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## **What the IMF Should Do (and What We Should Do about the IMF)**

Since the Asian crisis erupted, the IMF has been at the center of the storm. Some have criticized it for pushing currency devaluation on its developing-country members, with generally disastrous consequences, while others have denounced it for demanding that countries hike interest rates to defend their currencies, precipitating deeper recessions and aggravating financial problems. Some criticize its lending for eroding market discipline and only heightening the likelihood of future crises, while others attribute its inability to stabilize the crisis economies to a failure to lend more freely. Some criticize the microeconomic and structural conditions that the Fund attaches to its loans as meddling in the internal affairs of countries that has the perverse effect of undermining investor confidence, while others insist that it has no choice but to insist on institutional reform because this is essential for the restoration of investor confidence and that to lend without such conditions would be to throw good money after bad.

This disagreement about whether the IMF should be expanded, restricted, abolished, or restructured is understandable insofar as changes in the environment in which it operates are forcing its mission and operating procedures to be rethought. Public debate is a healthy part of that process. The confusion surrounding that debate is not so healthy.

### **Why Radical Reform Won't Work**

In a world where not all information problems are remediable, crises will still occur. And in a world of highly levered financial institutions, serious

crises can still threaten systemic stability and spill across countries. These are convincing grounds on which to dismiss the extreme recommendation to abolish the IMF (see Shultz, Simon, and Wriston 1998; Schwartz 1998). While there is no question that the Fund will have to become more involved in standard setting and debt restructuring, they are grounds on which to dismiss the idea that it should get out of the lending business entirely in order to concentrate on these other tasks (see, *inter alia*, Wolf 1998). To be sure, the financial safety net that the Fund provides is a source of moral hazard, but moral hazard cannot be the sole concern of policymakers. Moral hazard risk must be balanced against meltdown risk. We do not abolish central banks' discount facilities or national deposit insurance schemes because they create moral hazard for domestic financial institutions. We do not abolish fire departments because they encourage people to build their houses out of wood. We do not prohibit motorists from using seat belts because they encourage some to drive faster. For drivers as for financial markets, we worry about more than just moral hazard. We worry also about the sudden stop.

This means that there will remain a role for IMF lending to countries that experience a sudden stop—where there is a shock to investor confidence, where capital inflows dry up, and where the exchange rate has to be unpegged or devalued, resulting in financial distress. Using IMF resources to replenish their international reserves will allow central banks forced to devalue to continue intervening in the foreign-exchange market to prevent the shock to confidence from wholly destabilizing the currency and precipitating a complete financial meltdown that creates severe problems not just in the country of origin but also abroad. It can give the government the fiscal resources to support the banking system and expand the social safety net without going on an inflationary binge. Properly administered, IMF support can help governments to respond to a crisis in ways that limit the financial distress, shock to confidence, and recession that tend to occur in its wake. And it can bolster political support for reform.

What the IMF cannot do is to follow Walter Bagehot's classic advice for a domestic central bank to lend freely against good collateral at a penalty rate. Compared to a domestic central bank, its resources are too limited, as is its leverage over the recipient. Unlike a domestic lender of last resort, the IMF cannot print money, nor would its principal shareholders let it (see Schwartz 1998). Compared to a government dealing with a problem bank, the IMF has less ability to force corrective action on its members. Because the Fund does not possess the other legal and regulatory powers of a government, it lacks the leverage to ensure that it will get its money back. This is why the IMF is endowed with fewer resources, why it lends less freely, and why it relies more heavily on continuing performance criteria when providing funds. It is why the IMF hesitates

to front-load its disbursements, requiring evidence that policy reforms are in train before releasing each additional bit of finance.

## The Clinton Proposal

Because the IMF does not have the powers of a government is also why the provision of contingent credit lines to countries in advance of financial difficulties is not in general a feasible IMF response to the crisis problem. This idea was advanced by the United States during the IMF annual meetings in October 1998 as a response to the problems facing countries such as Brazil. Later that month it was embraced by the G-7 in its declaration on strengthening the financial system. As described there, IMF members would agree to establish a new facility to provide a contingent short-term line of credit for countries pursuing strong IMF-approved policies and exposed to the danger of contagion (G-7 1998).

