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# Conditional Benevolence: The IMF and the Developing World

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# Introduction

On 29th June 2023, the International Monetary Fund (IMF) announced its latest agreement with the Pakistani government – extending nearly USD 3 billion in loans to a country teetering at the brink of economic default. This loan is formalized through a new Stand-By Agreement (SBA)[1], with the IMF stating that the arrangement will help in "stabilizing the (Pakistani) economy from recent external shocks."[2] The recognition of external factors, such as the war in Ukraine and the severe flooding in Pakistan in August of 2022[3], comes as a positive indication of the IMF recognizing the unique struggle faced by debtor countries including factors that were beyond their control.

However, it cannot be ignored that relief from the IMF comes with stringent conditions attached. Countries that accept IMF loans are often compelled to implement harsh fiscal and monetary policies including austerity measures, interest rate hikes and currency devaluation. For Pakistan's economy, already crippled by uncontrollable circular debt and unproductive sectors, these measures could exacerbate inflation, lead to even higher unemployment, and choke any

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[1] IMF, "IMF Reaches Staff-Level Agreement with Pakistan on a US$3 Billion Stand-By Arrangement," 29th June 2023

[2] *Ibid.*

[3] Al Jazeera, "Pakistan, IMF Reach $3bn Staff-Level Agreement," 30th June 2023.

development projects required to service a population of 22 million citizens.

The question then arises: why is the IMF still the primary international lender for developing countries? Furthermore, why are developing countries still unable to improve their bargaining position vis-à-vis the IMF to negotiate less stringent conditions?

This brief identifies the structural factors that allow for the IMF to maintain its indomitable position as 'the lender of last resort'. It assesses the structure of the organization as it allows for the imposition of not merely neoliberal economic policies, as well as analyzes the US' influence directly and indirectly in the IMF's operations. Finally, with the rise of alternative lending bodies, this brief concludes with an analysis of the efficacy of these alternative bodies, and how developing countries like Pakistan could approach IMF negotiations in the future to negotiate better terms.

## When do countries approach the IMF?

The IMF was originally envisioned as an international lender which would help stabilize exchange rates by providing loans that would "ease the flow of adjustment" globally.[4] However, over the decades,

[4] James Raymond Vreeland, *The International Monetary Fund (IMF): Politics of Conditional Lending*, 2006

developed countries decreased their reliance on the IMF. Eventually, the IMF evolved into its modern role of a “lender of last resort” for developing countries facing financial crises. As the phrase implies, developing countries will often only go to the IMF after exhausting other financial options to service debt and are hampered by factors such as acute balance of payment crises. However, providing relief at such critical junctures is accompanied by strict conditions owing to the high-risk nature of the transaction, with most conditions rooted in neoliberal economic policies.

This is called IMF “conditionality,” where a country under an IMF program will only continue to receive disbursements of its loan if it complies with certain policy conditions.[5] Formally, conditionality exists only to act as an antidote to the economic rationale of “moral hazard”, where a debtor country (or even individual investors) may enact policies recklessly, secure in the knowledge that the IMF will always bail them out. Measures can include granting further subsidies to uncompetitive sectors of the economy which the IMF feels should not be subsidized, etc.

In reality, however, IMF conditionality often impinges on the notion of national economic sovereignty and compels the debtor country to take stringent fiscal policy conditions. Indeed, Pakistan had to cut back on subsidies for the energy and export sector, raise fuel

[5] Vreeland, 2006.

prices and hike up interest rates.[6] Such fiscal austerity measures often cause immediate backlash from the citizenry against the sitting government since they drive up inflation. Meanwhile, there is no guarantee that such "structural adjustment" on behalf of the IMF can lead to economic stability in the long-term. In direct contradiction with the IMF's conditionality and reliance on austerity measures, often government investment in health, education and infrastructure projects is necessary to spur sustainable economic growth and prevent relapsing into economic crises. This poses a conundrum for most developing economies, which struggle with pursuing a balanced economic policy that prioritizes long-term investment in human development while preventing a relapse into economic crises.

# Institutional Legitimacy

The IMF further enjoys global legitimacy, brought about by its affiliation with the United Nations as a core part of Bretton Woods institutions. This legitimacy continued to be afforded to the IMF even as it expanded its mandate beyond its originally intended role of stabilizing exchange rates and broader economic cooperation to an international lending institution.[7] In the modern status quo, global politics make such mass accession to financial institutions increasingly difficult. Financial ties are often likened to political

[6] Al Jazeera, 30th June 2023.
[7] Vreeland, 2006

allegiances, and several non-aligned countries may not want to pick a side between competing financial powers.

