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**Article — Digitized Version**

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Intereconomics

*Suggested Citation:* Mayer, Otto G. (1998) : IMF under fire, Intereconomics, ISSN 0020-5346, Springer, Heidelberg, Vol. 33, Iss. 6, pp. 249-250

This Version is available at:

<https://hdl.handle.net/10419/40212>

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# IMF Under Fire

Already in the run-up to its annual meeting from 6<sup>th</sup> to 8<sup>th</sup> October, the International Monetary Fund (IMF) came under heavy fire. World-famous economists like Jeffrey Sachs, Paul Krugman, Joseph Stiglitz and Milton Friedman called outright for its dissolution. The Fund, they claimed, could do little or nothing at all to help remedy the Asian, Russian or Latin American crises or the crisis on the international financial markets; on the contrary, it was a contributory factor. Its readiness to provide extensive funds fast to countries in crisis and thus safeguard the investments of private creditors in these countries engendered a moral hazard for governments and creditors, which itself was the cause of crises. This socialization of private losses misled international banks and investors into engaging in over-risky financial transactions.

Former US Secretary of State Henry Kissinger goes a step further. Because of the way it manages crises, the IMF all too often exacerbates political instability on top of economic uncertainty or crisis. In the name of an orthodox, almost purely academic free market theory, it usually tries to remedy all the weaknesses of a country's economy at once. In this way, the IMF all too often impairs the political fabric of the country and hence the basic prerequisites for lasting reform, Kissinger thinks.

Now, criticism of the IMF's stabilization programmes is nothing new and one can argue with good reason in every individual case about whether its standard stabilization programmes have always been properly adapted to the conditions in the particular country which finds itself in an economic crisis. But it would be wrong to make the IMF into a scapegoat for political unrest in these countries generally. It is an empirical fact that such countries do not call on the IMF when relatively smooth processes of adjustment still look possible; they turn to it as a last resort when profound and painful interventions have become unavoidable. As a rule also, the IMF is not called on in time because governments do not even feel able politically to implement the processes of adjustment based on (let us assume) sound stabilization programmes. The governments of Thailand, Indonesia and South Korea, for example, were initially very hesitant in implementing the respective programmes, which only had an effect and stabilized currencies when new governments came into office. Whether it really makes sense to gloss over the economic problems of a country through unconditional finance with a view to safeguarding the government's political survival is an open question, to say the least. Experience with the IMF's involvement in Russia should give ground for scepticism.

Over the last few years, the Russian government has tried with various programmes to stimulate domestic industry, raise tax revenue and improve the investment climate. The IMF took benevolent notice of these programmes but obviously it did not monitor them closely enough. Major reform measures and particularly the modernization of the chaotic laws on taxation were left undone. Russia is the first country where the government has taken money from the IMF without changing anything afterwards. Also, the decision of the IMF this summer - largely in response to pressure from major Fund members - to grant another loan nevertheless surely cannot be gauged as much more than a ploy to bolster Yeltsin's power, yet there have been no discernible substantial improvements in economic or political

stability. But: once Russia had set off along this path, turning back did not look like a better option. We can therefore expect that good money will continue to be thrown after bad.

So are the radical critics of the IMF right to call for its abolition according to the motto, "nip it in the bud before it's too late"? This argument would be difficult to refute if countries had to bear the consequences of their economic policy failure alone. It could of course be argued for example that lax financial and monetary policy (under fixed exchange rates) results in external imbalances that cannot be redressed in the long term without devaluations or foreign trade restrictions, i.e. without welfare losses. It is worth recalling that the countries hit by the latest crises had fixed or semi-fixed exchange rates. In other words, they would have been forced to make the necessary adjustments even without the intervention of the IMF, only sooner. How serious the social consequences are depends crucially on the flexibility of the goods and labour markets. Financing the process of adjustment through the IMF always means providing a social buffer and buying time for corresponding reform measures. The ultimate aim behind this is to keep the markets open, i.e. to avert an attempt by the countries concerned to resort to trade restrictions and capital controls and cause lasting damage not only to themselves but also to other countries. From this standpoint, assistance should be considered to ensure that borders and markets remain open - one of the IMF's foremost tasks, according to its statutes.

The question admittedly then arises whether the risk of moral hazard can be avoided or at least mitigated. Helpful here is a strict supervision of the countries and a conditionality that is not just confined to classic macropolicy but also includes the quality and structure of financial systems and bank supervision, especially if the IMF members could bring themselves to allow Fund statements to be published unedited, even if the statements relate to them. If we accept that especially with progressive economic globalization there is a growing need for a generally accepted regulatory framework, we need an institution to act as a kind of catalyst to find solutions to these questions. Now, some progress has been made at international level regarding bank supervision — the Basle Capital Accord or the Core Principles for Effective Banking Supervision, for instance. What is missing is their application in the countries themselves. Who should act as a catalyst and provide the necessary technical assistance, if not the IMF?

There are, however, grounds to doubt whether these rules are enough, since present banking supervision looks at individual banks in the belief that if all banks are healthy, so is the system. This would be the case if the risks taken by individual banks were statistically independent of one another. Due to interbank relations, they are not, however, so "acceptable" individual risks accumulate, which is a different matter altogether. For example, many Asian banks raised their finance on the international capital markets in dollar securities and extended dollar loans to local enterprises with these funds. After local currencies plunged in value against the dollar, these enterprises had difficulties servicing their dollar-denominated debts. Where the banks went bankrupt, the credit risk reverted to the international banks that had granted the original loans to the Asian banks. A conventional banking supervisory body today would in this case have big problems correctly assessing the risk positions of the international banks, the Asian banks and their borrowers - if it were possible at all. In future, internationally and nationally, banking supervisory authorities should at all events try to think in systems and risk correlations and span a kind of safety net on this basis.

To do this, the private sector - banks, insurance firms and other institutional investors - must be involved to rule out a moral hazard as far as possible. One possibility might be to set up safety funds with financial deposits from international creditors. In a crisis like the one in Asia, the IMF would have to check whether assistance made sense, just as it does now, but it would provide little or no funds of its own. The socialization of private losses would thus be kept within limits and the incentive for international investors to engage in "all too risky" financial transactions would be less. There are quite good reasons, therefore, not to do away with the IMF.

*Otto G. Mayer*