The problem is that contingent credit lines, to be effective, would have to be large, and once extended they would have to be unconditional. But while this approach might be practicable for countries such as Argentina, which is small relative to global markets and whose policies are exceptionally strong, there is reason to doubt that it could be used to meet the needs of the Brazils and South Koreas. The November 1998 loan to Brazil was not a contingent credit line; rather, it was a conventional 36-month standby arrangement. To be sure, that loan has some special features: the first tranche is large, and the date of disbursal of the second can be advanced in the event of need. But availability is still tied to ongoing performance criteria—that is, to evidence that Brazil is meeting a variety of fiscal conditions.

The reason is not hard to see. Embracing the precautionary credit proposal with open arms would mean, for the G-7 countries, effectively giving the IMF a blank check. The IMF's traditional approach to standby lines of credit implies a specific, determinate financial obligation: the Fund calculates the current-account deficit consistent with the budgetary target and provides a standby in this amount (net, typically, of other available sources of finance). A precautionary credit, in contrast, would not be tied down in this way. It would have to be large enough to offset all sales of domestic and foreign assets that financed outflows over the capital account of the balance of payments. Inevitably, the resources of the IMF are small relative to those of the relevant financial markets. How many \$42 billion Brazilian-sized credits could be provided by an IMF whose lending capacity is still less than \$200 billion even with the approval of an additional \$90 billion by the US Congress and its foreign counterparts?<sup>1</sup> This budget

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1. Some observers—Guillermo Calvo, for example—have argued that contingent credits adequate to head off a crisis will have to be significantly larger even than the \$42 billion extended to Brazil.

constraint naturally renders the Fund concerned to husband its limited resources and reluctant to disburse resources without attaching (and therefore having to negotiate) new conditions that maximize the probability of repayment. Moreover, questions about the recipient's willingness to adjust will inevitably lead the IMF to insist on additional conditions at the time of disbursement. Like any lender, the Fund would regret having preapproved a credit line were the economic policies and performance of the borrowing countries to take a turn for the worse. Not only might repayment be jeopardized, but were the Fund to then revoke its preapproval, its negative signal could precipitate a crisis (see Goldstein and Calvo 1996, 271). And credit lines that could not be revoked—that were not conditioned on ongoing performance criteria—could give rise to *very* serious problems of moral hazard.

It is revealing that there was some discussion in 1994 of the creation of a short-term financing facility under which the IMF would disburse funds to countries experiencing temporary payments problems and whose eligibility had been determined in advance (see Williamson 1998). These discussions were not informed, however, by an appreciation of the magnitude of the funds that might have to be disbursed to restore confidence, given the rapid growth of the liquidity of private financial markets. Once the Mexican crisis revealed the extent of the commitments that would be required, the idea of contingent credit lines receded from view.<sup>2</sup>

The G-7 declaration itself provides veiled acknowledgments of these problems. Acknowledging that the IMF will not have the resources to provide contingent credit lines to several significantly sized emerging markets simultaneously, it suggests that G-7 countries might have to activate bilateral contingent financing lines alongside the IMF facility. Acknowledging implicitly the difficulty of extending and revoking access to contingent credit lines, it says nothing about whether countries would be prequalified or about how qualification would be determined. Nor does the G-7 raise the possibility that the Fund might take its cue from the private sector. This is the idea that it could take guidance on the availability and pricing of the facility from the banks, charging the same

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2. The Supplemental Reserve Facility (SRF) approved by the IMF's Executive Board in December 1997 is in fact a small step in the direction of exceptional credit lines. It is designed to provide financial assistance to a member suffering from a temporary loss of market confidence and exceptional balance of payments problems (presumably reflecting turbulence in other countries), where there is the expectation that the problem can be corrected in short order. The idea is that these extra funds, sufficient to offset the impact on domestic markets of a sudden decline in market confidence, would be disbursed quickly (in conjunction with an existing standby or extended arrangement). Note, however, that access is not negotiated in advance, which is the critical point given the argument in the text about the Fund's limited ability to provide standby lines of credit.

