THE IMF'S TRANSITION FROM KEYNESIANSIM TO MONETARISM AND ITS CONSEQUENCES

ROSS REYNOLDS

Senior Sophister

In this essay, Ross Reynolds examines the progression of the International Monetary Fund from its Keynesian beginnings to the Monetarist nature it employs today. He considers how effective the organisation has been in fulfilling its original aims and the resulting consequences for the world economy, in particular developing countries. He concludes that acting in a more advisory role, with less emphasis on US interests and international intervention, could lead to a more effective organisation.

Introduction

The world was a different place in the summer of 1944 when John Maynard Keynes and Henry Dexter White first met at Bretton Woods to discuss the beginnings of what is now known as the International Monetary Fund (IMF). The world was at war. The great depression had occurred only ten years previously. Economics had only recently been shaken by the publication of Keynes' classic *General Theory* in 1936. There was no talk of globalisation, or the environment and the world had not been engulfed in the storm that is information technology.

These men met to create an organisation that would help the world to grow. This organisation would be given key responsibilities; promoting international monetary cooperation, facilitating international trade, lending to those with short-term balance of payment difficulties, encouraging economic stability, promoting exchange rate stability and the establishment of a multilateral system of payments.

The main question this essay will seek to answer is - how successful has the IMF been in achieving these goals set out over sixty years ago? Has the Keynesian doctrine that heralded the beginning of its existence been changed? If this is the case, do new policies give the IMF a legitimate chance of reaching the goals it set out in its Articles of Agreement?

The Beginning to the Washington Consensus

Keynes arrived at Bretton Woods with a radical plan for an IMF equal to half the world's imports, a world central bank with its own reserve currency and the ability to create sufficient international reserves where needed (Power, 1995). Balance of payment deficits would be financed by taxes on surpluses in other nations meaning a reduction in debt problems. It would act as a countervailing balance to US economic power.

In fact Keynes' plans were diluted by White's own formula for the IMF and further still by US support for White, i.e. the IMF would promote trade in a way to preserve the central role of the US in international finance (Boughton, 1998:4). However crucially, the IMF was set up to deal with problems using Keynesian economic ideas. Keynes' central beliefs were that macroeconomic equilibrium is consistent with involuntary unemployment and that national income depends on the volume of employment. He hypothesised that markets alone are insufficient and the state should have a prominent role in guiding output and employment to their optimum levels. (Snowdon and Vane, 2005:58) Consequently, the government should be encouraged to use counter-cyclical fiscal policies, i.e. deficit spending in recession and limiting of inflation in boom times. All this was given a short-term focus, as Keynes famously believed that "in the long run we are all dead" (Keynes, 1971:65). Thus the institution was set up to pressure countries into striving for full employment and to provide liquidity to countries facing downturn. The IMF was an institution set up to deal with *market failure*.

So what of today, has the IMF changed its philosophy and policies? It would seem so. Many refer back to the early 1980s when Margaret Thatcher and Ronald Reagan took power in the UK and US and preached a free market mantra (Palast, 2002:149). The result for the IMF was the implementation of the now much-derided 'Washington Consensus'.

The encompassed ideas changed the nature of the IMF from an organisation attempting to correct market failure, to one preaching the values of free markets. Despite the Washington Consensus being based on an implausible model of a market economy that assumes perfect information, perfect competition and perfect risk markets (Stiglitz 2006:28), this set of guidelines was quite literally taken as fact by the IMF. The Washington Consensus consisted of a few main policies that countries who borrowed from the IMF had to implement as part of 'Structural Adjustment Programmes' (SAPs), or more recently 'Poverty Reduction Growth Facility' (PRGPs).

