



The International Monetary Fund (IMF'S) financial programming approach to construction of stabilization packages agreed with Less Developed Countries (LDC'S) and its divergence from foundational Islamic norms

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ABSTRACT

The paper exposes some of the unethical practices that surrounds IMF stabilization polices. It specifically examines the functionality of the financial programming model of the IMF vis-à-vis its adoption and imposition on LDC's. This is in turn juxtaposed with foundational Islamic norms. The author concludes with some remarks and recommendations.

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Financial Programming, Stabilization, Islamic norms, International Monetary Fund, Less Developed Countries.

Introduction

Financial programming remains a focal point in the presentation and composition of stabilization packages to LDC's. Over the years, LDC's cum member countries run to the IMF in times of Balance Of Payment (BOP) crisis for help, the antidote in turn given to them by the IMF have proved to be ineffective as it has in most cases aggravated the problem and ultimately led to periods of recession. The reason for this is not far fetched as the IMF practically uses the same model for its beneficiaries neglecting the fact that each country has her own underlying peculiar structures which make it to respond differently to policy prescriptions. In essence a policy that works for country A might not necessarily work for a country B. This evaluation is pertinent as the IMF model have been unchanged over the last fifty years or so in dealing with short term stabilization issues, which has yielded little or no positive results. This essay will present a theoretical and practical exposition of IMF's financial programming approach, expose its functionality and tries to explain why the standard policy prescription emanating from this approach often generate non standard results. This write-up also attempts to pinpoint the divergence of this adynamic approach from fundamental Islamic norms and values.

Financial programming and stabilization

Generally speaking, the term financial programming refers to the IMF's analytical framework applied to stabilization programmes conveyed to economies needing such programmes. The IMF in one of its occasional papers (1987) asserted that the financial programming have been formulated over the years taking into account cogent institutional and structural developments in the ailing economies of its beneficiaries, major changes in international economy, progress in the study of macroeconomic and international issues. However, very little has in fact changed in the basic IMF framework over the past fifty years as the similarities of the programs are strikingly more remarkable than the differences (Buirra 1983). Stabilization measures on the other hand is generally believed to be a short

term panacea goaded by the IMF aimed at reducing mainly inflation and correcting adverse balance of payment through selected policy variables such as domestic credit, exchange rate presumed to be under the control of the state. Economic stabilization became prominent in LDC's in the early 1980's owing to the rise in oil prices, debt crisis and the deteriorating balance of trade. (Jhingan 2005)

IMF and conditionalities

The IMF established at the Bretton Woods conference in the first three (3) weeks of July 1944 by representatives of forty-four (44) nations was set up to promote international monetary cooperation by providing a machinery for consultation and collaboration. Never before had international monetary cooperation been attempted on a permanent institutional basis. IMF today, composed of about one hundred and eighty-eight Nations (188) has evolved into a lending institution and boasts of billions of dollars in his kitty as loanable funds to its country members. IMF draws its financial power from membership fees of its country members which are proportional to the country's economic size but on rare occasion draws its funds by borrowing from official entities. Member countries are allowed to draw from the IMF based on its membership fees (Quota) contributed. They are by right allowed to draw 25% of their quota which is the reserve tranche. A country that needs to draw more than the stipulated limit will face policy conditionalities. The borrowing is however limited to five (5) times the reserve tranche but in some cases, extended facilities make it possible to borrow more than the stipulated. These policy conditionalities are the bedrock of IMF stabilization packages agreed with the LDC's.

It should however be noted that IMF is limited by its charter to tackling basically short term balance of payment disequilibrium alongside achieving acceptable levels of inflation during the stabilization programme, meaning, long term BOP problem does not fall under the purview of IMF as BOP problem which are long term require supply side measures to quell and her IMF concentrates on demand side management. This we

would see in the following model exposition cum assumption that underpins its financial programming framework in her bid to achieve economic stabilization.

