

Willett, Thomas D.

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Understanding the IMF Debate

THOMAS D. WILLETT

Director, Claremont Institute of
Economic Policy Studies
and
Horton Professor of Economics
Claremont McKenna College
and
Claremont Graduate University

Address: School of Politics and Economics
Claremont Graduate University
160 East 10th Street
Claremont, CA 91711
Tel: 909-621-8787
Fax: 909-621-8460
E-mail: Thomas.Willett@cgu.edu

*This paper is based in part on my presentations at panels on reform of the international financial architecture held at the annual meetings of Academy of International Business in Charleston in November 1999 and the Western Economic Association in Vancouver in July 2000. Without necessarily implicating them in the contents of this paper, I admit to borrowing shamelessly from many of these observations of my fellow panelists, Charles Adams, Peter Clark, James Dean, Eduard Hochreiter, Catherine Mann and John Murray. I would also like to thank Sven Arndt, Graham Bird, Martin Edwards, Erica Gould, Robert Higgs, Joseph Joyce, and Allan Meltzer for helpful comments.

1. Introduction

The International Monetary Fund (along with the World Bank) was established during the international negotiations at Bretton Woods, New Hampshire, toward the end of World War II to oversee the operation of the post war international monetary system and provide financing for countries with balance of payments problems. In its early days, it helped facilitate a rapid expansion of world trade and the recovery of war torn economies. For decades, such success led the IMF to operate in relative obscurity. Over time, however, the system of adjustably exchanged rates devised at Bretton Woods proved incapable of operating effectively in a world of growing international capital mobility. Currency crisis became increasingly common, culminating in a breakdown of the exchange rate regime in the early 1970's.

Over the preceding decades the International Monetary Fund had become so closely identified with the exchange rate regime over which it had presided that many assumed that the end of the exchange rate regimes would also be the end of the IMF. To the pessimists the result was expected to be a catastrophe – a return to the economic warfare of the 1930's. To the optimists floating exchange rates would take care of all international monetary issues and an organization like the IMF would no longer be needed.

Both views were wrong. We had neither a catastrophe nor a solution to all our problems. Both predictions were flawed because they were based on a lack of understanding of the full range of activities with which the IMF was charged. These included discouraging the use of competitive depreciations that had added so much to the costs of the Great Depression in the 1930's and provide a mechanism to encourage

countries to follow sound monetary and fiscal policies. These rationales for the IMF continue to be important even if all countries have adopted flexible exchange rates.¹ Furthermore, despite the collapse of the formal international system of pegged exchange rates, many countries continued to peg their exchange rates. Thus, while the roles of the IMF have evolved quite substantially over time, it is wrong to argue that it has become obsolete.²

Whether it has been doing a good enough job is quite a different issue, however. In many developing countries, the IMF long has been a household word. It is infamous for forcing countries into austerity programs, i.e. adopting stabilization policies. In recent years this role of the IMF as the bad cop who forces countries to live within their means and offers meager amounts of financial assistance in exchange for macroeconomic stabilization and market liberalization policies has been extended to the former communist countries who are now struggling to adjust to the ways of the market. While often seen as a valuable friend by finance ministers and reform minded economists in developing countries, many politicians there see political advantage in vilifying the IMF. Thus, it is easy to see why many citizens in emerging markets and the far left in the industrial countries have long been critics of the IMF.

Until quite recently interest within the industrial countries in the operations of the IMF had been limited almost exclusively to a narrow spectrum of experts, interest groups, and policy officials. What is new today is that many on the far right in the United States have joined in condemnation of the IMF while the left has taken to the streets in

¹ Of course a completely free float competitive depreciation would not be a problem, but few flexible exchange rates are not subject to some degree of government management.

² On the evolution of the activities of the IMF see James (1996) and Meltzer (1999).

public demonstrations against the IMF as an agent of globalization. Combined with widespread concerns about the failure of the IMF to prevent the rash of international financial crises that plagued the 1990's and increasing fears about the effects of globalization, attacks on the IMF have begun to receive widespread attention, including heated debates in the U.S. Congress. In March of 2000, the IMF joined the World Trade Organization as a poster child for the evils of globalization as the same group of NGO's (non-governmental organizations) that created such havoc at the WTO meetings in Seattle and led one wag to label this episode as "Senseless in Seattle" converged on Washington, D.C. to attempt to shut down the IMF during the meeting of its oversight committee from national governments.³

What should the general public and our national policy makers make of this phenomenon? We might be inclined to suspect that anything both the far right and the far left can agree is bad must really be awful. What should give us pause about this interpretation, however, is that most of those in the middle do not share this opposition to the IMF. Indeed, when we look closer we see that the far right and left agree on this issue only because they have vastly different perceptions of what the IMF actually does. The far right and left cannot both be correct in their perceptions about the IMF, but they can both be wrong and indeed they are. Few of the harshest critics from either side really know very much about the IMF.⁴ Rather the comfort of strong ideological commitments and a few anecdotes consistent with these views give many on each side all of the information that they think they need.

