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## Aiding the Transformation of Economies: Is the Fund's Conditionality Appropriate to the Task

### Cover Page Footnote

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# ADING THE TRANSFORMATION OF ECONOMIES: IS THE FUND'S CONDITIONALITY APPROPRIATE TO THE TASK?\*

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*In this Essay, Professor Lichtenstein suggests that the Group of Seven's decision to use the International Monetary Fund to channel economic assistance to Russia was a mistake. Professor Lichtenstein examines the International Monetary Fund's charter, history, and institutional culture. She concludes that it is not a suitable vehicle for funneling the Group of Seven's promised aid to Russia.*

IN July 1993, the seven leading industrialized countries that meet together as the Group of Seven<sup>1</sup> (the "G-7"), delighted with the end of the Cold War and with the prospect that President Boris Yeltsin of Russia, under the policies to be imposed by his chief economist and Deputy Prime Minister Yegor T. Gaidar, would move full speed ahead to transform Russia into a democratic nation with a privatized economy, pledged \$28.4 billion in grants and loans to Russia to aid its transformation to a democratic market economy.<sup>2</sup> Unfortunately for Russia, the G-7 has no legal structure. The G-7 is just that—seven nations that meet together as its members see the need; its only public announcements are diplomatic communiqués. Not only is the G-7 not an intergovernmental organization, it has not established its own financing agency or development bank to channel funds "pledged" to recipients. The G-7's lack of structure contrasts with the European Bank for Reconstruction and Development (the "EBRD"), the creation of which was the result of a decision in 1990 by a group of Western industrialized nations to channel aid to Eastern European countries to help their transition from centralized economies to private market economies. The EBRD was founded with a charter and specific instructions on how to proceed—and on what conditions—to disburse the funds contributed to the new development bank by the founding nations.<sup>3</sup> The process of negotiating the terms of the EBRD's charter, in the form of a treaty, forced its founding nations to conceptualize what the ERBD was to achieve.<sup>4</sup>

In July 1993, however, the urgency of the Russian economic situation,

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1. The G-7 consists of the United States, the United Kingdom, France, Germany, Japan, Canada and Italy.

2. See John-Thor Dahlburg, *G-7 Gives Yeltsin More and Less Than He Wanted: Diplomacy*, L.A. Times, July 10, 1993, at 7.

3. See Agreement Establishing the European Bank for Reconstruction & Development, May 29, 1990, 29 I.L.M. 1077 (1990).

4. For a brief discussion of the EBRD's founding, see *Present at the Creation: A*

to say nothing of the speedy action desired by Russian reformers, seemed to preclude the creation of a separate institution to channel the G-7's promised \$28.4 billion. What to do? The members of the G-7 simply could have let their individual bilateral aid agencies disburse the promised amounts according to each country's own procedures. However, in the case of the United States' contribution, to leave the fate of Russian economic and democratic transformation to the Agency for International Development (the "AID") with all the strings on aid disbursement that Congress has written into AID's appropriation acts would achieve nothing. Presumably the other members of the G-7 had similar structural difficulties in granting this quantity of bilateral aid to Russia.<sup>5</sup> Thus, the G-7 decided to use an already existing international organization, the International Monetary Fund (the "IMF" or the "Fund"), to do the "administrative work" of disbursing the aid.

Why not? Although the Fund's founders in 1945 originally would not have conceived of the Fund as a fairy godmother waving the magic wand of grants and loans to change the Russian pumpkin into a Russian coach, in recent years the Fund has begun to provide a type of lending, with the rather extraordinary name of the Enhanced Structural Adjustment Facility (the "ESAF"), that seems extremely far from the founders' conception of the Fund. Moreover, in April 1993, the Fund created a temporary facility,<sup>6</sup> the Systemic Transformation Facility (the "STF"), specifically for the purpose of lending to Russia "and the other states of the former Soviet Union as well as other economies in transition."<sup>7</sup>

This Essay, however, suggests that the G-7's decision to use the Fund for its foreign policy goal of support for Russia's hoped-for democratic transformation was a mistake. My thesis of mistake is not based on any economic theory of how to do transformation financing, but rather on the idea that international economic institutions, like all institutions, are products of their own history and that the Fund's culture, developed over the fifty years of its history, does not make it a suitable vehicle for funneling the G-7's \$28.4 billion in aid to Russia. The choice of the Fund to disburse the promised money would seem, as of this date,<sup>8</sup> to be

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*New Development Bank for Europe in the Age of Environmental Awareness*, 84 Am. Soc'y Int'l Law, 77-95 (1990).