Under the Washington Consensus countries are required to:

- Privatise state companies
- Liberalise capital markets
- Employ a market pricing system
- Deregulate trade
- Cut balance of payment deficits (Hanhel, 1999:52)

The IMF and Monetarism

These policies are clearly opposed to the fundamental values Keynes espoused in 1936. Keynes believed in concentrating on the short run; spending in order to stimulate an economy in recession and for the government to have a large role in aiding economy to reach full output and employment. New Keynesians also add real-world imperfections into the mix, for example imperfect information. (Snowdon and Vane, 2005:360) The policies engaged in by the IMF can arguably be traced more to Monetarism then to Keynesianism. Monetarism is built upon the notion that the market is stable in the absence of unexpected changes in the money supply, meaning no government intervention is required. Monetarists see the supply and demand for money as the primary means by which the economy is regulated and that economies should focus on *price stability* as the main objective. (Snowdon and Vane, 2005:173). The IMF seems to have subscribed to this view of price stability, as it pressures countries to raise interest rates in order to reduce inflation. (Stiglitz, 2002:96)

Monetarists argue that restraint of government spending is the most important target to restrict excessive monetary expansion, which invariably results in inflation. Here we can see a huge convergence with IMF policy that has made reducing government spending and cutting balance of payment deficits a cornerstone of its programmes. Cutting government spending has often resulted in increased poverty and suffering for the poorest people in developing countries. In the case of Malawi in 2002, the IMF forced the country to sell its surplus grain supplies for foreign exchange just before famine struck. Out of necessity, the government imported food from abroad. However this move out the country off-track in cutting its balance of payment deficit, and so the IMF suspended aid to the country. (Petifor, 2002)

This has led some economists to tar the IMF with same brush as monetarists, criticising "the disciples of Milton Friedman and of radical market reforms, who paid little attention to the social and distributional consequences of policy." (Stiglitz, 2002:167)

IMF Policy- Success or Failure?

> Many of the policies that the IMF pushed…have contributed to global instability. (Stiglitz, 2002:15)

Many academics are of the opinion that the IMF's new policies have done more harm then good, particularly in the last 20 years as the IMF has made lending to help solve balance of payment problems its main focus. So why is this?

The IMF and Politics

An organisation such as the IMF, which was born to concentrate on global monetary matters to benefit all, should not be used in any way as a political tool; in fact, this is not the case. During the formation of the IMF in 1944, the US received 17% of voting rights. As an 85% minimum was required for major voting decisions, the US was effectively given a veto. US dominance does not end there; there are many examples of blatant policymaking in US interest:

1. In Russia in 1995 the IMF insisted on instant privatisation despite the certainty of such a move resulting in corruption and money being smuggled from the country. Added to this was a large loan just before elections were held. This did not act in the interests of the Russian people, yet it helped get the White House-approved Boris Yeltsin re-elected, by postponing the onset of huge amounts of inflation and the subsequent economic collapse. (Stiglitz, 2002:242)
2. On many occasions the IMF has been accused of 'bailing out' Western banks when debtors appear unable to pay. For example in Argentina in 2001 a $20 billion bailout package was given to the country. However as Argentina owed $128 billion, between the interest owed and the 16% risk premium charged, the amount due was $27 billion. The money never left Washington and went directly to the Westernbanks. (Palast 2002:160)

With this in mind, how can the IMF profess to be trying to achieve the goal of international monetary cooperation? If it does not function as a multilateral institution but rather as one acting in the monetary interests of the US, then this is simply an unreachable target.

Conditionality

This refers to the stipulations forced upon countries in order to qualify for an IMF loan, i.e. SAPs (or PRGPs as they were renamed) due to the Washington Consensus. The IMF has been criticised for blindly applying the same criteria to all countries and crises. There is overwhelming evidence to back up this claim (Mussa and Savastano, 1999).

It seems that “any country capable of meeting such stringent requirements is already a developed country themselves” (Naím, 2000:92). In other words a developing country does not have the monetary and banking structure or quality of institutions to succeed in implementation, meaning IMF reforms often perpetuate poverty and inequality (Welch, 2000). One wonders how Less Developed Countries (LCDs), many of which depend on agriculture and natural resources for income, benefit by allowing competition against highly subsidized US and EU food markets for example? The type of trade is crucial to LDCs. They need to end their dependency on the primary goods that some have relied on for the past thirty years. This critical point is not addressed by the IMF (Lockwood, 2005). In no way is this the ‘balanced growth’ set out as a target by the IMF; balanced growth is gradual and, as history shows, begins in the domestic market. When new competition from abroad and reduced government spending are taken into account, the likelihood of growth is limited.

