A Primer on the International Monetary Fund

John H. Boyd
Senior Economist
Research Department

David S. Dahl
Regional Economic Affairs Specialist
Research Department

Carolyn P. Line
Community Affairs and Government Information Specialist
Office of Public Information

Federal Reserve Bank of Minneapolis

The International Monetary Fund (IMF) is currently at center stage in the international debt crisis, but to the general public it is a relatively unfamiliar institution. This article is a nontechnical primer on how this official group of nations assists its members with balance of payments problems. To give readers some perspective, the article also explains the purposes, history, and organization of the IMF and the institution's relationship with its largest member, the United States.

Background

Objectives

The IMF's most fundamental objective is to promote the growth of international trade and finance and thus contribute to worldwide economic growth. Central to this objective is the maintenance of a system of international payments that is stable, predictable, and effective. Therefore, one of the IMF's functions is maintaining surveillance over members' exchange rate policies. The IMF is constantly on the watch for foreign exchange restrictions, predatory exchange rate manipulations, and other beggar-my-neighbor types of actions in the international financial arena. Another important function of the IMF is ensuring the adequacy of international liquidity. A third function, the one this article focuses on, is providing a mechanism through which member nations may obtain funds to finance temporary balance of payments deficits.

In the context of this function, it is not unrealistic to think of the IMF as a large group of nations that have come together and pooled resources. In any period of time—a quarter, a year, or longer—some nations in this group will experience balance of payments deficits and others will experience surpluses. In most cases, those nations with deficits can finance the deficits by drawing on their stock of *international reserves,* that is, currencies or other assets that are generally accepted among nations. In other cases, however, the deficit nation may have an insufficient supply of such assets. That is when other nations—through the IMF—can help. By providing resources to the IMF, those nations with surpluses can make funds available to those with temporary balance of payments deficits.

Any nation can have a balance of payments deficit, sometimes due to forces beyond its control. Yet no nation can run balance of payments deficits indefinitely, with or without the IMF. In the long run, balance of payments deficits will be corrected one way or another, and the IMF tries to help make this adjustment as prompt and orderly as possible. The IMF provides temporary financing to member nations with deficits. At the same time, it makes recommendations as to how those nations may set about correcting their deficits so that IMF resources are used in accordance with IMF purposes and provisions. (The accompanying box discusses balance of payments accounting.)

Origin and Evolution[1]

The IMF was one of two international institutions established near the end of World War II to ease the transition from a wartime to a peacetime environment

[1] This section is adapted from Kaufman 1981, chap. 17, and we recommend this source to readers seeking an in-depth treatment.

The Balance of Payments

Just like an individual or a corporation, a country produces a deficit when it spends more than it takes in. And the nation (or individual or corporation) unavoidably must run down its wealth or borrow to finance that deficit. When a deficit occurs between countries, resulting from their trade and capital flows with one another, it is called a *balance of payments deficit.* In the balance of payments terminology, wealth is called *international reserves.* It is composed of gold, strong currencies that other nations are willing to accept, and special drawing rights at the IMF. The table below lists the main types of transactions involved in a nation's balance of payments accounting.

Economists distinguish between the balance of trade and the balance of payments, and they use several different, but related, measures of both of these concepts (see the table below). The official settlements balance is the one meant in the accompanying article when references are made to the balance of payments. It measures changes in official reserve assets and short-term capital among governments.

A Nation's **RECEIPTS** *less*	Its **PAYMENTS** *equals*	The Nation's **BALANCE OF PAYMENTS**[1]
EXPORTS of Merchandise	IMPORTS of Merchandise	
		Balance of Trade
Services	Services	
		Balance of Goods and Services
Private and government aid	Private and government aid	
		Balance on Current Account
CAPITAL INFLOWS From	CAPITAL OUTFLOWS From	
Investment	Investment	
Government borrowing	Government lending	
Long-term private borrowing	Long-term private lending	
		Basic Balance[2]
Short-term private borrowing	Short-term private lending	
Liquid	Liquid	
Nonliquid	Nonliquid	
		Official Settlements Balance
SALES of Reserves	PURCHASES of Reserves	

[1] Each balance in this table is a cumulative measure of all the items above it.
[2] The basic balance is also known as the balance on current and long-term capital account.
Adapted from Kaufman 1981, p 433

and to help prevent the recurrence of the turbulent economic conditions of the 1930s. The International Bank for Reconstruction and Development (the World Bank) and the IMF were formed by a conference of 44 nations at Bretton Woods, New Hampshire, in July 1944. The World Bank was established to make long-term reconstruction and development loans; the IMF, to provide short-term balance of payments adjustment loans. Thus, in a real sense, the World Bank and the IMF are complementary institutions.[2]