³ This was only partially successful. The meetings weren't stopped, but sufficient downtown congestion was generated for the Fund to give most of its staff the day off.

One might think that the strong attacks for opposite reasons coming from both sides might give each side pause. Can the IMF really be such an agent of socialism if the left wants it abolished? Can it be such an agent of global capitalism if the right wants it abolished? Seemingly, each side thinks that the other's intellectual facilities are sufficiently deficient that they need be given little attention.

Indeed, defenders of the IMF can (and have) made a case that the opposition from both the far left and right shows that the IMF is doing a good job. One major criterion of the efficiency of democratic institutions is the degree to which they conform to the preferences of the median or average citizen. On this score, political outcomes should lie well in the middle of the spectrum of underlying preferences. Thus, the Fund can point to the attacks of the left and the right as balancing out one another.

The attacks on the Fund from the far left and right are often misguided, but a successful defense of the Fund from these attacks does not logically imply that all is well. Indeed, there is overwhelming evidence that this is not the case. In my judgment, the Fund is predominantly a force for good not evil, but contrary to the far left's perception of the Fund as an all powerful bully dictating the behavior of the poor and the weak, the Fund's track record of securing compliance with its programs has been poor. And far from being run by an autonomous bunch of international bureaucracies completely insulated from the oversight of national governments, in a number of instances the Fund has been forced to abandon its economic principles to do the political bidding of its major shareholders, the governments of the United States and the other industrial countries.

⁴ Please note that my statement says few, not none. There are of course some very strong but knowledgeable critics on both sides of the political spectrum.

What the Fund needs is strengthening, not abolition, but such calls for sensible reforms of the IMF have received relatively little attention in the public media. They are much less dramatic than protestors in the streets. Informed discussion in terms of shades of gray lacks the bumper sticker punch of the black and white visions of those on the extremes. Fortunately, however, this imbalance is beginning to be corrected. Over the last year or so, several groups of experts have prepared important public reports on the IMF. As would be expected, there is not complete agreement among these reports and indeed, most of them contain minority dissents; but there is fact a quite substantial core of points on which there is widespread. This paper highlights a number of major areas of widespread agreement and discusses some of the most important remaining disagreements.

2. Recent Reports

Two of the recent reports are official. One was commissioned by the IMF itself (IMF, 1999) and was prepared by three leading outside experts who canvassed the views of a broad range of policy officials and academics and private sector experts. The second official report was mandated by the U.S. Congress as a part of the compromise and legislation that provided for the increase in IMF funding. Chaired by Alan Meltzer (and hence widely called the Meltzer Commission), the Commission was formally titled the International Financial Institution Advisory Commission. It consisted of six experts picked by the republicans and five by the democrats and included in its membership academics, leaders of policy institutes and former government officials and members of Congress. It held a number hearings and solicited input from a wide range of experts and interested parties. The third report was from a task force commissioned by the Council of

Foreign Relations. Chaired by Carla Hills and Peter Peterson and with Morris Goldstein, a former senior IMF official now with the Institute for International Economics, as its project director, it consisted of a prestigious group of academics, leaders from the private sector, and other members of the policy community.⁵

When the Meltzer Commission's Report was issued, the press made much of the fiery rebuttals contained in the minority statement. This generated the impression that the Commission's efforts had accomplished little beyond codifying the divergencies of view that split along party lines. But this was often overshadowed in the eyes of the press by the fiery verbiage to which the minority statement sometimes resorts. For example, the majority report is accused of resting on "misinterpretations of history and faulty analysis." (p. 119)

There is substance to some of the minority criticisms. The majority report is somewhat too negative in its characterization of the research on the effectiveness of IMF programs as finding that "IMF interventions...have not been associated, on average, with any clear economic gains to recipient countries" (p. 40).⁶ There is no question that the IMF is widely perceived by the left as hurting the countries it is supposed to help. Much of this criticism is based on an excessive focus on the short run and a lack of understanding of macroeconomics. The IMF is seldom called in before domestic economies have gotten out of control. Usually the situation requires macroeconomic

⁵ The membership of these taskforces is reported in the appendix. Reference will also be made to a report from four leading academics, de Gregorio, Eichengreen, Ito, and Wyplosz (1999) and a task force for the Overseas Development Council (2000), which focuses on the role of the IMF in economic development. This paper does not attempt to systematically cover all of the recommendations from these reports but rather emphasizes several of their major themes. For a more detailed review of these reports, see Williamson (2000).