The most successful developing countries, such as China, began by building their economies behind protectionist policies before slowly and cautiously opening their doors to the world. This is the exact opposite of what is preached by the IMF and echoes a return to Keynes’ concept of intervention.

The Never-ending Cycle

The integral problem is that, despite IMF programs actually reducing growth rates (Dreher and Veubel, 2004), countries have no choice but to accede to IMF demands. Once indebted, it is impossible to raise funds anywhere else without accepting IMF conditions; the alternative is being frozen form the world economy. There is in fact a positive correlation between the number of conditions per program and the prior use of credit (ibid:26). These countries are stick in a vicious cycle; the longer they borrow from the IMF the less chance they have of overcoming debt problems, increasing the power of the IMF over these countries.

The only policy to negate this is to build up reserves to avoid the use of the IMF. This can be seen in East Asia where countries are wary after the policies that exacerbated the crisis in the late 1990s. Other countries such as Brazil and Argentina are fully repaying their loans ahead of time in order to be free of the IMF (Bello, 2006). This represents a crisis of legitimacy for the IMF. Its returns from loan repayments and interest will be lower in years to come, meaning funding will have to be found elsewhere. Thus one of its main functions, lending to countries with balance of payment difficulties, will be worth less.

The Future of the IMF- Back to Keynes?

Ideology

So what now for the IMF? Is there still a positive role it can play or should it quite simply be abolished? The opinion that it would be "…unwise for the fund to disengage…unless there are fairly compelling reasons to believe that the fund's role could be better played by other agencies" (Bird, 2005:40) is the most sensible one. The IMF should narrow the scope of its operations to surveillance and lender of last resort activities (Caballero, 2003:32). It has placed itself on an ideological podium, pronouncing a monetarist free market perspective to be the one and only way forward. The way each decision should be made is to take into consideration that "a healthy, well-fed, literate population…is the most intelligent economic choice a country can make." (George, 1990:235)

Even countries in crisis with their own economically sound alternative plans, such as Ecuador and Bolivia in the 1990s, are not allowed to implement them (Stiglitz, 2006:146). Could it not be possible that those closest to the problem have the best solution for it? Offering governments greater discretion, while still monitoring performance and offering technical and procedural advice, would seem to be the way forward. Structural conditionality would be more fully self-designed (Bird, 2005:44). In simple terms, the IMF should move from being an organisation simply promoting one economic idea, that of the free market, and take into account alternative economic strategies. It should be a facilitator, not a director of operations.

SDRs – A Multilateral System?

One of Keynes' original ideas was for the IMF to have its own reserve currency, which he called 'Bancor'. This was proposed to be fiat money, meaning it would only exist in bookkeeping entries in funds' banks. His contemporaries originally scorned the idea. However, a limited version of this idea was implemented some decades after his death with the creation of Special Drawing Rights (SDRs). The problem is that SDRs today are worth only 3% of the world's liquidity and are limited to the world's wealthiest countries.

There is an argument for the creation of a global reserve system to replace the two-currency reserve system we seem to be moving towards (Stiglitz, 2006:260). The IMF could provide this fiat money to act as reserves, which countries could exchange for currency in times of crisis. This system would alleviate the growing problem of a global system reliant on the increasing debt of the United States. One of the greatest contradictions in the world's financial system may also be rectified. The IMF is an organisation largely controlled by the US, yet the stringent IMF policy of limiting balance of payment deficits is not being followed by the US itself. Its trade deficit and overall balance of payment deficit shows no sign of abating. A global reserve system would go a long way to helping to solve this.