5. See Jeffrey Sachs, *The Reformers' Tragedy*, N.Y. Times, Jan. 23, 1994, at 17 ("The U.S. and its allies had turned over the task of bailing out Russia to the International Monetary Fund and the World Bank, principally because these institutions could make loans that did not require Congressional or parliamentary authorization.")

6. This term is Fund jargon for the specialized forms of lending that the Fund has created in recent years.

7. *Special Facilities: Financing Helps Members Adjust to Special Balance of Payments Problems*, International Monetary Fund (IMF) Survey Supplement, Oct. 1993, at 18, 20.

8. This Essay originally was prepared before the Fund's announcement on March 22 that it had agreed to provide Russia with \$1.5 billion in aid in exchange for a promise of new taxes and strict curbs on government spending. See Michael Specter, *Russia Promises Budget Curbs to Win Loan of \$1.5 Billion*, N.Y. Times, Mar. 23, 1994, at A1.

most problematic for both the G-7 and Russia itself. Indeed, the choice has led to the unedifying spectacle of Professor Jeffrey Sachs, Professor of International Trade at Harvard University and former economic advisor to President Boris Yeltsin, blaming the Fund for the resurgence of the "Communist Old Guard" in Russia.<sup>9</sup> It also has led to the equally unedifying spectacle of Michel Camdessus, the head of the Fund, publicly proclaiming that the Fund has been made "a scapegoat" by the Russians, Western governments, and various experts for Russia's own faltering economic reform effort.<sup>10</sup> Mr. Camdessus also added, somewhat plaintively, that according to its by-laws "the I.M.F. can only extend financing conditional on appropriate economic policies."<sup>11</sup>

Mr. Camdessus was right. The legal structure and, indeed, the institutional culture of the Fund has engraved into stone that "thou shall not lend except upon conditions." Yet the only conditions that the Fund seems capable of asking for are exactly the ones that Professor Sachs deemed inappropriate to Russian needs.<sup>12</sup> This is not to say the Fund is at fault. It is only to say that the G-7 has asked the Fund to perform services that are beyond its institutional capacities and the authoritative interpretation of its charter. Further, this Essay suggests that the merging the World Bank and the Fund will not trump the problems associated with using the IMF to channel Western aid to sustain Russia in its transformation.<sup>13</sup> Finally, this Essay concludes that, in making economic foreign policy, nations must consider the institutional frameworks involved in the implementation of that policy. Elementary international organization theory posits that *appropriate* vessels for cooperation in economic assistance are necessary to achieve the policy goals.<sup>14</sup>

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Although Russia has squeezed out more of the promised aid from the Fund, just as the Fund has squeezed out of Prime Minister Viktor Chernomyrdin the promise of expenditure curbs, this does not change the analysis that the Fund process is not appropriate to the G-7's foreign policy goal.

9. See Sachs, *supra* note 5.

10. Thomas L. Friedman, *IMF Head Defends Russia Loan Policy Against Criticism*, N.Y. Times, Feb. 2, 1994, at A1.

11. *Id.* Mr. Camdessus also noted that the Russians often did not provide the "basic data which were needed to discuss seriously [the terms of the extension of credit]." *Id.*

12. See Sachs, *supra* note 5 ("The I.M.F.'s relentless advice was to cut the deficit, not to find acceptable and noninflationary ways to finance part of it.").

13. For a discussion of this idea, see Dominique Carreau, *Why Not Merge the International Monetary Fund (IMF) with the World Bank?*, 62 Fordham L. Rev. — (1994).

14. Interestingly, this same debate has taken place over the years in the institutional structure that has been created by the former European Community (now the Union) to aid the integration of less economically developed regions or members into the Community. See Proceedings of the Second Joint Conference of the Amer. Soc'y of Int'l Law and Nederlandse Vereniging Voor Internationaal Recht on Contemporary International Law Issues, *Regional Development Assistance to Reduce Disparities Among Member Countries: Does EC Experience Point the Way for NAFTA?* 209 (1993) (remarks of Joachim Müller-Borle). The Community started with a rather traditional development bank, the European Investment Bank, which provides project lending to less developed regions of the Community after assessing the proposals for each particular project and the extent to which the particular project will aid growth. Conversely, the structural