⁶ For recent reviews and references to the recent literature on the IMF see Bird (1996), Killick (1995), Killick, Bunatilaka and Marr (1998) and Ul Huque and Khan (2000).

stabilization policies that in the short-run do cause recession and hurt growth. But the maintenance of the status quo would not have been viable. There is considerable evidence that bringing inflation under control is necessary for countries to reach their growth potential.⁷ This requires some short-term pain is required for long term gain. Thus, the common criticism that IMF policies are in general bad for growth is not well founded.⁸

In some areas, IMF programs have tended to have good effects on average. These involve primarily the international dimension, which has been the IMF's traditional major focus. Generally, IMF programs are associated with the adoption of more realistic exchange rates and improvements in the balance of payments. The fact remains, however, that the available research does not find that IMF programs have had nearly as strong positive effects as they should. This is not primarily because the IMF was recommending bad policies, but because the policies agreed between the IMF and national governments were often not carried out.

The IMF is not stupid, at least not usually. Of course it does make mistakes. But it also often learns from its mistakes. Its track record of policy advice is in fact quite enviable despite the frequency with which one hears criticisms that its policies worsened the Asian crisis.⁹ Most of the IMF staff is highly competent (as they should be since they are highly paid) and IMF advice is usually well in the mainstream of the best economic analysis.

⁷ See, for example, the analysis and references in Burdekin et al. [1995], [2000] and Sorel [1996].

⁸ This does not mean, of course, that IMF policies have been the best possible for helping growth over the long term.

⁹ For examples of such charges see Furman and Stiglitz [1998] and Radelet and Sachs [1998] and for a response by the IMF see Boorman et al [forthcoming].

What can so easily give the opposite impression is that there is so much controversy among macroeconomists. Economics is far from an exact science and like the behavior of general critics of the IMF from its far left and right, some macroeconomists make ideological or religious type commitments to particular schools of thought. While I look at this field and conclude that there must be a good deal of uncertainty because a lot of very bright economists are reaching opposite answers, some decide that they know the right answer and that all those who do not agree are suffering from ideological bias.

The IMF is frequently accused of having doctrinaire commitments to particular macro economic theories, but it is interesting to note that once again these charges do not all come from the same direction. Thus, to those on the left, with strong Keynesian leanings, the Fund is seen as being much too monetarist. But to supply-siders from the right, the IMF is seen as being much too Keynesian. This tendency to highlight the disagreements emanating from conflicting schools of macroeconomic thought gives an exaggerated impression of the total amount of disagreement among macro economists.

The IMF's point of view on macroeconomics issues is where it should be – well in the mainstream of professional opinion. This doesn't assure that IMF analysis is always correct. Like most economists the IMF failed to give sufficient attention to the serious financial sector problems in Asia and the resulting depth of the recession accompanying the Asian crisis. These recessions in turn invalidated the IMF's initial recommendation for fiscal tightening. Nor does it mean that I don't spend considerable time trying to convert the Fund to particular policy positions in areas where I have done research and that I don't feel some frustration when I am not successful. I must say,

however, that in my experience, the Fund's management and staff have on average shown much more open mindedness than have many of their leading critics.

Sadly I must add that this statement is not inconsistent with many stories one hears of IMF staff on missions who treat local officials with arrogance and a lack of understanding of local conditions. The interviews conducted by the IMF's external evaluation teams (IMF, 1999) suggests that such deplorable behavior is not the norm, but it does occur frequently enough to hurt the Fund's effectiveness. Creating better disincentives for such behavior needs to be a priority for the management and senior staff of the Fund.

We have every right to demand that the implementation of IMF programs be held to higher standards. There is less disagreement about how improvements should be made than one might have expected. What was often missed in the press coverage of the Meltzer report was the substantial amount of agreement among all of the members of the commission. Indeed, this is stressed in the beginning of the minority statement. This having been said, a health discounting of extreme views from the left and right is not sufficient to give the IMF a clean bill of health. A number of the most important areas in which improvements are needed are discussed in the following sections.¹⁰

3. The Implementation of IMF Programs Must be Improved

¹⁰ Other points of widespread agreement (including both the U.S. Treasury and the IMF itself) are that national governments and the IMF (and World Bank) need to increase their focus on and ability to analyze financial sector issues and that national government's need to do a better job of monitoring international financial flows and holding adequate levels of international reserves. There is considerable evidence that holding adequate levels of international reserves in relation to short-term foreign debt had substantial effectiveness in helping to shield countries from the financial contagion following the Mexican and Asian crises.

There is widespread agreement that IMF programs have not been working well enough. While the left charges the IMF with imposing too much austerity on poor countries, the truth is that the IMF has been relatively ineffective in getting countries to implement the policies to which they have agreed in IMF programs. Indeed, many on the right have charged that the financing accompanying IMF programs has typically allowed countries to delay adjustments more frequently than such programs have increased adjustment. Many examples where adjustment has been delayed can indeed be given. However, my reading of the evidence suggests that on balance, IMF programs have done a good deal more good than harm. Still the track record is not as good. Failures to be sufficiently tough in enforcing policy conditionality have come both from internal IMF incentives for staff not to rock the boat if they wish to continue to advance up the career ladder¹¹ and strong arming from major industrial countries to use the IMF as a slush fund to achieve geopolitical objectives.¹² The results of these political economy problems have become extremely serious. It is not just that the public money has been poorly utilized and needed policy adjustments have not been made. Even more important is the damage that has been done to the credibility of the IMF's seal of approval.¹³