fees and requiring the same collateral.<sup>3</sup> Only if a country qualified for a credit from the commercial banks would this be supplemented by the Fund. The problem the G-7 presumably worried about is that access would be limited to a few countries with exceptionally strong economic policies (the Argentinas of the world), and that politicians would lose their discretion to decide whether or not to extend a loan.

For a variety of reasons, then, these kind of schemes can operate only on a limited scale. They are not a silly idea, but they can provide only limited insurance against financial shocks.

## The Calomiris Proposal

Charles Calomiris suggests that the Fund could square the circle by lending only to countries that accept a long list of conditions for strengthening their financial systems. Eligible countries would have to agree to raise capital requirements to 20 percent of assets so that bank stockholders would suffer a “credible first tranche of private loss . . .” in the event of an international rescue, mitigating the moral hazard problem (Calomiris 1998b, 16). They would have to require banks to issue subordinated debt and to hold substantial shares of their assets in cash and liquid securities. They would have to allow free entry into the domestic market by foreign banks and to adopt limited programs of deposit insurance. The Fund would lend only to countries that met these (and several additional) criteria.<sup>4</sup>

Calomiris’s proposal is essentially an international variant of the narrow-banking proposals for domestic bank regulation described in chapter

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3. See Gavin and Hausmann (1998) and Feldstein (1998b). As described by Gavin and Hausmann, the regional development banks, along possibly with the World Bank, would participate as members of syndicates along with commercial banks, with all of them agreeing to provide standby lines of credit; in Feldstein’s variant, the IMF would do the same. Official cofinancing would give the credit lines effective seniority in repayment that would make them attractive to private lenders. The financial structure would be analogous to a private-sector “A/B loan,” in which the Inter-American Development Bank (IDB) is the lender of record but agrees with private participants in the facility to share all payments with other lenders. Drawings would have to be repaid in three to five years. In one variant of the proposal, the mechanism would rely more on price and less on collateral than would existing commercial credit lines. The credit line would be renewed and the price would be adjusted at regular intervals (say, every 12 months). The IDB and allied multilaterals would extend such credit lines only to countries whose economic policies satisfied certain strong policy conditions. It would be possible, for example, to make eligibility for drawing on the facility contingent upon a good report in the IMF’s Article IV consultations.

4. In a sense, these other preconditions for IMF support are designed to buttress the stability of the domestic financial system, providing the international analog to Bagehot’s rule that a domestic lender of last resort should lend only against good collateral—in other words, insuring against the collapse of the domestic financial system and maximizing the probability that the Fund will get its money back.

4. Just as narrow-banking proponents argue that the moral hazard associated with the domestic financial safety net can be mitigated if it is extended only to banks that are subject to strict limits on their use of leverage and the composition of their investment portfolios, he assumes that the moral hazard created by IMF assistance can be contained by extending it only to countries that place similar restrictions on the entire banking system. The two proposals are open to the same objections. In the case of narrow banking, it is implausible that the failure of finance companies and other financial intermediaries operating outside the regulatory fence will be free of systemic implications. As the case of Long Term Capital Management reminds us, this makes it implausible that the authorities will really be prepared to stand by idly. In the case of IMF lending, it is similarly implausible that a crisis in a country that did not follow Calomiris's prescriptions would be free of systemic repercussions. In turn this renders it questionable that the time-consistent policy for the Fund would be to stand aside.

The reality is that simple rules for IMF lending are no more feasible than simple rules for intervention by national central banks. In both cases, there will inevitably be an element of discretion involved. Calomiris's proposal has the merit of at least highlighting the role of the Fund in promulgating international financial standards. But it does not finesse the fact that IMF resources will always be scarce and that the Fund will never be in the position to lend freely even to its most creditworthy members. And it assumes a willingness to ignore potential systemic repercussions that simply does not exist.