A review of the IMF's legal structure will illustrate my thesis. The Fund was created in 1945 by an international treaty signed by most of the nations<sup>15</sup> that in 1945 also created the United Nations.<sup>16</sup> In creating the Fund, its founders stated in the Introductory Article to the Articles of Agreement of the International Monetary Fund (the "Fund Agreement") that: "The International Monetary Fund is established and shall operate in accordance with the following provisions: . . ." <sup>17</sup> When the parties to the Fund Agreement amended the Articles of Agreement in 1968, they changed the Introductory Article to read: "The International Monetary Fund is established and shall operate in accordance with the provisions of this Agreement as originally adopted and subsequently amended. . . ." <sup>18</sup> As amended in 1978 and unchanged to date, Article I of the Fund Agreement states the Fund's "Purposes."<sup>19</sup> It is not possible to read this statement of purposes and to determine where, in the text, bilateral or coordinated foreign assistance for economic transformation channelled through the Fund would come. There is no specific mention in the "Purposes" of the use of the Fund as a channel for aid and, as far as granting financial assistance to its members, the closest the Fund Agreement comes to recognizing such a purpose reads: "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."<sup>20</sup> These "general resources" of the Fund are the pool of currencies contributed to the Fund by its members.

Note the reference to making the general resources of the Fund "temporarily available." This phrase would seem to imply that, before making its resources available—to aid members to deal with maladjustments in their balances of payments—the Fund should inquire about whether the member's need is going to be "temporary" or, in fact, if the member

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funds established after 1975 by the Community and the new Cohesion Fund, which has been established to aid the economically less able members of the Union to achieve the economic criteria necessary under the Maastricht Treaty for admission into the European Monetary Union, makes grants to particular programs when member state budgets cannot cover on their own the particular objective of the particular program—a form of compensatory finance. *See id.* This latter conception of aid to integration resembles Professor Sachs' proposed medicine for the transformation of Russia—"international grants and loans . . . to help the Government pay its bills." Sachs, *supra* note 5.

15. Although represented at the Bretton Woods Conference, the Soviet Union did not become a member of the Fund. *See* Andreas Lowenfeld, *The International Monetary System* 17 nn. 1 & k (2d ed. 1984).

16. *See id.* at 17.

17. Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, Introductory art., 60 Stat. 1401, 2 U.N.T.S. 39.

18. Amendment of Articles of Agreement of the International Monetary Fund, May 31, 1968, Introductory art., 20 U.S.T. 2775.

19. *See* Second Amendment of Articles of Agreement of the International Monetary Fund, April 30, 1976, art. I, 29 U.S.T. 2203.

20. *See id.*

drawing on the Fund's resources could not be expected to repay the drawing, as borrowing from the Fund is called, for a period longer than any reasonable interpretation of "temporary." The history of the Bretton Woods Conference, at which the Fund Agreement and the World Bank charter were drafted, indicates that Great Britain, led by Lord John Maynard Keynes, and the United States, led by Harry Dexter White, had quite different ideas about whether the Fund's members "would be entitled to draw at will on the pools of currencies in the Fund."<sup>21</sup> In extending its resources, the United States took the position that the Fund should have discretion in permitting drawings "if the Fund's resources were to be conserved for the purposes for which the Fund was established and if the Fund were to be influential in promoting what it considered to be appropriate financial policies."<sup>22</sup>

The United States, in short, was insisting on what has come to be called "conditionality," and it got it. One of the first steps taken by the Executive Directors of the Fund was to promulgate in 1946 a decision on the purposes for which Fund drawings could be used.<sup>23</sup> This decision again used the words "temporary assistance" and suggests that requests for drawings are subject to scrutiny by the Fund.<sup>24</sup> Shortly afterwards in 1948, the controversy was renewed. At a time when the United States was starting the Marshall Plan, it became worried that "allowing automatic drawing rights would exhaust the Funds resources without reasonable hope for early repayment."<sup>25</sup> This time the Executive Directors issued a decision that, as Professor Lowenfeld points out, "asserts the right of the Fund to reject an application for a drawing or to accept it subject to conditions. The Decision thus constituted a thorough-going adoption of the United States view that drawing rights were to be conditional."<sup>26</sup>

That was in 1948, and the Fund has not deviated from the concept of conditionality since. The Fund is an exemplar of the theory of familial relations called "tough love." The Fund will promise the availability of funds, but the applicant country must demonstrate that it will embark on policies that, in the Fund's view, will enable the applicant country to repay the borrowing as soon as possible. Moreover, the Fund has sought to enforce an applicant's adherence to the agreed-upon economic policies by dribbling out its loans. A country initially gets to take only part of its

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21. Lowenfeld, *supra*, note 15, at 28.

22. Richard N. Gardner, *Sterling-Dollar Diplomacy in Current Perspective* 113 (3d ed. 1980).

23. Lowenfeld, *supra* note 15, at 28 (quoting Executive Directors' decision) ("The Executive Directors of the International Monetary Fund interpret the Articles of Agreement to mean that authority to use the resources of the Fund is limited to use in accordance with its purposes to give temporary assistance in financing balance of payments deficits on current account for monetary stabilization operations.").