Financial programming; MABOP and Polak models

The financial programming approach of the IMF has its roots in the Polak Model and The Monetary Approach to the Balance of payment (MABOP). Indeed Financial programming of the IMF is essentially the Polak and / or the MABOP. This is not difficult to see as a common theme run through the fund's program when the approach of the financial programming is being analysed (Buira 1983). This theme which is the cornerstone of fund's approach to economic management is the regulation of money growth rates usually through credit policy.

Jacques Polak (1957) developed the Polak model named after him. The development of the model was borne out of the need of the fund "to have an understanding of the causes of payments deficit and both quantitatively and qualitatively of the policy measures to overcome them as it is only through the understanding that it could come to a judgment whether the actual or proposed policies of the member would be sufficient to restore balance and if not to insist on a strengthened policy as a condition for its credit" which is usually the case. The model is still very much alive today (Polak 1997). What Polak did was to come up with a model that study the effects of the two (2) most important exogenous variables operating on the economies of the great majority of nations in the early post war period, namely autonomous changes in exports and the creation of bank credit on income formation and the balance of payments. He suggested and established links between; domestic autonomous expenditure and credit creation, exports and additions to money supply from abroad hinged on a money demand function, of which evidences as at that time indicated that a function of demand proportional to GNP appears a reasonable approximation devoid of complexities (IMF 1997). What could be tagged as the simplest version of the Polak Model given in IMF (1977) is represented below;

$$\Delta MO = k\Delta Y - A$$

$$M = mY - B$$

$$\Delta MO = \Delta R + \Delta D - C$$

$$\Delta R = X - M + K - D$$

Where;

MO = Money supply

Y = GNP

M = Imports

R = Reserves

D = Domestic Credit of the Banking system

X = Exports

K = Net Capital inflow of the Non banking sector

k = The inverse of the velocity of Circulation of money

m = The marginal Propensity to Import

The model has two (2) behavioural (A&B) and definitional equations (C&D). It is further composed of endogenous variables such as ($\Delta MO, \Delta Y, M, R$) cum exogenous variables such as ($\Delta X, \Delta K, \Delta D$). The model is predicated on the following assumptions;

- Money Market always clear (Money demand = Money Supply = MO)
- There is the presence of an open economy operating a fixed nominal exchange rate rather implicit in the model.

- A fairly stable well defined money demand function which depends on nominal income only.
- Import is a fraction of Nominal Income
- Money circulates at constant velocity.
- Export (X) and Net capital Inflow (K) are given.
- Model is kept in nominal terms and there is no distinction between .price and real income changes.
- Savings are instantly invested; implicit in the model.

The target variable in the model is ΔR while the policy variable is D.

How the model works.

Since the object is an improvement in the balance of payments and an acceptable inflation rate, the model works as a policy package in that.

- Cut Domestic Credit Expansion (D) of the government – Reduction in the money Supply (MO) – These further reduces nominal income (Y) – This feeds directly into reduction (M) – means less pressure on foreign reserve which might/should increase – favourable balance of payment – object achieved-crisis over. It is believed that once the money supply is brought under control, inflation is reduced to a single digit acceptable rate.

Polak's result was powerful and it continues to form the theoretical core on which financial programming exercises are carried out in the policy wing of the IMF (Tarp 1994).

The MABOP championed by Frenkel and Johnson (1976) is similar to the Polak model in many respects except that MABOP circumvents the increase in nominal income as against the Polak model, as a decrease in domestic credit feeds directly into a decrease in demand and imports. Therefore reserve improves and a crisis is gone. Thus any excess supply of money is instantly expunged. The model considers real output to be exogenous and thus independent of the aggregate demand. The bottom line of the model is that BOP performance depends on controlling mainly domestic credit expansion (D) and probably exchange rate. This is a more powerful result than Polak's as the working of the model is much more direct and faster, though Polak's might be more realistic. (Tarp 1994)

Worthy of note is the exchange rate policy variable in the MABOP. The exchange rate policy variable makes the policy prescription of devaluation an option in IMF's financial programming especially in a flexible exchange rate region but in the model its impact is temporary. The argument is that with an external imbalance, the demand for money is below money supply. With devaluation, there is an increase in the domestic price level which increases the demand for money, thus the imbalance between money demand and supply is eliminated temporarily. This temporarily equilibrium is only sustained if domestic credit is eventually limited to the level consistent with growth in money demand reflecting endogenous increase in real output. It therefore suggests that devaluation if it must be applied has to be carried out alongside domestic credit restriction to achieve BOP improvement.