Over time, changes in the international economic environment have required changes in the way the IMF operates. Two of these operational changes are particularly important and have been reflected in major changes to the IMF's Articles of Agreement. They are important not merely as an illustration of the IMF's responsiveness to changing conditions, however. They are fundamental

[2] The reader may have heard of a third international financial agency called the Bank for International Settlements (BIS). The BIS is a central banking organization and is distinct from the World Bank and the IMF. It has recently worked with the IMF, however, to provide short-term or emergency "bridge financing" to nations with balance of payments difficulties. Most often, BIS financing has been provided before IMF lending but in consultation with the IMF.

to understanding the international financial context within which the IMF operates.

□ *A New International Reserve*

The first of these amendments to the Articles of Agreement, which took effect in 1969, created a new international reserve asset. Before 1969, the two main forms of international reserves had been gold and the currencies of a few major trading nations, particularly the U.S. dollar. At any time, only a finite supply of gold exists, and during the postwar period, the stock of gold had risen very slowly, primarily because (until 1972) a low official price of gold held back new production. It was therefore unavoidable that most of the growth in international reserves be in currency holdings. Most of this growth was in U.S. dollars. For example, between 1950 and 1969, the amount of foreign-owned dollars rose from around $8 billion to around $45 billion. This situation could not continue indefinitely. Because of continuing large U.S. balance of payments deficits, other nations began to lose confidence in the dollar and stepped up their purchases of gold from the United States at the then official price of $35 per ounce. As a result, dollars came back to the United States and so were no longer available to other countries as international reserves. To many people, the total supply of international reserves then appeared in danger of becoming inadequate, a situation which could have slowed the growth of international trade.

After extended negotiations, in 1969 the IMF created its own international reserve asset, called the *special drawing right* (SDR). The value of an SDR was initially tied to gold, but since 1978 has been tied to the value of a group of currencies of the major trading nations. Members of the IMF voted to initially distribute about 10 billion SDRs (officially expressed *SDR 10 billion)* as a supplement to gold and currency holdings. SDRs were allotted to member nations in proportion to each nation's contribution to the IMF, as defined by its share of the aggregate contribution of all nations, or its *quota.* This procedure has been followed in subsequent SDR allocations, and by mid-1983 about SDR 22 billion had been allocated.

□ *Floating Exchange Rates*

The second major change in the operations of the IMF is reflected in the second amendment to its Articles of Agreement, which took effect in 1978. This amendment adjusted IMF operations in response to the shift from fixed to floating exchange rates which had occurred somewhat earlier.

From the founding of the IMF until the early 1970s, IMF members operated under a system of fixed exchange rates. The value of their currencies was established with respect to gold or to the U.S. dollar. The dollar, in turn, was pegged to gold at a price of $35 an ounce. This value was enforced by the fact that the United States stood ready to buy gold from or sell gold to foreign governments at this price.

In the 1950s and early 1960s, the system of fixed exchange rates operated well. But by the late 1960s, many years of differing rates of growth and inflation in member countries put enormous pressure on fixed exchange rates. By the end of 1971, the currencies of most industrialized countries were revalued upward relative to the U.S. dollar. However, economic conditions continued to vary significantly among the major industrial nations, and pressure mounted for basic change in the exchange rate regime. In early 1973, the fixed exchange rate system was finally dismantled and rates for the currencies of most major industrial countries were permitted to fluctuate with market conditions.

Since the IMF had been central to the fixed exchange rate system, this change to a floating rate system required major changes in its operations. Under the new rules formalized in 1978—and still in effect today—the IMF permits considerable flexibility in the ways member nations can manage exchange rates. Members may choose from a variety of alternative exchange rate regimes. They may, for example, tie the value of their currency to that of another, to the SDR, or even to some composite indicator. Members may also simply allow their exchange rate to float. Members are not, however, permitted to peg to gold and are still discouraged from attempting to manage exchange rates so as to achieve short-run gains at the expense of other nations.[3]

Organization

The IMF provides balance of payments assistance to its members through a Board of Governors, an Executive Board, a managing director, and a staff.