This means that as capital markets continue to expand, the Fund will have to rely less on lending and more on other levers. It will have to redouble its efforts at crisis prevention, promoting the promulgation of standards, strengthening its surveillance, and pressing its members to adopt sensible policies toward the exchange rate and the capital account. Inevitably, however, crises will still occur, and it will not be possible (or, for that matter, desirable) to meet them all with large-scale financial assistance. The Fund will then have play a more prominent role in debt workouts, acting as honest broker and attempting to bring debtors and creditors together. It can provide institutional incentives for the establishment of creditors' committees by working with those committees and financial incentives for the incorporation of renegotiation-friendly provisions into loan contracts by lending to countries that adopt the relevant contractual provisions at relatively favorable interest rates.

## **The Edwards Proposal for Breaking Up the IMF**

The need for the IMF to concentrate on these new tasks and the unrealism of assuming that it can simply stand aside when countries fail to meet

a formidable list of conditions for receiving standby credits have been acknowledged by Sebastian Edwards (1998c). These realizations lead Edwards to propose three new entities to supersede the Fund: a Global Information Agency to rate the health and stability of countries' economies and financial systems, a Contingent Global Financial Facility to provide contingent credit lines to countries meeting minimum standards of information disclosure and transparency as well as economic health, and a Global Restructuring Agency to provide conditional lending and advice on debt restructuring to crisis countries. Each of the new agencies would be "small and efficient" compared to the IMF and would have clearly defined responsibilities.

While this institutional division of labor has the merit of clearly delineating the tasks of each of the hypothetical agencies, it would do so at the cost of creating some potentially serious coordination problems. One can readily imagine, for example, confusion between the agencies responsible for contingent credits and conditional loans about who should provide assistance to a country such as Brazil. And it makes little sense for one international agency to set standards for financial transparency and disclosure and an entirely different agency, with no say over the design of those standards, to condition its lending on them. (Even worse would be for the Contingent Global Financial Facility to condition its lending on an entirely different set of standards than those set down by the Global Information Agency.) The proposal assumes that the transparency- and disclosure-rating function should be taken on by a multilateral, where this is best left wherever possible to the private sector.<sup>5</sup> It assumes the international community's willingness to underwrite much more generous international financing than heretofore; otherwise, the idea of contingent credit lines will remain impractical. It assumes a willingness to pay the salaries of additional international civil servants, because these three entities will have to be staffed not only by current IMF employees but also private-sector experts in debt restructuring and financial regulation, as Edwards acknowledges. Moreover, the premise that this global rating agency would improve on the performance of Moody's and Standard & Poor's assumes that these salaries would be more attractive than those offered by the private sector (so that the best analysts would choose to work for the multilateral). It assumes that national governments would accept the uncertainty that would come with establishing new international institutions that lack a track record. For all these reasons, Edwards's proposal is a nonstarter.

## **IMF Exchange Rate Advice**

The Asian crisis raised obvious questions about the wisdom of the IMF's advice—for that matter, about the wisdom of everyone's advice—regard-

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5. As argued in chapter 3.

ing the management of exchange rates. The *Wall Street Journal* view, that only pegged exchange rates are compatible with monetary and financial stability, is vulnerable to the criticism that pegged rates are strongly associated with crises. Pegged rates create one-way bets for speculators, making sitting ducks of the central banks and governments seeking to operate them. On the other hand, the view that high capital mobility should and will lead most countries to float their currencies must confront the fact that floating was a disaster in Asia, where currencies, rather than adjusting smoothly downward, collapsed abruptly, bankrupting financial and nonfinancial firms with debts denominated in foreign currency.