Traditional international financial lore holds that even more important than the funds the IMF provides are the effects of its programs in reducing capital flight and encouraging capital inflows. But IMF programs will have these stabilizing effects on private financial flows only if there is a reasonable likelihood that these programs will actually be implemented. Some slippage is inevitable, but the IMF must start to do much

¹¹ This problem is indicated in IMF (1999) as well as in a number of papers by academic economists such as Meltzer (1998) (1999) and Vaubel (1996).

better. The credibility of its seal of approval has been seriously damaged, but not fully destroyed. While the IMF has been heavily criticized (in some cases fairly and others unfairly) for its handling of the Asian crisis, it cannot be argued that the countries with IMF programs did not undertake a substantial amount of adjustment. This gives the IMF a good base on which to build.

It is not clear to what degree top officials in the IMF and national finance ministries recognize the seriousness of this challenge to the effectiveness of the IMF. To the majority of the Meltzer Commission, these problems are so serious that they would limit the IMF's role to emerging crisis lending where a set of preconditions are met. Most experts would not yet give up completely on IMF policy conditionality¹⁴, but they agree that continuing with business as usual is not feasible. The IMF has responded by committing to set up an independent evaluation groups that should tilt internal incentives more in the direction of enforcement. To be effective, however, such institutional reforms must be carefully designed and strongly supported by management. The IMF would, of course, love to be given greater independence from the political pressures of the major countries. So far, however, the U.S. Treasury has offered no admission that the continued abuse of the IMF as a political slush fund threatens to seriously undermine its effectiveness.

The political manipulation of the IMF has concerned some scholars so much that they have recommended that the IMF be given much greater formal independence along the lines of the Federal Reserve and the new European Central Bank (see De Gregorio et

¹² See the discussions in De Gregorio et al (1999); Willett (forthcoming) and the Meltzer Commission Report.

¹³ See Willett (2000c).

al [1999]), while I have proposed that the major industrial countries establish a Geo Political Fund in order to take pressure off of the IMF. (Willett, 1999) The recent fiasco with the appointment of a new Managing Director for the IMF has generated considerable official interest in a number of IMF governance issues, but there has been little indication of official willingness to seriously entertain prospects for radical restructuring of IMF operations and governance procedures.¹⁵

4. Policy Conditionality

Assuming that some degree of policy conditionality lending by the IMF will be retained, two additional issues need serious attention. One concerns the scope of IMF policy conditionality. This has grown drastically over time. Not only are agreements on fiscal policy now much more detailed, but far wider ranges of policies have been included. In some cases such as the financial sector, this was absolutely necessary, but in many cases the scope of policy issues covered fell far outside the range of IMF expertise and raised questions both about effectiveness and the appropriateness of external influence on domestic policy processes.

The IMF's own external review of its surveillance policies concluded that in most instances, mission creep had resulted in lower quality policy advice in the new areas than

¹⁴ An exception is Killick et al (1998).

¹⁵ Despite continued warnings of opposition from the United States and a number of European governments, the Germans continued to push a national candidate who was ultimately rejected. This process received considerably bad publicity at a time when strong leadership at the IMF was especially needed. Underlying the German push was a long-standing informal tradition that the IMF would be headed by a European and the World Bank by an American. Since the last two IMF Managing Directors had been French, the German government apparently felt that it was now their turn. This incident gave rise to widespread criticism of the formal appointment process and the informal exclusion of candidates from the developing countries. Other major governance issues that have been raised include the distribution of formal voting power in the Fund, charges that the United States has experienced informal clout, the tendency for the Fund's Executive Board to avoid formal votes, and a widespread perception that the average level and quality of national appointments to the Executive Board have declined over time.

in the IMF's traditional areas of core competence – macroeconomic and balance of payments policies – and that the inclusion of a larger number of policy conditions inevitably diluted the effectiveness of the Fund's major recommendations. This mission creep has not come exclusively from IMF bureaucrats working to expand their domains. Much of it has come from pressures from the U.S. and other industrial countries to use financial crises to force trade liberalization on emerging market countries. While this is quite understandable from the perspective of real politics, the use of such leverage runs the risk of seriously damaging the legitimacy of the IMF.

Other pressures for mission creep, especially into the areas of labor market and environmental policy, have come from NGO's in the industrial countries and even from recipient country's governments themselves. Economic and financial officials often attempt to use IMF programs to help them get policy through their legislators. A lot of the mission creep also came from the proclivities of Michael Camdessus, the long time IMF Managing Director who resigned in 2000. A highly capable individual, Camdessus felt little bound by institutional restraints and penned a strongly negative response to the recommendations of the IMF's External Surveillance Report that this mission creep be reversed. Fortunately, the new Managing Director, Horst Köhler, has given initial indications that he takes this criticism much more seriously.