Practically in a nutshell, when the LCD's face BOP crisis and the IMF is called in, the following ensues as far as stabilization is concerned.

- Policy framework Papers (PFP) is drafted by the country seeking aid with the help of IMF officials ratified by the executives of IMF. The PFP describes the crisis and specifies the objectives to be achieved
- Target variables such as foreign resources (R) mainly, inflation using change in domestic price as proxy and in some cases credit to the private sector are established. Also, estimates

of exogenous variables such as export, real output and net capital inflows of the non-bank sector are generated. So also, import values are checked for consistency with the level of resources i.e. if the country can afford the current level of imports. If consistent, no stabilization required, if otherwise, stabilization proceeds as discrepancy must be resolved.

- Devaluation policy is assessed for desirability by looking at its impact on export, output and capital inflow. If desired, a new exchange rate is established. Also money demand value is established using the constant velocity assumption with interest rate action allowed if desired. Thus the overall acceptable domestic credit expansion is determined.

- Hence, the IMF's thinking about stabilization is applied as in the workings of the MABOP and Polak model.

- Final agreement on implementation is agreed in a letter of intent from the beneficiary government to the IMF after a consistency check of the over-all programme is done. This letter would also include performance criteria to be used in monitoring.

It should be noted that in cases of structural adjustments, some other policy prescriptions such as liberalizations in forms of price, credit and tariff, income policies, exchange rate, as well as adjustment of structure of production are usually embedded.

Why this financial programming approach of the IMF to the construction of stabilization programme agreed with LDC's do not often achieve the objective of correcting short-term BOP equilibrium and regulating inflation consistent with high employment and real income targets is explained subsequently.

A plausible explanation for quasi-fiasco policy results

Drawing extensively on the Porter and Ranney (1982) article, the author attempts to model a structuralist idea; that the LDC's have their own peculiar structures which makes the application of orthodox economic laws which have hitherto worked for the developed countries on them uncritically, a disaster. I argue that the main philosophies in the IMF programme of monetary contraction and devaluation are likely to produce grave negative economic consequences of recession, stagflation and price rises(inflation). However, fiscal policy measures of reduction in government spending might be an option if need be. This however falls outside the purview of this revelation. The model is concisely described below;

- LDCs have an informal (curb) interest rate (i) which differs from the formal one considered in most IMF programme.
- Exogenously determined real output Y [full output notion] as in the financial programming is not the case in LDC's. 'Y' is subject to shift as it depends on [P, i, e, w] where P=price, i=curb interest rate, w=nominal wage and e=exchange rate.
- Monetary base dominated by cumulative government debt ($\sum J$) and trade balance ($\sum B$) and restriction in form of reserve ratio (q) are functional in LDCs.
- Investment in LDCs is financed majorly from government sources (I_g) and retained earnings.
- Net exports depend on world prices and are moderated by tariffs and taxes such as [tx and tm] also, consumption C is also affected by a proportional tax rate (ty).