Why did the Asian devaluations have such devastatingly negative effects?<sup>6</sup> If there is one explanation, it is that governments failed to prepare the markets for the change in the exchange rate. The currency peg having been the centerpiece of their economic policy, jettisoning it was a heavy blow to their policy credibility. It raised doubts about their competence and about their commitment to their stated policy goals. Their stated commitment to the peg lulled banks and firms into the mistaken belief that there was no need for costly insurance against exchange rate fluctuations. Debtors saw no need to use forward and futures markets to hedge against exchange rate fluctuations. Hence, when the inevitable adjustment came, it was devastating not just to confidence but to the solvency of banks and corporations with unhedged foreign exposures. Investors, having been lulled into complacency by official assurances that the exchange rate was fixed, scrambled for the exits once they realized that those promises were empty. Banks and corporations with unhedged foreign liabilities scrambled for cover, purchasing the additional foreign exchange needed to service their debts and to hedge against further currency fluctuations. Both responses pushed the exchange rate down still further, which pushed yet additional banks and firms into bankruptcy. This only fed investor fears, further weakening the exchange rate and aggravating the difficulty of servicing private-sector debts.

Recommending that countries operating exchange rate pegs avoid these land mines by warning the markets that the peg can be changed, thereby encouraging banks and corporations to hedge their exposures, is disingenuous. Any government operating a peg that sends the message that it is prepared to change the rate invites a speculative attack. The first priority of any government seeking to peg the currency is to convince the markets that it is committed to maintaining that peg. To protect its reserves it will be forced to deny that it is contemplating an adjustment in the level of the exchange rate or change in the regime. Inevitably, its statements will discourage banks and corporations with liabilities denominated in foreign

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6. This section summarizes the more elaborate discussion of Asia's experience with devaluation in appendix C.

currency from undertaking costly transactions in currency forward and futures markets to hedge that foreign exposure. Consequently, when the change in the exchange rate eventually and inevitably comes, its effects will be devastating.

It follows that in a world of high capital mobility there are only two feasible approaches to exchange rate policy. One is not just to peg the exchange rate but to lock it in—the Argentine strategy. In this case it matters little whether banks and firms hedge against exchange rate fluctuations because there is a negligible probability that the exchange rate will change. Of course, credibly locking in the exchange rate is easier said than done. Doing so requires abolishing the central bank and its discretionary powers in favor of a currency board and creating high hurdles to reversing that change (e.g., by putting the currency-board statute into the constitution).

Closing off all avenues for discretionary monetary policy not just for a time but for the foreseeable future is something that few societies are prepared to do. The vast majority of countries will consequently have to follow the other alternative of allowing their currencies to fluctuate. If the exchange rate moves regularly, banks and firms will have an incentive to hedge their foreign exposures, and they will then possess insurance against the negative financial effects of unexpectedly large currency fluctuations if and when these occur. By implication, the vast majority of emerging markets should move to greater exchange rate flexibility sooner rather than later.

The IMF should therefore push more of its members to adopt policies of greater exchange rate flexibility before they are forced to do so in a crisis. Even if this evolution is inevitable, it will be associated with financial distress, as in Asia, if it is forced on reluctant governments that fail to prepare banks, firms, and households for the eventuality. If, on the other hand, the authorities move gradually toward greater exchange rate flexibility while capital is still flowing in, banks and firms will hedge their exposures and not suffer catastrophic losses when the exchange rate moves by an unexpectedly large amount. If the government does not link its entire economic-policy strategy to the maintenance of a fixed currency peg but develops a more diversified portfolio of intermediate targets and anchors, it will not lose all credibility when it bows to the inevitable.

Hence, the IMF needs to more forcefully encourage its members to move to policies of greater exchange rate flexibility, and the sooner the better. With few exceptions it should pressure its members, in the context of Article IV consultations and program discussions, to abandon simple pegs, crawling pegs, narrow bands and other mechanisms for limiting exchange rate flexibility before they are forced to do so by the markets.