At the same time that the IMF needs to be given greater insulation from political manipulation, it also needs to increase its political sensitivity. By its very nature, the IMF is involved in crises of political economy, not just economics. Its mandate includes helping countries to avoid crisis by running better economic policies and most of these

policies must be implemented through domestic political processes. It does little good to reach agreement with finance ministry and central bank officials on a sensible economic strategy if, for example, the required budget measures stand little chance of being passed by the legislature. Where there is a strong group in support of reform and stabilization, IMF programs have the potential of helping to tilt the domestic political equilibrium in this direction. Thus, the IMF can often be a finance minister's best friend.

Some criticize this role of the IMF as representing inappropriate external manipulation and an undermining of domestic democratic pressures, but it can in fact be strongly defended along the same lines as independent regulatory agencies and central banks. It is well known that some types of issues are best kept out of day-to-day politics least short time horizons and rent seeking by interest groups lead to macroeconomic instability and microeconomic pork barrel.

From my perspective, the key issue is how to get the IMF to play its policy conditionality role more effectively. One part of the answer is to encourage national financial officials to do a better job of getting key domestic political actors on board for IMF programs. Establishing such 'ownership' of programs is, of course, a time consuming process and IMF programs are frequently negotiated under tight time constraints in the midst of crises. Still, there is likely to be considerable scope for improvement on this score. The recent IMF negotiations with Argentina suggest that this is a lesson that the Fund is taking to heart.

Another key part is that the IMF must be prepared to say no much more often. This is not easy. There is a natural tendency for IMF officials to think that even with weak programs, they will be able to maintain some influence for good, while with no

program IMF influence is likely to fall drastically. This is likely true in the short run, but not necessarily so in the long run. Even if true, however, the threat to the credibility of IMF programs is now so great that a major reorientation of IMF lending programs is needed.

One thing that will help is to move more in the direction of preconditions rather than promises before lending programs are begun. The official community is unlikely to be willing to go as far in this direction as the majority of the Meltzer Commission recommended, but a substantial tilt in this direction is desirable and, indeed, has already been begun. The international community should make clear that the recent track record of IMF programs has not been satisfactory and future increases in IMF funding should be made conditional on substantial improvements on this score.

To help this process the IMF needs to develop a better capacity for political analysis. Not only could this help increase the likelihood that the IMF programs would be effectively implemented, it could also help create a better framework of internal incentives to make it easier to say no where the odds of successful implementation are too low. The IMF's external review committee spoke to this first aspect by calling for the IMF to hire more senior staff with national policy experience. This should be complemented by also hiring and utilizing more political scientists and economists trained in political economy.

5. Emergency Lending Policies

The widely respected Bagehot rule for dealing with financial panics is for the central authority to lend freely, but at a penalty rate. If one is to lend at all, then the amount should be sufficient to calm the markets. It is interesting to note the differences

in the lessons drawn by experts about the effects of the growth in private international financial flows on the desirable size of IMF programs. One view is that with bigger private capital flows, we need bigger official programs. The other is that private flows have grown so much that there is no hope of official programs being large enough to be effective.

There are in fact elements of truth in both of these seemingly contradictory reactions. In the face of a fundamentally unstable situation, there is no hope that official programs can be big enough to offset private capital flows. But, this is not a bad thing. There should not be official programs in these circumstances anyway.

The Council on Foreign Relations Task Force argued that the size of IMF programs should be reduced. Until the credibility of the IMF's seal of approval is substantially strengthened, however, this could be a dangerous course. I would argue that the typical size of emergency IMF programs should be increased to help assure that markets will be calmed, but that many fewer programs should be approved.

The IMF has two distinctly different types of clients among emerging market countries. One type is hooked on IMF funding, and often makes insufficient progress toward economic improvement. These are the cases where IMF lending has strayed far from its original mission and looks much more like World Bank aid. It is important to recognize that both the majority and minority reports from the Meltzer Commission agree that this type of IMF program should be stopped, although there is disagreement over

whether such funding should be stopped all together or just transferred to the World Bank.¹⁶

The second type of country has both better economic performance and a much greater reluctance to come to the IMF. Here the problem is that such countries usually do not come to the Fund soon enough. The Council on Foreign Relations Task Force recognizes this problem and argues that the incentives for countries to join the IMF's good housekeeping club need to be improved. Indeed, official agreement on this point has been reflected in the recent agreement to lower the interest rate on borrowings from the new Contingent Credit Line (CCL), while interest rates on many forms of IMF lending have been increased. This is an inadequate response, however. Outside observers are virtually unanimous that the CCL was a badly constructed innovation, designed in haste to give officials political cover against the charge that they should put more efforts into preventing crises rather than waiting until they occur.

The structure of traditional IMF policy conditionality programs was designed to deal with a world of limited capital mobility where international financial problems developed fairly slowly. For many countries this world no longer exists. Thus, there is a real need for a new IMF facility that focuses on dealing with crisis as a quasi lender of last resort, but the CCL does not fit the bill. Fortunately, its flaws are so obvious that to date, it has remained unused. While officials will have a strong tendency to tinker with revising it in order to save face, it would be much better for the IMF's credibility to scrap it and start over with a better design.