All nations that become IMF members have a representative on the Board of Governors, the IMF's

[3]IMF members have adopted several different exchange arrangements. At the end of June 1982, 55 had pegged their currencies to that of another nation, most commonly the U.S. dollar. Another 39 members had tied their currencies to composites such as the SDR. Among members that did not peg, 4 set their exchange rates according to a set of indicators. Most remaining members used a system of "managed float." (See Hooke 1982, pp. 19-20.)

senior decisionmaking body. Each of the member nations is represented by a governor, who typically is a minister of finance or a governor of a central bank. (Today the IMF has 146 members.) The Board of Governors has certain specific powers, as well as all powers not expressly conferred on another IMF body. The board's specific powers concern, among other things, the admission of new members, the allocation of SDRs, and the determination of members' quotas. (See Hooke 1982, p. 11.)

Each nation's quota determines the number of votes it has, the amount of funds it must make available to the IMF, and the amount of funds it can draw from the IMF. A member's quota is determined by a formula that includes its relative economic size and significance in international trade. In essence, the quota is related to the economic magnitude of a nation. This is illustrated by the fact that today the United States has the largest quota, which amounts to 20.6 percent of the total, whereas some nations' quotas are well below 1 percent. Quotas are periodically reviewed, and changes in relative quota shares have taken place.

Under the direction of the Board of Governors, the IMF's Executive Board supervises the institution's day-to-day business. The managing director heads the Executive Board, which currently also consists of six appointed and sixteen elected executive directors. The five members of the IMF with the largest quotas each appoint an executive director. Today these members are the United States, the United Kingdom, West Germany, France, and Japan. Additional executive directors are appointed by members whose currencies have been actively used in recent IMF transactions. For this reason, Saudi Arabia has appointed an executive director since 1978. The remaining sixteen executive directors are elected by various groups of member countries.

Besides heading the Executive Board, the managing director is chief of the IMF's operating staff, which actually conducts the IMF's daily business. The Executive Board chooses a managing director for a term of five years. This individual has traditionally been a citizen of one of the IMF's European members.

Operations

Sources of Funds

The IMF obtains funds to assist members with balance of payments problems from two major sources: pooled funds of members, called *subscriptions* (or quotas), and loans. According to the IMF's balance sheet (Table 1), at the end of April 1983, about 82 percent of all IMF assets were financed by member subscriptions and about 15 percent were financed by IMF borrowing.[4]

□ *Subscriptions*

Member subscriptions are by far the largest item on the liability side of the IMF balance sheet. As mentioned earlier, the quota broadly reflects a member's economic and financial import in the world. When a nation becomes a member, it must pay into the IMF an amount equal to its quota, and if there are subsequent quota increases which the member accepts, it must pay an additional amount. Originally, 25 percent of a member nation's quota was paid in gold and the remaining 75 percent in its own currency. Now, however, when quotas are increased, 25 percent of the quota increase usually is paid in SDRs created by the IMF (or another acceptable currency designated by the IMF) and the other 75 percent in the member's currency.

The initial process of meeting the own-currency part of a nation's quota requirement is hardly more than a bookkeeping entry. This is so because each member has the option to substitute nonnegotiable, non–interest-bearing securities for almost all of its currency held by the IMF. These securities become part of the IMF's currency holdings and are cashable on demand. Not until some other nation draws a member's currency from the IMF does the member's currency actually flow from it to the IMF. Any member nation's actual cash transactions with the IMF thus depend on the actions of other nations—when they draw or repay its currency.

□ *Borrowing*

Although subscriptions are the IMF's basic source of funds, the IMF, with Executive Board approval, can also obtain resources by borrowing. It can borrow any currency and from any source—from private sources like commercial banks, for example, as well as from official agencies. However, one important restriction on this borrowing is that the IMF must obtain the consent of any member whose currency it wishes to borrow.

So far, the IMF has only borrowed from official sources, not from private sources, and at the end of April

[4]The balance sheet also lists *reserves*, which are essentially the equity or retained earnings of the IMF and which at the end of April 1983 amounted to only about 1.4 percent of total assets. The other entries on the liability side are small and in the nature of accruals.