Here the US-China trade war stands out as a prominent example. Research into global summits on China's Belt and Road Initiative (BRI) have likened participation in the BRI to "acceptance of China's global economic leadership."[8] Thus, if countries chose to affiliate with Chinese backed international financial institutions, they may risk weakening economic ties with the United States. In such situations, while membership in regional organizations may rise, the formation of a new organization with the same neutral foundation that the IMF gains due to its ties with the IMF is unlikely.

## US Veto and the Voting Structure at the IMF

One of the largest impediments to developing countries having a larger voice at the IMF is the voting structure at the IMF. Voting shares in the IMF, which are more commonly referred to as "quotas", are based on the size of a country's subscription to the IMF.[9] Since developing countries have less economic resources, their share of funding in the IMF is substantially smaller than large economies like the United States and

[8] J. Lawrence Broz, Zhiwen Zhang, and Gaoyang Wang, "Explaining Foreign Support for China's Global Economic Leadership," *International Organization* 74, no. 3 417–52, 2020

[9] Vreeland, 2006.

Germany. For example, the United States has 16.5% of the total voting shares while a lesser developed nation like Argentina has only 0.66%.[10] Hence, more affluent countries hold substantial leverage over the IMF and so its impact on the developing world. This becomes even more concerning when one realizes that, aside from China, all top vote holders (United States, Japan, United Kingdom, France and Germany) belong to the same economic/political bloc. Due to this, it has long been critiqued that the undue influence of the Western Bloc and allied nations results in the IMF forcing developing nations to lower controls and prematurely move towards free market economies.

The rigidity of the quota system in place at the IMF also poses significant problems in admitting new leadership. Despite its economic wealth, a country cannot simply choose to increase its financial contribution and thus expand its voting influence at the IMF. Rather, a change in the size of a country's quota can only come through a 85% supermajority vote.[11] This has made the reform process of the voting shares at the IMF woefully slow, resulting in asymmetric quotas that do not reflect global economic reality nor dynamics. For example, before the 2008 reforms, a much smaller European economy like Belgium (2.083%) had greater voting shares than India (1.882%) and only slightly less votes than a large country like Russia

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[10] IMF, "IMF Members' Quotas and Voting Power, and IMF Board of Governors,"
[11] Vreeland, *The International Monetary Fund (IMF).*

(2.686%)[12] – all contributing to the question of undue domination of Western Allies.

Furthermore, since it has the largest subscription at the IMF, the US holds 16.5% of the votes at the IMF and so it can solely veto any change in quotas. It is thus not surprising that the first major restricting of voting shares at the IMF came after the 2008 financial housing crisis (The Great Recession) where the US suffered great reputational costs for its economic policies. The slow reform process and explicit power imbalance has led to discontent amongst other big players in the global economy, particularly those with strong regional markets. For example, both China and India have had relatively stagnant voting shares at the IMF since the 2010 reforms in spite of large increases in the size of their economies in the past decade.

As a result, China in particular, opted to form an alternative international financial institution in the form of the Asian Infrastructure Investment Bank (AIIB) where China and India have the highest and second highest voting shares respectively.[13] While the AIIB is not a *direct* competitor to the IMF, since it is a development investment organization rather than a dedicated international lender, it does provide direct competition to the World Bank and so lends to an

[12] "IMF Members' Quotas and Voting Power, and IMF Board of Governors," IMF, accessed July 20, 2023, https://www.imf.org/en/About/executive-board/members-quotas.
[13] "Members of the Bank - AIIB," accessed July 24, 2023, https://www.aiib.org/en/about-aiib/governance/members-of-bank/index.html.

overall decrease in reliance on the Bretton Woods Organizations.

## Formal and Informal Influences over the IMF

A prominent factor that helps maintain the IMF's status as the premier global financial lending body is the support of the United States. As its primary donor and with the largest voting share, the US exercises a great amount of leverage in the functioning of the IMF, particularly its executive management.

IMF operations are formally headed by the Managing Director of the IMF and the Board of Governors on the Executive Board.[14] The US has not only been a permanent member of every Executive Board at the IMF since its inception, but the Managing Director is also unlikely to go against the wishes of the US since it can veto their appointment/reappointment. Decisions are taken through consensus and the aforementioned factors all make the US have substantially more say in decisions than weight than that of a developing country, especially one that has approached the IMF for a loan.