Hence; $i = (p, q, I_g, e, w, \sum J, \sum B)$

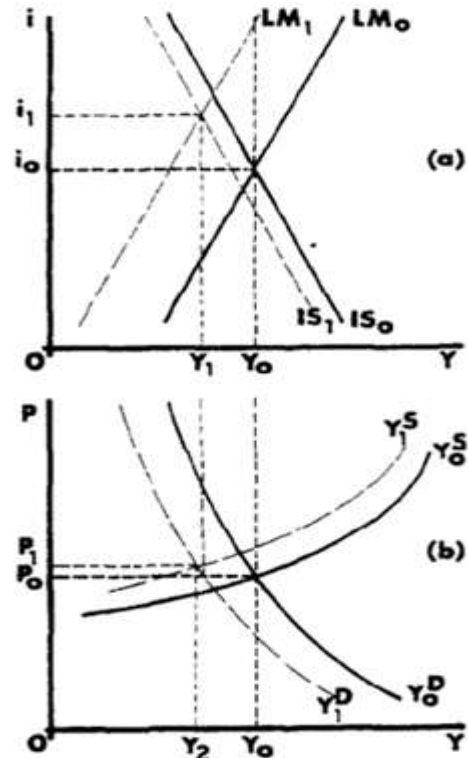
$Y^d = Y^d(P, q, I_g, ty, tx, tm, e, w, \sum J, \sum B)$

$Y^s = Y^s(P, i, e, w)$

$Y^s = Y^d = Y [P, i (P, q, I_g, e, w, \sum J, \sum B), e, w]$

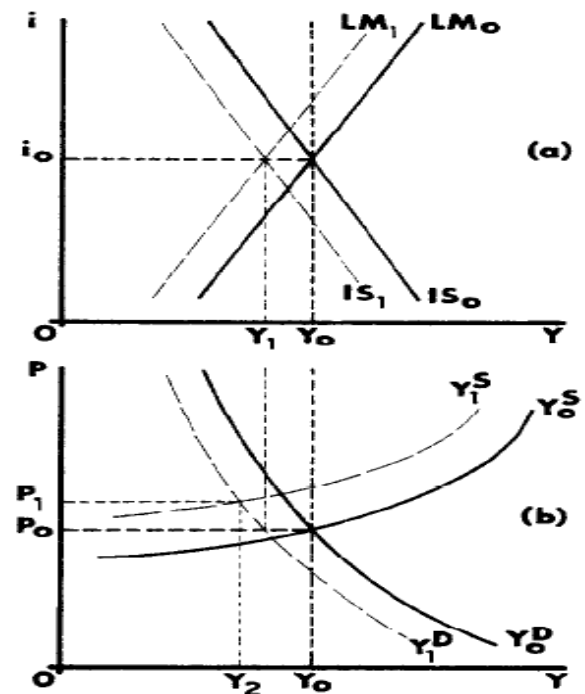
Representing the above using the IS-LM and AS-AD framework, we can explain the effects of monetary contraction and devaluation on prices, output and employment in LDCs.

Monetary Contraction



From the above diagram an increase in reserve ratio(q) has a profound effect on the LM curve at a given price level, this is due to low interest rate elasticity of money demand and lack of low interest commercial bank loans which discourages retained earnings. As a result, a rise in the interest from i_0 to i_1 shifts the LM curve leftward (LM_0-LM_1), IS curve shift inwards as Y also falls and aggregate demand shift downward (AD_0-AD_1). The policy implication is that a monetary contraction instead of reducing both output Y and price P, it reduces Y but increases P, as such inflation persists with fall in productive capacity. This is not desirable.

Devaluation



Form the diagram, with a devaluation, the IS and LM curve shift leftwards (LM_0-LM_1) and (IS_0-IS_1), aggregate demand also shifts downward with interest rate not bulging, even at that aggregate supply shift upward (AS_0-AS_1) as devaluation increases variable input costs. This leads to a reduction in output and an increase in price instead of the expected effect of increased price and output. Again an unfavourable situation.

Divergence from foundational Islamic norms

As a corollary, such adynamic approach and its attendant ineffectiveness generate some axiomatic differences when compared with Islamic norms and values. Such axiomatic themes running from the above exposition include; Lack of creativity and innovation, fostering of disunity, Restriction on Liberty to act engendered by conditionalities, empathy devoid postulations as well as gross imbalance between “factology” as opposed to “theology” which gives birth to technical extremism. This differences are explained below under the following headings; Unity, Freedom of Action, Moderation and balance, Amanah and justice and Social responsibility. These Islamic norms follow that of Zubair (2011).