Table 1

The IMF's Balance Sheet[1]

as of April 30, 1983
(thousands of SDRs)[2]

	1983	1982
Assets[3]		
Currencies and securities	64,064,554	59,861,433
SDR holdings	4,334,909	5,456,084
Gold holdings[4]	3,620,396	3,620,396
Subscriptions receivable	—	10,800
Borrowed resources held in suspense	1,780,609	236,447
Charges receivable and accrued	505,334	370,749
Other assets	13,231	13,920
Total assets	74,319,033	69,569,829
Quotas, Reserves, and Liabilities[3]		
Quotas		
Subscriptions of members	61,059,800	60,684,800
Reserves	1,000,715	935,320
Liabilities		
Borrowing	10,952,479	6,772,754
Remuneration payable	981,121	908,633
Interest payable and accrued	268,868	239,956
Other liabilities and deferred credits	56,050	28,366
Total quotas, reserves, and liabilities	74,319,033	69,569,829

[1] The balance sheet of the IMF's General Department.

[2] An SDR is currently worth about $1.06.

[3] SDRs are accounted for under a different set of books and do not appear on the IMF's General Department balance sheet except as the IMF receives them in official transactions. As of April 30, 1983, about SDR 21.4 billion had been issued.

[4] Gold holdings of the IMF are shown at historical values.

Source: International Monetary Fund 1983a, p. 189

1983, borrowing amounted to only 18 percent of subscriptions. This is much less than the guideline the IMF established in 1982 for its borrowing: a maximum range of between 50 and 60 percent of total IMF subscriptions.

Much IMF borrowing is done under what are called the *General Arrangements to Borrow* (GAB). The IMF and major industrial countries initially entered into these arrangements in 1962, and they have been periodically renewed since then. The present arrangements, which expire in 1985, permit the IMF to borrow the currencies of ten industrial countries: Belgium, Canada, France, Italy, Japan, the Netherlands, Sweden, the United Kingdom, the United States, and West Germany. Borrowings under these arrangements can finance only drawings from the IMF by these countries. The total value of the present arrangements is SDR 6.4 billion, but for technical reasons it would be impossible for the IMF to ever lend the full amount.

The IMF also has a number of other borrowing arrangements, many of which are for special purposes and with single countries. For example, in May 1981, the IMF concluded an agreement with Saudi Arabia to borrow up to SDR 8 billion over two years, with the possibility of a further draw of SDR 4 billion in the third.

Interest payments and other terms on IMF borrowing arrangements vary considerably. Frequently, but not always, interest is charged according to a floating rate. Loans are to be repaid within five years under the GAB

and within seven years under many of the other arrangements.

Uses of Funds

As mentioned earlier, in accordance with the fundamental purpose of the IMF, members can draw against the IMF's pooled and borrowed funds to finance temporary balance of payments deficits. Although it is common to refer to such draws as "borrowing" and IMF "loans," the procedure actually consists of a member nation purchasing another nation's currency or SDRs with its own currency.

□ Terms

All IMF loans are subject to some degree of *conditionality.* Conditionality is generally associated with economic and financial policies that members, in consultation with the IMF, agree to implement in order to obtain IMF resources. These policies are designed to correct the member's balance of payments deficit and to promote noninflationary economic growth. The terms of conditionality are, in a broad sense, similar across those IMF lending arrangements that involve stabilization programs. IMF stabilization programs known as *standby* and *extended arrangements* are generally from one to three years in length. Further, they seek to rectify balance of payments problems exacerbated by "inappropriate exchange rates; subsidies and protectionism; distorted prices; inefficient state enterprises; excessive government expenditures and large fiscal deficits; inflationary money growth; and interest rate controls which discourage private savings and distort investment patterns" (Regan 1983, p. 2).

The amount each member can borrow from the IMF is expressed as a percentage of its quota. Under guidelines adopted in 1981, a member could purchase currencies up to 150 percent of its quota for one year and 450 percent for three years, excluding purchases under special facilities.At the IMF's last annual meeting, in September 1983, however, these guidelines were modified in connection with a proposed increase in quotas. (See International Monetary Fund 1983b, p. 3.) Member purchases now

> will be subject to annual limits of 102 or 125 per cent of quota, three-year limits of 306 or 375 per cent of quota, and cumulative limits of 408 or 500 per cent of quota, depending on the seriousness of the balance of payments needs and the strength of the adjustment effort. . . . As at present, the Executive Board should retain the flexibility to approve stand-by or extended arrangements for amounts above the access limits in exceptional circumstances.

