driven by growth strategies rather than macro-economic populism
- The nature of the economy's growth model is also critical as it determines the vulnerability of the economy to external shocks. Factors that play a critical role in this :
 - Growth was driven by domestic savings or foreign capital,
 - Reliance on the manufacturing sector or natural resources.
- Political stability and quality of governance are very important for continuity in economic policy.
 - Rule of law continues to be the central pillar for implementation of any public policy.
- Also, there should be no mismatch between the IMF loan and conditions of structural adjustment imposed on the crisis-ridden economy.
 - As the IMF bailout package is short-term in nature, but the structural adjustment is a long-term commitment.

Apart from the debate of effectiveness of IMF bailouts, IMF as an institution is due for reforms as demanded by new economic world order.

Quota reforms of IMF for long are required for the representation of emerging economies that will be in line with their growing relative economic position in the world,

Why Quota reforms are needed?

- The IMF's quota system was created to raise funds for loans. Each IMF member country is assigned a quota, or contribution, that reflects the country's relative size in the global economy. Each member's quota also determines its relative voting power.
- This makes wealthy countries have more say in the making and revision of rules.
- This leads to the problem where countries that grow economically have tended to become under-represented as their voting power lags behind. For eg: BRICS countries.
- Also, there is tension around governance issues because of these two groups: creditors and borrowers
 - The developed countries are like creditors which provide the financial resources but rarely enter into IMF loan agreements
 - The developing countries are like borrowers, as they use the lending services but contribute little to the pool of money available to lend because their quotas are smaller.
 - **This institutionalizes borrower subordination and creditor dominance.**
- Thus, in 2010 International Monetary Fund's (IMF's) **Quota and Governance Reforms** had been drafted; which finally became effective in 2016.
- The reforms that it undertook are as follows:
 - These reforms shifted more than 6% of the quota shares to emerging and

developing countries from the US and European countries

- Under this **India's voting rights increased by 0.3%** from the current 2.3% to 2.6% and China's voting rights increased by 2.2% from current 3.8% to 6%.
- The combined quotas or the capital resources of IMF also have doubled due to reforms to \$659 billion from the earlier \$329 billion
- The voting power and quota shares of the IMF's poorest member countries will be protected.
- Also for the first time, the IMF's Executive Board will consist entirely of **elected Executive Directors** and it **ends the category of appointed Executive Directors**.

Though for the first time BRICS countries featured in top 10 quota holders, still IMF quota is far from representing the true economic image of the world

- For Eg: Africa which is continent of hope, that will propel the next phase of economic growth in the world, doesn't get representation in IMF quota
- Due to this China sought to form its own economic world order challenging Bretton woods institution like the world bank and IMF
China does this by establishing a New Development Bank, Asia Infrastructure Investment Bank etc.

Conclusion

Neo-liberal world order is represented by 3 pillars i.e. World Trade Organization (WTO), IMF, and World Bank which emphasize on free trade, but today's global economic scenario faces challenges like protectionism, trade tensions and tightening of financial conditions. In this context the world not only needs more democracies but democratization of international economic order.

Drishti Input:

The IMF's resistance to reforms and failure to include aspirations of emerging economies has led to rise of new institutions like New Development Bank, Asia Infrastructure Investment Bank. Discuss.