24. *See id.*

25. *Id.* at 29.

26. *Id.*

standby, as Fund lines of credit are called. If the applicant country adheres to the agreed-upon macroeconomic policies, then it gets to take out more. The Fund is so conditioned to set conditions that it is no longer capable of imagining making a transfer of funds that, say, simply makes up a budget deficit while the country drawing upon the Fund's resources decides itself upon the economic policies that might best aid it in its particular circumstances to grow, to transform, to achieve whatever *are* the goals of the lending.<sup>27</sup>

But to return to our starting point, the Fund's purposes are set out in the Fund Agreement. The use of the Fund's resources, however conditioned, were to help members with temporary shortfalls in their *balance of payments*. If growth is the goal of the aid, was not the World Bank established at Bretton Woods to aid developing countries to grow? How did the Fund get into the "growth" business? This, too, is a matter of history,<sup>28</sup> but that history illuminates the seemingly inseparable connection between multilateral lending through the Fund and conditionality.

For a period of time in the 1970s, a number of countries sought to evade the dilemma of Fund conditionality by persuading Western banks to recycle petroleum dollars into sovereign dollar lending. As private creditors, banks disbursed loans, but had no enforcement mechanisms for ensuring wise use of the proceeds. As numerous works point out, the debt crisis of the late 1970s and the 1980s resulted from the inability of indebted countries to pay either the interest or principal on these privately extended sovereign loans from private banks and the consequent threat to the solvency of those banks themselves. As the debt crisis deepened, the bankers themselves realized that they had been caught in a trap: without a Fund program to which the indebted country was required to adhere, the banks had no power to force a borrowing country to pay, and the private banks' only remedy was to cease lending and to call the loans. Then what? The banks themselves would be insolvent, would have to admit publicly their insolvency, and the entire house of cards would come tumbling down. The result in the 1980s was arrangements among private bankers, indebted nations, and the Fund that linked extensions of both time to repay old borrowings and new bank loans to the applicant country's agreement to accept the Fund's prescriptions for regaining economic health.<sup>29</sup>

For the Fund, the more new loans it could persuade private banks to extend, the more those funds could be used to keep interest on external debt current without using Fund resources for such an unsanctioned purpose. Thus, the Fund, too, was happy to send its technicians into the

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27. Numerous works on conditionality exist. For a recent book by a former Fund official, see Jacques Polak, *The Changing Nature of IMF Conditionality* (OECD 1991).

28. For an examination of the later history of the Fund and the World Bank, see Economist, *A Survey of the IMF and the World Bank: Sisters in the Wood*, Oct. 12, 1991, at 7-48.

29. See *id.* at 14.



indebted country to work out the conditions for a standby that would include a rescheduling of private bank debt.

At the same time, a rethinking of what might aid a "return to economic health" also took place.<sup>30</sup> Recall again that the original idea of the Fund was to be a pool of currencies drawings that would permit countries to withstand a temporary balance of payments crisis. Now the question/goal at issue was how a country could start earning enough hard currency to repay the debt it had borrowed from the banks and official lenders and be able to return to the capital markets for additional funding. The concept of Fund aid changed from balance of payments funding to aiding indebted countries to "grow" their way out of their extreme debt burden.<sup>31</sup>

The economic prescriptions for returning to balance of payments stability, however, might be quite different from the economic prescription for growth.<sup>32</sup> There is a difference in concept between aid in overcoming a temporary liquidity crisis and aid to produce a transformation in the macroeconomic structure of a country so as to further, in theory, growth. Indeed, so it proved. By the early 1980s, both the Fund and the World Bank were putting their heads together to design country programs that were labeled "structural adjustment."<sup>33</sup> As articulated by the Fund and the Bank, structural adjustment involves liberalization of prices, trade, and exchange followed by "public enterprise reform" (read privatization) and "financial and banking sector reform."<sup>34</sup> Underlying the formal description seems to be the conviction that *only* market economies can grow and that financial assistance, at least in the case of the Fund's special facilities, is to help the countries receiving the facilities deal with the disruptions caused by the move from state ownership to private ownership of means of production, the removal of tariffs, and the freeing of prices. Thus, the Fund's description of its special facilities in its October 1993 Supplement is headlined—"Financing Helps Members Adjust to Special Balance of Payments Problems."<sup>35</sup> Of course, it will be recalled that, under the Fund's charter, what the Fund is supposed to be doing is aiding members with balance of payments problems. But what *if* those

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30. *See id.* at 23.