Members normally must repurchase their currencies, that is, repay their loans, within three to five years. Under special circumstances, they may take up to ten years. Members can generally purchase funds in installments, or *tranches,* during the program period as the conditions specified under the loan agreement are met. Finally, the IMF levies several charges on member purchases.[5]

□ Lending

Members of the IMF may draw on its financial resources to meet their balance of payments needs. Under *reserve tranche* policies, a member can purchase foreign currencies up to an amount equal to the excess of its quota over the IMF's holdings of its own currency essentially without question, except that funds must be required because the member has a balance of payments need. These purchases are not subject to policy conditionality, carry no interest charges, and have no requirement to repurchase.[6] Under *credit tranche* policies, a member can purchase foreign currencies in amounts beyond the reserve tranche limit, with each of four tranches being equal to 25 percent of the member's quota. Drawings in the credit tranches are subject to conditionality and to charges and are phased over a period that typically ranges from one to three years.[7]

Besides these basic lending programs, the IMF operates several lending facilities to help member countries finance balance of payments deficits stemming from specific causes. These facilities, along with the tranches, are described in Table 2. Some of these facilities are financed fully with the IMF's quota resources. As discussed earlier, some are financed in part by loans from individual countries or groups of countries. For

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[5]The IMF levies three charges. One is a service charge on all drawings except those in the reserve tranche (described in the next section). Another is a charge on standby arrangements not unlike a commitment fee charged by a commercial bank. The third is an annual charge against IMF holdings of a member's currency when those holdings exceed the member's quota. (See Hooke 1982, p. 32.)

[6]Reserve tranche purchases do, however, have an opportunity cost equal to the foregone interest income on funds withdrawn.

[7]A nation's reserve tranche depends on the actions of other nations as well as its own. This is so because the reserve tranche is the difference between the nation's currency quota and the IMF's actual holdings of its currency. Thus, as other nations draw its currency out of the IMF, the nation's reserve tranche increases, and as other nations pay its currency into the IMF, the nation's reserve tranche decreases.

Table 2

The IMF's Financial Facilities

Facility	Description
Reserve tranche	Use of a member's own liquid reserves.
Credit tranches	Credit available in four tranches in connection with standby arrangements; each tranche equivalent to 25 percent of a member's quota.
Extended facility	Assistance to members with very weak balance of payments or structural balance of payments problems that need a longer period of adjustment than is typically provided in standbys.
Supplementary financing	Resources available to members with standby or extended arrangements under the credit tranches or the extended facility that need more funds than those arrangements provide. (Funds no longer committed under this program after early 1982.)
Enlarged access	Assistance beyond limits on other facilities to members with balance of payments problems that are large relative to quotas; in effect, an extension of supplementary financing; used in association with standby and extended facilities.
Compensatory financing	Assistance to members with balance of payments problems resulting from export shortfalls that are both temporary and due largely to factors beyond the member's control.
Buffer stock	Financing available to members to contribute to an international buffer stock accepted as suitable by the IMF.

Source: Hooke 1982, pp. 41–51

example, most of the large loans made in connection with stabilization programs over the past few years have been financed in part by loans made by Saudi Arabia and some industrial countries. Depending on a member's situation, it can purchase funds from a combination of these special programs. The number of special facilities and their uses vary with world economic conditions, as is apparent in the accompanying graph.

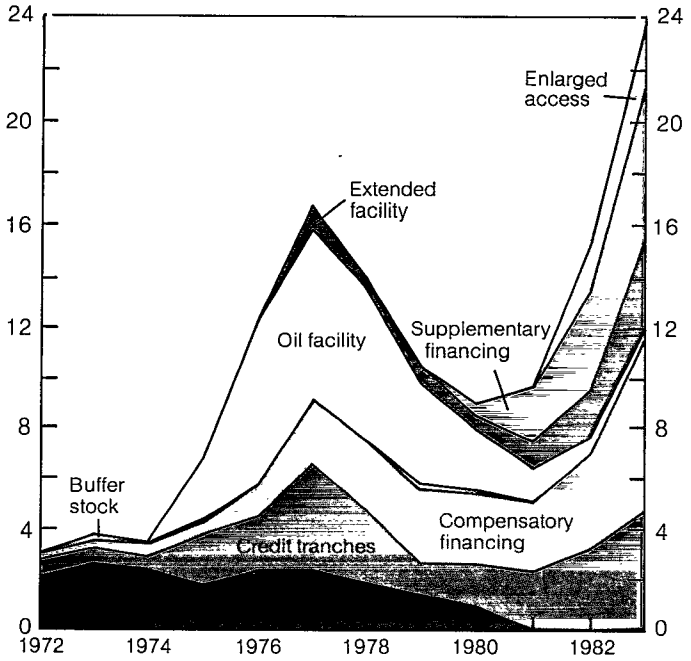
The IMF generally finances only part of a country's balance of payments deficit. However, when the IMF makes funds available to a member in connection with a policy adjustment program in that country, this frequently has the effect of keeping the world's private capital markets open and accessible to that country. In addition, IMF assistance is sometimes made in loose association with World Bank lending. Although the World Bank is primarily concerned with long-term project financing, more than 10 percent of its lending is now for "structural adjustment," a purpose which is in some ways similar to that of IMF lending (Money for the fund, 1983, p. 16).