¹⁶ The official community has offered mixed reaction to such advice. There is general agreement that a tilt in this direction is desirable, but many officials seem disinclined to go very far.

The majority proposal of the Meltzer Commission for the design of such a facility is much too stringent to secure official acceptance, but it should not just be dismissed out of hand. It contains a number of good ideas that should be incorporated in a reformed facility. For example, the criticisms from the minority that it fails to include provisions for sound monetary and fiscal policies is easily remedied. Indeed it is a shame that the tight deadline imposed on the commission by Congress did not allow for more of a meeting of the minds between the majority and minority on this important topic.¹⁷

6. Just Say No to Pegged Exchange Rates

It is quite understandable that officials in most countries prefer to adopt neither of the extremes of perfectly fixed or freely floating exchange rates. Indeed, the theory of optimum currency areas explains that this response is quite rational on economic as well as political grounds. This body of theory shows that there is no ideal exchange rate regime for all countries.¹⁸ There are substantial costs as well as benefits to any exchange rate regime. Furthermore, the ratio of costs to benefits for any particular regime will vary systematically across countries depending on a number of factors delineated in the theory. Economic size is one of these. A flexible exchange rate is likely to be best for a large country like the United States, while a fixed rate is much better for a tiny country like Estonia.

Most countries fall in between, however, and would prefer intermediate exchange rate regimes. The problem is that compromise regimes such as the adjustable peg system

¹⁷ In evaluating the appropriate degree of stringency of conditions credibility issues must be given considerable weight. If preconditions are made too stringent, they are unlikely to be believable. This puts the design of emergency facilities in the realm of political economy, but just pure economies.

¹⁸ For recent exposition and references to the literature, see Wihlborg and Willett (1999) and Willett (forthcoming).

adopted by the Bretton Woods international monetary system created at the end of World War II became unworkable in a world of substantial capital mobility. They become subject to the so-called one-way speculative option. Market participants may not know if there will be a major change in the exchange rate over a particular period, but they will know in what direction any change will be. Thus, both prudent international investors and the gnomes of Zurich will have incentives to move money out of weak currencies, and in the process, this will increase the likelihood of crisis.

This process caused the breakdown in the Bretton Woods system in the early 1970's, but it is apparently hard for some national policy officials to learn this lesson. They often think that with some minor tinkering, they will be able to escape this dilemma. The evidence is otherwise. In 1992, George Soros took almost a billion dollars off of British taxpayers because their finance minister had not learned this lesson. The Mexican crisis in 1994, the Asian crisis in 1997, the Russian crisis in 1998, and the Brazilian crisis in 1999 all resulted in large part from governments trying to maintain adjustably pegged exchange rate regimes that were insufficiently flexible. Thus, a major recommendation of the Council on Foreign Relations Task Force is "just say no to pegged exchange rates." The Meltzer Commission concurred.

The United States Treasury has been a strong advocate of the position that the IMF should discontinue lending to countries with adjustable pegs and First Deputy Managing Director Stanley Fischer has registered a substantial amount of agreement. A number of members of the IMF's Executive Board have not yet been convinced, however.

Part of the disagreement stems from how the proposition is put. The most extreme form is that the IMF should lend only to countries with permanently fixed or highly flexible exchange rates. This view can be criticized on the grounds that for many countries neither of these extremes is attractive and that there are a number of cases where more flexible versions of intermediate regimes, such as crawling bands, have proven workable.¹⁹

The problem is that over time, governments frequently succumb to political incentives to excessively limit the flexibility of these regimes. This is not just a trait of emerging market countries. The evolution of the European Monetary System and the resulting crises in the early 1990's is a prime example. It will be difficult, if not impossible, to develop simple rules for whether a particular exchange rate regime is sufficiently flexible. It is hard to see how we can avoid tasking the IMF with making judgments about whether a country is allowing sufficient flexibility to warrant IMF financial support. While the IMF has excellent technical expertise to undertake this task, it must guard against the bureaucratic and political incentives to support insufficient flexibility.

7. Reducing Moral Hazard

Another major problem is moral hazard. Moral hazard results from explicit or implicit government guarantees against loss. While sometimes serving worthy purposes and other times cronyism, all forms share the attribute that they distort incentives for economic actors to take risk into account. In some cases as is insurance for small bank deposits the costs are trivial. But in other cases they can be enormous. Moral hazard can

¹⁹ See, for example, Williamson (1998).

generate incentives for overlending and overborrowing that result in the inefficient allocation of investment, insufficient incentives to monitor one's investments, and frequently in financial crisis.