31. *See id.* at 23-33.

32. *See id.* at 37.

33. For a description of the World Bank's shift from project lender to a setter of macroeconomic policy conditions on project loans to the making of structural adjustment loans, see *id.* at 9 & 41.

34. *See, e.g., Kyrgyz Republic: Further Structural Reforms are Vital to Macroeconomic Stability*, IMF Survey, Oct. 25, 1993, at 322 (describing structural adjustment policies followed—successfully according to Fund—by Kyrgyz Republic).

35. IMF Survey Supplement, *supra* note 7, at 18; *see also id.* (providing picture of Kyrgyz market and stating that "[t]he country's continued policies of price liberalization and privatization, especially in agriculture, have lead to increased supplies of goods in its markets. IMF financial assistance provided under the STF is intended to held cushion the impact of Kyrgyz Republic economic transition.").

problems are caused by the Fund's own medicine prescribed *to create* growth?

In 1986, continuing its involvement with low-income developing countries that had come with participation in the multilateral solutions to the debt crisis, the IMF established a new structural adjustment facility (the "SAF") to make concessional loans at 0.5 percent interest with repayments beginning 5 years and ending 10 years after each disbursement—using repayments to a fund that originally had been established at the time of the Second Amendment to the Fund Agreement to help developing countries with concessional loans. In December 1987, the IMF established an additional fund, the Enhanced Structural Adjustment Facility (the "ESAF").<sup>36</sup> Just this March, an enlarged ESAF has been put into place and this facility includes contributions from several countries that had benefitted in the past from the facility, such as Bangladesh.<sup>37</sup>

With the SAF, the ESAF, and the enlarged ESAF, it is hard to tell whether the Fund is making concessional loans to help countries deal with the balance of payments problems that come with liberalization of trade, prices, and exchange *and* privatization or whether the IMF is making the concessional loans to encourage, nay, insist upon such policies as a condition of the loans. The IMF Survey October 1993 Supplement describes one of the "objectives" of these facilities as "to help these countries establish the conditions for sustainable growth. . . ."<sup>38</sup> Most interesting of all, the SAF and the ESAF clearly served as the *model* for the Fund's Systemic Transformation Facility (the "STF").<sup>39</sup> The Fund created this facility last April for Russia and the other states of the former Soviet Union. The Fund described the STF as being intended specifically to aid Russia in dealing with balance of payments difficulties caused by its shift from "trading at non-market prices to multilateral, market-based trade" and its shift to "world market pricing, particularly for energy products."<sup>40</sup> Very well—certainly the former states of the Soviet Union *have* these problems, if for no other reason than the break up of the Council of Mutual Economic Assistance, the trading organization of the former Soviet-bloc countries. But what entitles these countries to *use* of the facility, which is *not* concessional, but on the terms charged by the Fund for use of its general resources? Use of the facility by a country is conditioned on compliance with the IMF's usual panoply of conditions, including "a written policy statement describing the objectives of its economic policy; macroeconomic projects; the *structural*, fiscal, mone-

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36. See *Concessional Facilities Assist Low Income Countries*, IMF Survey Supplement, *supra* note 7, at 21.

37. *Camdessus Welcomes Activation of Enlarged ESAF & Broad Based Support*, IMF Survey, Mar. 21, 1994, at 81.

38. IMF Survey Supplement, *supra* note 7, at 21.

39. See *supra* note 6 and accompanying text.

40. See IMF Survey Supplement, *supra* note 7, at 20.

tary, and exchange measures to be implemented over the next 12 months; and if applicable, a technical assistance program.”<sup>41</sup> Moreover, if the country is requesting the STF financing outside of borrowing from the Fund under its usual arrangements or an ESAF arrangement, the country must convince the Fund that “it will move as soon as possible towards policies that the IMF could support under one of these kinds of arrangements.”<sup>42</sup> There, the cat is out of the bag. The *goal* of the financing is the conditions themselves, macroeconomic policies in which the Fund believes.

It is, of course, possible that the G-7 deliberately chose to funnel the promised \$28.4 billion to Russia through the Fund because the G-7 themselves wanted to hold back funding until Russia promised reforms *satisfactory* to the Fund. In other words, the G-7 wants to use the Fund as its “tough love” mother. That is as it may be. But, if the G-7 did want to aid Russia quickly, without palaver, along the lines Professor Sachs recommended, they chose an inappropriate institutional method for doing so.

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41. *Id.* (emphasis added).

42. *Id.*