Conclusion

The IMF needs to take a few steps back and rediscover the role of being the "ballast that stabilized the global economy" (Power, 1995). Although Keynes believed in intervention, his was a belief in government intervention rather then by an international organisation more or less controlled by the US. The IMF should assist governments in running their economies, not force them into certain policies that lack proof of success. Keynes' ideas are being taken on board more so by developed countries if anything, despite the monetarist nature of the European Central Bank and the likes of Alan Greenspan. For example consider the actions of both Bill Clinton and George Bush; spending to try to stimulate the economy and campaigning on a platform of trying to reach full employment. Recall Clinton's motto of simply 'Jobs, Jobs, Jobs'. (Stiglitz, 2002)

The question over what would have transpired if the IMF had let countries in difficulty use Keynesian counter-cyclical expansionary policies to emerge from a recession rather then tightening the noose on spending, will remain. Would Argentina have crashed in 2001? Would the East Asian crisis in 1997 have been so severe? These are questions we can but guess the answer to. Our objective should be to look to the future and ensure the people of the world, particularly those less fortunate then us, are not restrained in any way by corporate or foreign interests. The world must avoid the mistakes of the past to ensure its future.

Bibliography

Bello, W. (2006) *WB/IMF in Crisis, Spring Meeting Wrap-up.* Viewed at www.50years.org/cms/updates/story/325 accessed on 20/03/07.

Bird, G. (2005) 'The IMF and Poor Countries: Towards a More Fulfilling Relationship' in Teunissen, J.J. and Akkerman, A (eds.) *Helping the Poor? The IMF and Low-Income Countries.* The Hague: Fondad.

Boughton, J.M. (1998) 'Henry Dexter White and the International Monetary Fund'. *Finance and Development* 35:3. Viewed at www.imf.org/external/pubs/ft/fandd/1998/09/boughton.htm accessed on 22/03/07.

Caballero, R. J. (2003) 'The Future of the IMF'. *American Economic Review*, 93:2.

Dreher, A. and Veubel, R. (2004) 'The Causes and Consequences of IMF Conditionality'. *Emerging Markets Finance and Trade*, 40:3:26-54.

Dreher, A. and Jensen, N. (2007) 'Independent Actor or Agent? An empirical analysis of the impact of US interests on IMF conditions'. *Journal of Law and Economics*, 50:1 (Forthcoming)

Ewert, K.S. (1989) *The International Monetary Fund.* The Freeman, April 1989. Viewed at www.self-gov.org/freeman/8904ewer.hml accessed on 22/03/07.

George, S. (1990) *A Fate Worse Than Debt.* New York: Weidensfeld.

Hanhel, R. (1999) *Panic Rules! Everything you want to know about the Global Economy.* Cambridge: South End Press.

Keynes, J.M. (1971) [1923] *Collected Writings of John Maynard Keynes. Vol 4: Tract on Monetary Reform.* London: Royal Economic Society.

Lockwood, M. (2005) *We Must Breed Tigers in Africa*. The Guardian 24/08/2005.

Mussa, M. and Savastano, M. (1999) 'The IMF Approach to Economic Stabilization'. *NBER Macroeconomics Annual No.144.*

Naím, M. (2000) *Washington Consensus or Washington Confusion.* Foreign Policy No.118: 86-103.

Palast, G. (2002) *The Best Democracy Money Can Buy*. London: Robinson.

Petifor, A. (2002) *Debt is still the lynchpin: the case of Malawi*. Jubilee Research 04/07/2002. Viewed at www.jubileeresearch.org/worldnews/africa/malawi040702.htm accessed on 22/03/07.

Power, J. (1995) *G-7 Should Give Keynes New Look*. San Francisco Chronicle 19/06/1995.

Stiglitz, J.E. (2002) *Globalisation and its Discontents*. London: Penguin.

Stiglitz, J.E. (2006) *Making Globalisation Work.* London: Penguin.

Snowdon, B. and Vane, H.R. (2005) *Modern macroeconomics: its origins, development and current state.* Cheltenham: Edward Elgar.