The United States and the IMF

Without question, operations of the IMF affect the economy of the United States, it largest member nation. These effects are both indirect and direct. Over the postwar period, the IMF has made a significant contribution toward international financial stability and thus toward its most fundamental goal—fostering world trade and economic growth. Although such indirect benefits are extremely difficult to quantify, they undoubtedly have accrued to citizens of the United States as well as those of other nations. IMF operations also have a number of important direct effects on U.S. federal government financing which are easier to quantify.

Use of IMF Resources

as of April 30, 1972–83
(billions of SDRs)



Source: International Monetary Fund 1983a, p. 87

These are discussed below.

Since the IMF's creation, other members have frequently drawn dollars from the U.S. quota subscription, and the United States has also drawn currencies from other members' subscriptions. The United States, of course, has drawn funds from the IMF for exactly the same reason that other nations have—to finance balance of payments deficits. U.S. drawings to date have totaled about $6.5 billion, the second largest use of any member. It is worth noting, however, that the United States has never drawn in excess of the reserve tranche and thus in a real sense has not been a net debtor of the IMF.

As pointed out earlier, when the IMF increases member quotas, this essentially results in a bookkeeping transaction for the member, at least with regard to the 75 percent of the quota increase payable in its own currency. This is just as true for the United States as it is for other members. Nevertheless, a quota increase requires congressional authorization and appropriation in the United States.

Funds the United States subscribes in dollars are not transferred to the IMF by the Treasury until the IMF actually needs additional U.S. dollars, perhaps because some other nation has drawn them. If this occurs, though, the U.S. government records an offsetting decline in its securities held by the IMF. Thus, transferring dollars to the IMF does not result in net budget outlays, nor does it directly affect the size of the U.S. budget deficit. Likewise, when another member nation returns dollars to the IMF, no change occurs in the U.S. federal budget. IMF transfers to and from the U.S. Treasury have varied widely from year to year, producing cash outflows for the Treasury in some years and inflows in others.

Transfers of dollars to and from the IMF do affect the

Treasury's cash position and borrowing requirements, however. For example, when the IMF needs dollars, the Treasury has to obtain them, which normally entails borrowing. Thus, when other nations draw dollars from the IMF, the cost to the United States is the interest it must pay to obtain the funds. This is partially offset by the interest the IMF pays the United States for the use of its dollars.[8]

The Treasury has recently estimated the direct net cost to the United States of IMF membership. This computation is complex and involves a number of variables, including the amount of dollars drawn by other nations, the amount of time for which these dollars are drawn, the rate of interest paid by the IMF, the Treasury's cost of financing the dollar outflow by borrowing in the open market, and capital gains or losses on U.S. holdings denominated in SDRs. This computation puts the average net cost to the United States of participation in the IMF at about $107 million per year from the beginning of 1970 to the end of 1982, with considerable annual variability. (See Regan 1983, p. 10.) This direct cost of membership appears modest considering the benefits to the United States of worldwide economic and financial stability.

Summary

The United States and other members of the IMF have for almost 40 years used the IMF to ease balance of payments adjustments. Over the years, the IMF has adapted to the changing international economic environment. The basic approach the IMF has used to assist members, however, has not changed. Members subscribe funds to the IMF in an amount related to their economic size, and the IMF borrows member currencies. Members, in turn, can purchase these currencies with their own currencies and use them to settle their international accounts. In exchange for being able to purchase international reserves, members adopt economic programs aimed at correcting their balance of payments deficits. The IMF provides its assistance through a number of different programs which vary with international economic conditions. For the United States, the IMF's largest member, the direct cost of this membership seems modest compared to the worldwide economic benefits of IMF activities.

[8]The rate of interest (called *remuneration)* on a portion of reserve tranche positions is currently set at 85 percent of the SDR rate. The interest rate on SDRs is a weighted average of government security rates in the five countries whose currencies are used to define the SDR.

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