The debate over the importance of moral hazard as a source of recent international financial crisis is very difficult for an outsider (or indeed an insider) to follow. This is in part because participants frequently fail to be clear about what they are arguing. One version is that moral hazard was a quantitatively important cause of recent crisis and needs to be addressed by the policy community. This is a proposition for which there is massive support. Another version is that without moral hazard problems, none of these crises would have happened. This is a much more questionable proposition. To compound the confusion, there are also debates about to what extent the moral hazard generated by the Mexican bailout contributed to the Asian crisis (an issue not easily answered) and more generally about the extent to which IMF programs have contributed to moral hazard (which is also not easy to answer).

Most of the moral hazard is generated by the policies of national governments. Connected lending and pegged exchange rates have been two of the most important sources of moral hazard, but they are far from the only ones. Where the IMF comes in is that by providing funds to the governments of crisis countries, IMF programs help governments pay off on these explicit and implicit guarantees. At times IMF loans to countries with pegged exchange rates have helped to delay needed exchange rate adjustments while more private capital fled the country, in effect giving a subsidy to capital flight. The Russian crisis of 1999 is a prime example.

From a very short run perspective, it is almost always optimal to offer guarantees to try to stop speculative runs. The problem from a larger term prospective, however, is that there is strong likelihood that such responses will make future crises larger and more frequent.

Institutional reforms are needed to create better incentive structures facing international financial markets and international bank lending and borrowing. In particular, private institutions need to be given better incentives to take risk into account and better mechanisms need to be created to help coordinate investor responses in times of crises.²⁰ Such efforts to bail in rather than bail out the private sector will inevitably involve greater burden sharing, more use of collective action clauses in debt contracts, and the more frequent use of debt standstills and roll overs. Such reforms will in turn, reduce the size of crisis lending required by the IMF. Indeed, theoretically such mechanisms could be used as a full substitute for crisis lending by the IMF.²¹ The more one tilts in this direction, however, the larger will be the discouragement effects on international capital flows.

Up to a point, this will be desirable. Prior to the recent crises, moral hazard problems had likely generated excessive international financial flows to many emerging markets. Indeed, both the Meltzer and Council on Foreign Relations reports argue that prior to the crises, there had been excessive reliance on short term foreign borrowing by emerging market countries. There is much less agreement, however, about the best feasible ways of avoiding a recurrence. In this regard, there has been considerable

²⁰ On these issues, see Eichengreen (1999) and Mann (1999).

²¹ See, for example, Rogoff (1999).

interest in the so-called Chile tax that discourages short-term capital flows.²² Advocates of this approach argue that it should not be thought of as a form of capital control, but rather as a corrective tax to offset moral hazard distortions while better incentive structures and regulatory mechanisms are being developed.

Just how far we should change the tilt toward international financial flows is difficult to say on technical grounds. The issue becomes even more complex when rent-seeking politics is introduced. The conflicts between the interests of international financial institutions and broader social interests are often much less than perceived by populists from either the left or the right, but this is an area where this divergence is likely to be substantial. So far, the official policy community continues to pay lip service to the need for reforming the international financial architecture in this area, but relatively little actual progress has been made. To some extent, this reflects the complexity of the technical issues involved, but one cannot help but fear that the influence of major financial interests is also playing a role in slowing progress.

8. Increases in Transparency

There is a strong degree of agreement across the reports that a substantial increase in transparency is needed to strengthen the operation of the international financial systems. This takes two forms. One is improvement in the coverage, speed, and accuracy of the data made publicly available by national governments. The second is increased transparency in the operations of the IMF. The first should help strengthen national decision-making, monitoring by international organizations and credit rating agencies and

²² Again, see the analysis and references in Eichengreen (1999) and Willett and Denzau (1999).

prudent risk management by international investors and businesses. The second is essential to improve the accountability of the IMF.

Examples of bad practices by national governments abound during the recent crises. When speculative pressures mounted against the Mexican peso in 1994, the Mexican authorities delayed publication of their worsening international reserve position. In Thailand during 1997, the central bank fought speculative pressures by selling reserves in the forward, instead of the spot market. While publicly reported gross international reserves remained high at around \$30 billion, undisclosed sales in the forward market led to net international reserves that fell to almost zero. For a substantial period this deterioration in the true position was hidden not only from the public, but also from the rest of the Thai government.

In both Indonesia and Korea, short-term external borrowing by the private sector was much larger than was publicly reported. The amount of non-performing loans by banks was also substantially under reported. The poor quality of such information helped contribute to the failure of private financial markets to give adequate signals of impending crises. As estimates that were more accurate became available during the crises, this worsened confidence even further. In some cases, governments even falsely or misleadingly reported figures to the International Monetary Fund. Both Russia and the Ukraine have been accused of artificially inflating the figures on their reserve holdings that they reported to the IMF.

Fortunately, major efforts are underway to improve these problems. Of course, what information to publish should remain the sovereign right of national governments, but both the IMF and the private market can provide substantial incentives to national

governments to provide prompt and accurate disclosures of a broad range of key economic and financial data. Both the IMF and private investors need to be diligent and refuse to provide funds to countries whose data provision is inadequate.

