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The Need for a Political Economy Capability at the IMF

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The Need for a Political Economy Capability at the IMF

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In recent years, the IMF has come to under strong attack from both the left and the right. The harshest critiques from these quarters are based on false views of reality. The IMF is neither the all-powerful purveyor of excessively austere macroeconomic policies for the poor as seen by many on the left nor the helpless hostage of almost every client state as depicted by many critics from the right. It would be dangerous, however, to take the contradictory nature of these popular charges as a sign that all is well. The IMF, of course, makes mistakes from time to time in its policy advice, but it stays well within the mainstream of professional economic opinion. In my judgment, there is little question that most countries would have enjoyed improved economic performance if they had consistently followed IMF advice – not because IMF economists are smarter or better trained than economists in national governments but because national policies are heavily influenced by political pressures for short term fixes and interest group payoffs that bear substantial longer run costs in terms of increased macroeconomic instability and slower economic growth.

One of the important rationales for IMF programs of policy conditionality is to provide a system of external carrots and sticks to help national governments to overcome these short run politically inspired time inconsistency problems. The success of IMF programs in overcoming these incentives is far from total failure, but it is much less than one might hope. A serious weakening of the credibility of the IMF's seal of approval has resulted from the combination of several spectacular failures, such as the Russian programs, and growing recognition that success rates even with normal countries has not

been high. This is of the utmost importance since it undermines the catalytic role of IMF programs.

The conventional wisdom is that to countries with currency problems even more important than the direct access to official money that IMF programs bring is the effects of agreements on private capital flows. Quite sensibly, private markets have looked to the IMF to certify through its agreement on programs that the government in question was serious about adopting measures to promote macroeconomic stability and improve its international financial position. Thus, the negotiations of IMF programs have often been the key to unlocking private market financing. The working of this important mechanism rests crucially on the credibility of IMF agreements. Where the expectations of the success of a program are low, then the catalytic effort of the program is greatly weakened. In such circumstances, whether an agreement is reached may still have a substantial effect on private capital flows since a failure to reach agreement may stimulate greater capital flight, but the ability of the agreements to have a positive effect in turning outflows into inflows is greatly diminished.

So far, we have little systematic evidence on the qualitative magnitude of any such loss in the credibility of the IMF seal of approval, but the experience of recent programs suggests the possibility that it could be quite sizable. Thus, prudence suggests that this is a problem that should be taken quite seriously. I do not think that the damage done to IMF credibility has passed the point of no return, but I do believe that the need to restore the credibility of the IMF program must be treated as a matter of the utmost urgency.

This will not be an easy task. It will require the IMF to be much more selective in its programs and learn to say no much more frequently. Incentive structures must be substantially realigned. Instead of pressuring the IMF into helping them pursue geo political objectives on the cheap, as in the case of Russia, the IMF's principle shareholders - the major industrial countries – should apply policy conditionality of their own to IMF funding. Future increases in IMF quotas should be earned through improvements in the credibility of IMF programs.

Likewise, as noted in the IMF's recent external review of its surveillance policies, internal IMF incentive structures must be re-evaluated. If the path to advancement is tied to never rocking the boat, than the IMF will always operate as if it were hostage to client states. The report found concerns among IMF staff "that a report that is incisive but offends the authorities is damaging to a mission chief's career while one that is bland and later turns out to be lacking in some important respect will be overlooked." (p.90). As the report indicates, it is important that those in charge at the Fund "back up staff who give frank advice" (p. 91).

While changing the incentive structure is an absolutely necessary condition for doing the job of restoring the credibility of the IMF's seal of approval, it is not sufficient. The IMF also needs to develop a greater capacity to make judgments about the likely degree of implementation of programs. This task requires political economy expertise.

The IMF staff is dominated by economists who understandably specialize in giving advice on optimal economic policies. It does little good, however, to get a government to agree to such policy strategies if it does not have the intention or the political capability to implement these policies. Taking a purist economic approach to

the initial agreement and a subsequent "political" approach to forgiving lack of implementation is not a happy strategy for dealing with the interactions among politics and economics that inevitably surround IMF programs.

In the best scenario, the IMF's involvement can help tilt the domestic political equilibrium in favor of successful stabilization and reform, but this cannot be expected to occur in all cases. In some instances, successful implementation will require the adoption of second or third best economic policies, which, while not maximizing aggregate economic efficiency, will still substantially improve the economic consideration. In other cases, the best economic policies that could actually be politically implemented may not be sufficient to do the job. In such cases, if the IMF is to preserve credibility, it will just have to say no.

From this perspective, the design of programs and the decision of whether ultimately the IMF should put its seal of approval on the final package have to be based on a continual interaction between economic and political analyses. Of course, many senior staff at the IMF have picked up considerable political sophistication from their experiences over the years, but such explicit political economy thinking is not the norm. The External Surveillance Review reports a widespread, albeit not universal, perception among senior IMF staff that they "did not see it as their function to come up with policies that, while less than first best, moved the country in the right direction and were politically and institutionally acceptable" (p.43). The report likewise notes that IMF staff "…appear in general to be reluctant to give advice…that takes into account the political and institutional constraints within which policymakers need to operate" (p. 95).

Given the training of most economists, such reluctance is quite understandable. Economists have no particular expertise in making such judgments. What is needed is additional capability at the Fund so that it can engage in the necessary political economy analysis. Toward this end, the report recommends that a higher proportion of the senior staff at the Fund be selected from among economists who have had significant national policy experience. I think that this is a very worthwhile recommendation, but it does not go far enough. Unlike the situation twenty years ago, there is now a substantial group of political scientists and a smaller number of economists trained in the study of the intersection of politics and economics. For some time, political economy has been a highly active research field. It hasn't found all of the answers anymore than economics has, but it now contains a substantial body of useful knowledge that could easily be drawn upon by the IMF in the development of its programs. An example of the operational feasibility of such political economy analysis given in the accompanying paper by Jacek Kugler.

Not the least of the benefits of developing an explicit political economy capacity at the Fund would be the likely resulted tendency to consult more widely in the host country. Sometimes Fund programs have suffered from being insufficiently understood within parts of the host government much less in the broader political arena. Likewise, it has been argued that insufficient attention has sometimes been given to the development of perceptions of host country "ownership" of programs even by those with which the program is directly negotiated. A more consistent adoption of a political economy perspective by the Fund should make such failures less likely.

A time when the Fund is under widespread attack is not having the most opportune time to call for an increase in its budget, but the development of a greater capacity for political economy analysis at the Fund, if coupled with the will to use it, should easily pass the most stringent of cost benefit tests.