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IMF Reform: Sticking to the Essentials

For the most part, the Asian financial crisis seems to be under control. However, for the IMF, which played a central role in managing this crisis as well as the previous one in Mexico, effort has evidently not been rewarded. The drove of critics is growing continuously and the call to reform or even dissolve the IMF is getting louder and louder. This, although the IMF has been quite open-minded towards reforms and is working on a new financial architecture. Many critics, however, doubt that the chosen path is the right one. Looking closer at the Asian crisis management, one is inclined to join ranks with the sceptics.

The previous economic success of the Asian NICs involved a considerable influx of capital. It was obvious, however, that serious mistakes were made here by private investors. Firstly, Asian banks and other Asian borrowers used short-term renewable loans from foreign banks to finance long-term lending. When the renewal was not forthcoming they inevitably made large losses. Secondly, the Asian banks and enterprises borrowed in hard foreign currency such as dollars, marks or yen, but they granted loans in local currencies. They believed they had the advantage because interest rates abroad were lower, but they ignored the fact that interest rate differentials are affected not only by inflation differentials but also by the risk of currency devaluation. They took this risk without hedging. Thirdly, the foreign banks took no objection to the absence of hedging either.

These mistakes took their toll when in the course of 1997 the stock exchanges in the NICs recorded losses of between 65% and 75% and exchange rates plummeted by 40% to 70%. Investors with shares or with obligations in foreign currencies suffered gigantic losses.

But did the American, Japanese and European banks and their loans denominated in hard currency fare better? The IMF and the governments of the industrialised countries lent the Asian governments money to repay their bank loans or settle their interest payments. The fresh loans prevented the Asian banks from collapsing but the money flowed to the foreign banks. They incurred only slight losses as compared to the holders of shares, bonds and so on.

It cannot be denied that the IMF's rapid and much-praised intervention in Mexico, which followed a similar pattern, proved in hindsight to be its fall from grace because it exacerbated moral hazard on two levels. For one thing, it set the wrong incentives for prospective foreign investors in the emerging markets. After Mexico, they could be reasonably certain in the case of large countries that, if a crisis occurred, their claims would be honoured for the most part by international financial aid and they would not – or only to a limited degree – have to bear the consequences of their actions. They were misled into taking risks by the IMF. They had no incentive to check how high their borrowers' liabilities were, how much of the latter's short-term borrowing was re-lent long-term or how high their currency risk was.

For another, the wrong signals were also sent to countries under threat of crisis. Prompt and generous assistance undermines the political discipline of the recipient countries. They have no incentive to avoid large current account deficits due to overvalued currencies, to make sure that short-term liabilities do not exceed currency reserves in the balance of payments and – via effective banking supervision – to cause de facto insolvent banks to be closed down so that they cannot trigger a run on the banking system when the crisis breaks out and forces foreigners to adopt a cautious lending policy. Thailand, whose problems started the Asian crisis off, provides a good example of these mistakes.

The way in which the IMF dealt with the Asian crisis failed almost wholly to remedy this syndrome, not least because of the generosity of the assistance proffered. For Mexico, for example, US\$ 40 billion were made available, for Korea US\$ 57 billion, for Indonesia US\$ 34 billion and for Thailand US\$ 17 billion. The large sums in the IMF programmes in recent years are a core aspect of the problem. They convey the impression that the IMF is something like a 'lender of last resort'. But this is to forget that the national central banks in their capacity as lenders of last resort prevent a run on temporarily illiquid but essentially solvent banks by granting them unlimited credit at interest rates above the going market rate against sound but illiquid collateral. The IMF does not do this. It can provide large, but certainly not unlimited, sums. Moreover, its interest rates are below the going market rate and it requires no collateral.

The main idea behind the large subsidized funds is to empower the IMF to demand far-reaching reforms from crisis countries. In order to obtain the required funds it must attach conditionalities to its assistance that satisfy the member governments providing and guaranteeing such funds. This is why the conditionalities are no longer confined to macro-economics and financial policy and have gradually been extended to include labour market regulations, social policy, human rights, trade policy and business supervision. The size of the individual programmes provides the rationale for the call to increase IMF funds. As the example of Russia shows, these large sums and extensive programmes can have an adverse effect, because they make supervision more difficult and thus enable bad policies to be continued.

Despite the mistakes the IMF has made in crisis management during the nineties, the call for its dissolution is unwarranted. Although the transition to flexible exchange rates is still ongoing, we still need the IMF. Exchange rates are not just subject to the decisions of a single country; they are affected by the economic policies of several countries. The IMF should therefore act more intensively as a forum for avoiding incompatible economic policies. In addition, with the decontrolling of capital markets and the new financial instruments and derivatives it should be allotted the task of global watchdog for these markets.

It is also a good thing for the IMF to intervene in crises. Appropriate reforms will, however, have to be made in order to avoid repeating past mistakes. In future, the IMF should confine its role to that of an honest broker between creditors and debtors. The conditionalities should concentrate on the exchange-rate system, the balance of payments and the financial system. The key question for the programmes is whether the changes demanded by the IMF are necessary to induce international lenders to lend again.

Presumably, the best way to get the IMF to do this is to restrict its funds, not, as has now occurred, to increase them. Limiting funds will force it to concentrate on essentials: restoring sustainable, good relations with international capital markets. Countries will then also have funds for other reforms. Many of the measures taken or discussed so far in the context of building a new financial architecture will probably be less effective, with one exception. Efforts to reduce moral hazard by obliging private foreign lenders to contribute towards the costs of crisis management must be intensified.

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