A need for the IMF to abandon its embrace of the traditional secrecy of central banks has also been identified by almost all outside observers. Not only have the deliberations of the IMF's management, staff, and Executive Board, and its negotiations with member countries been kept secret, but so also have many of its reports on economic conditions in these countries and even content of the policy agreements associated with IMF loan programs. Clearly with such little information available, it was extremely difficult to hold the IMF accountable for its actions.

To its credit, the IMF has taken this criticism to heart and over the last few years, a remarkable amount of additional disclosure has been undertaken. Perhaps the most important outstanding issue in this area is how public the IMF should be when countries fail to follow its advice and appear to be headed for crisis. Making public such criticisms (and the threat to do so) would give the IMF a very powerful weapon to induce countries to adopt better policies.²³

Some fear that it is too powerful a weapon, however. Such announcements could easily leave the IMF open to criticisms that it was the cause of any subsequent crisis and adding this instrument to the IMF's arsenal might seriously damage the openness of confidential discussions between the IMF and national policy officials. The appropriate balance to draw is a delicate issue, but it seems likely that the IMF should tilt at least a little further in the direction of offering more public warnings.

²³ See, for example, the statement by C. Fred Bergsten in the Council of Foreign Relations Report.

9. Concluding Remarks

Contrary to some allegations, the IMF is not obsolete. Nor has it on average done more harm than good. Many of the criticisms of the Fund reflect controversies about policy strategies and as a consequence often given an exaggerated impression of the frequency of bad policy advice given by the Fund.

These points granted, however, the Fund needs to do a great deal better. The Fund has not been the all-powerful dictator of policy in developing countries that is so often depicted. Rather its track record for effective enforcement of its policy conditions has been woefully weak, indeed, so much that the traditional value of the catalytic effect of its seal of approval on private capital flows has become seriously endangered. It's not simply a matter of the IMF getting tougher in enforcement. It must also return to its traditional focus on key macroeconomic and financial issues and fight the temptation to attempt to impose conditions on all aspects of economic policy. It also needs to help assure that governments develop sufficient domestic political support for the most important policies that need to be implemented and to say no where the prospects for success look too low.

Such changes in orientation will not be easy. They must overcome bureaucratic incentives within the IMF and the tendency of governments of the industrial countries to pressure the Fund for short run political reasons. Yet despite all of the inevitable difficulties, considerable improvement is not an unreasonable objective. Incentive structures within the Fund can be modified and a substantial movement toward limiting the number of policy conditions and placing more emphasis on pre conditions can help yield a substantial improvement in the IMF's track record.

In a number of areas substantial improvements have already been made. There has been a very healthy increase in transparency at the Fund and the new Managing Director, Horst Köhler, appears to be a strong supporter of the view that the Fund needs to drastically reverse the trend toward every increasing numbers of policy conditions. There is also much greater support for the idea that the Fund needs to just say no to supporting Bretton Woods style pegged exchange rates.

Despite these promising signs, it is important to keep up external pressure on the Fund and the governments of the major industrial countries that have so much influence over it. In some important areas such as the design of effective programs for crises management and the protection of the IMF from under political pressures, there has been little if any real progress. In some other areas there is the danger of backsliding once the spotlight of public attention has turned elsewhere. By and large the public demonstrations against the IMF have been for the wrong reasons, but if they help to keep the Fund in the public's eye, then they may provide a valuable service.

Appendix A

Member of the Council on Foreign Relations Task Force and The Meltzer Commission

Allan H. Meltzer, Chair, is the Allan H. Meltzer Professor of Political Economy at Carnegie Mellon University and a Visiting Scholar at the American Enterprise Institute. He has served as an Acting Member of the President's Council of Economic Advisers, 1988-89, a Member of the President's Economic Policy Advisory Board, and an adviser and consultant to central banks, governments and international financial institutions.

C. Fred Bergsten, has been Director of the Institute for International Economics since its creation in 1981. He also served as Chairman of APEC's Eminent Persons Group from 1993 through 1995 and as Chairman of the Competitiveness Policy Council, created by Congress from 1991 to 1997. He was a member of the Independent Task Force sponsored by the Council on Foreign Relations on the Future International Financial Architecture (1999). Dr. Bergsten was Assistant Secretary of the Treasury for International Affairs during 1977-81 and also functioned as Under Secretary for Monetary Affairs during 1980-81.

Charles W. Calomiris is Paul M. Montrone Professor of Finance and Economics at the Columbia University Graduate School of Business, and a Professor in the Department of International and Public Affairs at Columbia University's School of International and Public Affairs. He co-directs the Projects on Financial Deregulation at the American Enterprise Institute, is a member of the Shadow Financial Regulatory Committee, and is a Research Associate of the National Bureau of Economic Research. His research spans several areas, including banking, corporate finance, financial history, and monetary economics.

Tom Campbell is a member of Congress from California's 15th district and Professor of Law at Stanford University. Congressman Campbell serves on the House Banking and International Relations Committees where he has worked on international trade and economic issues. A special interest is the promotion of democratic institutions in developing countries.

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