Unity

Unity simply means harmony. It could also be simply approximated to mean togetherness or a state of no discord. The Supreme Being sanctions this concept which is a requisite for love safety and effective performance. He says in the glorious Quran, Chapter 3 verse 103;

“And hold firm to the rope of God and do not become divided”

However, The negative position of some LDC's after the implementation of stabilization programmes have led to resentment of this institutions as well as the developed countries believed to be controlling them. This “bad blood” has led to disunity between the LDC's and MDC's to such extent that their relationships are more of a tolerating one and no options rather than willingness. Some LDC's believe the MDC's to be the architect of their misfortunes. Therefore there is promotion of disunity as opposed to normative unity.

Freedom of Action

The imposition of policy conditionalities on a vulnerable party mainly because they are need in an agreement or transactions goes against the collective freedom of action of a nation. In most cases this conditionalities remain as long as the country remains in debts despite the fact that these policy conditionalities contribute to the accentuation of these debt position. Almighty God says in Surah 42 verse 42 as well as in Surah 2 verse 280 respectively;

“The blame is only against the ones who wrong people and tyrannize upon the earth without right. Those will have a painful punishment”.

“And if someone is in hardship, then let there be postponement until a time of ease. But if you give from your right as charity , then it is better for you, if you only knew”.

Moderation and Balance

The creator commands a balance in what ever we do and thus moderation. The Cherisher communicates to us in Surah 17 verse 35;

And give full measure and weigh with an even (honest) balance. That is the best way and best in result.

The applicative rigidity of a particular model to virtually all beneficiaries even when evidence points to its non generalizability amounts to transgression and committing excesses. This somewhat shows lack of concern and empathy for the affected countries.

Amanah and Justice

Closely related to the above point is the concept of Amanah and justice; Allah says in the last testament; Surah 4 verse 58 “Indeed, God commands you to render trusts to whom they are due and when you judge, judge with justice. Excellent is that which God instructs you, God is ever Hearing and Seeing”.

This divine guidance reveals that the rights (Haq) of others are present in whatever we possess and that this right must be honoured. It is an obligatory act and not a charitable act. Therefore it is incumbent upon an organization cum countries to give out untied aids or better still unconditional loans to needy countries rather that subject them to likely intergenerational debts. This reasoning borders on the fact all provisions are originally Gods' and humans possess this resources as caretakers who should distribute with justice. More so imposing conditionalities associated with policy prescriptions erodes justice.

Social Responsibility

“.....And to Parents do good, and to relatives, orphans, the needy, the nearer neighbor, the neighbour who is a stranger, the companion at your side, the traveler you meet and those whom your right and possess. Indeed God does not like those who are self-deluding and boastful”. Quran chapter 4 verse 3

This verse enjoins on us to always pursue actions for the common good. IMF's stabilization programme have largely eroded social responsibility in terms of their dealing with LDC's. This is because the largely unsuccessful programmes have made them unable to fulfill their obligation to act in benefiting the society at large.

Conclusion

Having examined the financial programming approach and stabilization packages agreed with the LDCs vis-à-vis its deviations from the Islamic values, It is deducible that the IMF might have entered into the 80's grossly ill prepared for the challenges ahead, inheriting a set of intellectual methodologies filled with unforgivable intellectual flaws and pit falls. This inherited analytical formula was then continuously applied in a context not suitable for its application. This is not befitting from an organization of such pedigree. It is also glaring that the approach to fund's programmes agreed with the LDC's are divorced from religion or better still ethics. It is suggested that some flexibility be observed in the application of financial programming models. In fact, the role played by the organization might well be reduced to an advisory one such that they aid the countries in developing their own programmes. It is also recommended that the LDC's (both Muslim and Non-Muslim) countries explore financing based on Islamic finance principles or at least financing based on Godly principles as it is only through this means that success is imminent.

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