Thus, if a country has strained relations with the US, it may receive an IMF package with much stricter conditionality or may not enter a program at all. Here,

[14] Vreeland, 2006.

political economist James Vreeland gives the examples of Angola and Zaire. Zaire showed support for the US during the Cold War and concurrently entered several consecutive IMF programs from 1976 to 1989. On the other hand, Angolo which was a Soviet Ally, did not join the IMF at all until 1989.[15]

## Failures of Alternative Monetary Funds

A final factor that has bolstered the IMF's relevance over the years has been the failure of establishing alternative organizations with the same global appeal and legitimacy. This remains true even though a certain group of countries have individually turned their backs on the IMF completely.

For example, following the East Asian Financial Crisis, several East Asian Countries including Thailand, Indonesia and the Philippines refused to return to the IMF for a new program or loan.[16] Yet, these countries have not been able to create a competitive alternative institution. An attempt was made by Japan following the East Asian Financial Crisis, largely due to US' insistence on strict conditionality for East Asian Countries. Japan and Japanese investors had put in a sizeable amount of money into crisis economies and so preferred for there to be greater liquidity provision to

[15] Vreeland, 2006 .
[16] Phillip Lipscy, "Japan's Asian Monetary Fund Proposal.", 2003.

bail our East Asian countries. Since the IMF remained cautious about providing this funding, Japan sought to form an alternative monetary fund known as the Asian Monetary Fund (AMF).[17] This attempt would become one of the rare public foreign policy disagreements between the US and Japan. The proposal was stifled, with the US lobbying China against the AMF due to fear of Japanese hegemony.[18] Without regional consensus, the very purpose of a separate regional Asian Fund was thus lost.

The failure of the AMF proposal also highlights the centrality of global legitimacy in international organizations, and how inability to secure this legitimacy can disrupt alternative initiatives altogether.

## Analysis and Conclusion

This brief establishes how the voting structure at the IMF and extent of US influence can reduce the negotiating capacities of developing nations especially if they do not have the best relations with the United States. In addition, it finds that the failure of alternative global funds such as Japan's AMF proposal lend to the prevalence of the IMF. This leaves one fundamental question: will developing nations like Pakistan have to remain completely reliant on the conditional lending of

[17] *Ibid.*
[18] *Ibid.*

the IMF or is there room for greater bargaining in the modern status quo?

I would argue that while the quota system makes it difficult for emerging market economies like Pakistan to enhance their bargaining position, different diplomatic means/regional organizations can be used to enhance the autonomy of such nations when entering financial programs. For example, developing countries can supplement economic developmental projects with assistance from different multilateral development banks. Here, the IMF's partner organization of the World Bank is also not the sole option. Rather, a state like Pakistan could choose to go to the AIIB, led by China.[19] The ability to shop between forums of financial lending reduces state incentive to accept IMF conditionality. As more and more nations turn toward support of the AIIB, the US and the remaining Bretton Woods organizations will be forced to implement reforms that help maintain their relevance and appeal to the developing world.

Similarly, in cases of monetary/exchange rate instability, regional alternatives have recently developed in the form bilateral currency swap agreements. A prominent example of this is 2010's Chiang Mai Initiative for East Asian countries that came about after the failure of the AMF proposal.[20] Having

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[19] Jing Qian, James Raymond Vreeland, and Jianzhi Zhao, "The Impact of China's AIIB on the World Bank," *International Organization* 77, no. 1 (January 2023): 217–37, 2023.
[20] Lipscy, 2003.

discussed the difficulty of developing alternative global forums, bolstering regional cooperation and participating in regional organizations has become increasingly important. If developing countries shift their attention solely towards regional alternatives, they may no longer turn to the IMF, just like how members of the Association of South-East Asian Nations (ASEAN) no longer participate in IMF programs but have looked favorably upon the Chiang Mai Initiative.

As Bronz has noted in his research, the acceptance of Chinese-led institutions stem not just from the attractiveness of these organizations (or "pull" factors) but also the dissatisfaction caused by existing Western dominated IMF (the "push" factors).[21] Countries which underwent political turmoil while under IMF programs will be more willing to seek out alternative financial institutions like the AIIB or New Development Bank under BRICS. If these alternatives continue to develop, countries like Pakistan could use the multiple forums as leverage to negotiate better, more autonomous, programs at the IMF.

[21] Broz et al, 2020.