This does not mean that countries that reject the currency-board option will have to allow their exchange rates to float freely; they can still inter-

vene in the foreign-exchange market to dampen temporary fluctuations and limit the volatility that a freely floating exchange rate entails. What they should not do, by this argument, is commit to an explicit exchange rate target that would force them to issue misleadingly reassuring statements likely to lull banks and firms into a false sense of complacency and set the stage for an ugly crisis. Floating, even dirty floating, is uncomfortable because of the volatility that it tends to entail. It is that volatility and not the obtuseness of policymakers, of course, that leads many governments to continue to attempt to peg their exchange rates. But the globalization of financial markets both makes it easier to live with volatility (by creating additional opportunities for banks, firms, and households to hedge their exposures) and heightens the difficulty of operating a peg, strengthening the association between currency pegs and crises. Witness the case of Mexico, whose currency declined against the US dollar by more than 20 percent in the final quarter of 1998. The peso's depreciation has created problems for certain segments of the Mexican economy, to be sure, but it has not precipitated a crisis. Surely, most countries, given a choice between Mexico's situation and the dilemmas of the Brazilian authorities desperately seeking to defend their currency peg, would prefer the former, and with good reason.

### **Is There Still a Case for a Peg as a Nominal Anchor in Disinflation?**

Some otherwise strong proponents of greater flexibility still concede a temporary role for pegged rates in countries that are trying to bring down high inflation (e.g., Sachs 1998c; Bruno and Fischer 1990). If the country, having brought down inflation, can then smoothly exit the currency peg before being forced to do so in a crisis, the peg will have been worth the candle.

The problem is the same as with using heroin or morphine to treat a patient in pain; once the suffering subsides, the patient is still hooked. And open markets offer no padded cell into which to place the country until it kicks the habit. Smooth exits from currency pegs, whatever the original rationale for the peg, are very much the exception to the rule.<sup>7</sup> In fact, the secret to a successful exit is not that mysterious: governments can move to greater exchange rate flexibility without precipitating a crisis if they do so before capital stops flowing in—while the pressure is still for appreciation, not depreciation. Firms and banks will then learn to hedge their exposure to currency fluctuations before being taught that lesson by a devastating crisis. But the fact of the matter is that few governments are willing to move while there is still time. Having made the currency peg the touchstone of their anti-inflationary policy, they fear

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7. This pattern is documented in Eichengreen and Masson (1998).

that investors will interpret its relaxation as opening the door to a new round of financial excesses (Sachs 1998d). Almost without exception, they tend to put off the day of reckoning. Hence, when the exit finally occurs, it comes in the context of, and in turn tends to aggravate, a crisis.

This problem is intrinsic to the strategy of pegging the exchange rate in the early stages of inflation stabilization, when the government makes the currency peg the cornerstone of its economic-policy strategy. It is disingenuous to simply assume it away. The evidence that exchange-rate-based stabilizations are associated with pegs that outlive their usefulness, which are in turn associated with crises, is too compelling to be denied. It follows that the Fund should be much more cautious than heretofore to endorse exchange-rate-based stabilization strategies and should do more to push its members toward greater exchange rate flexibility.

### **The Currency-Board Option**

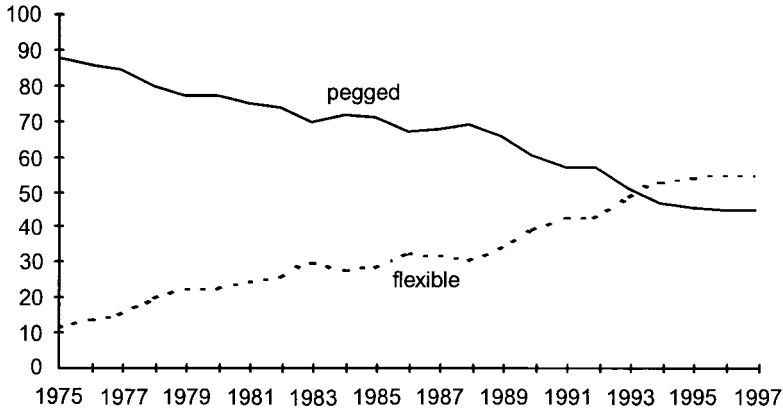
The only exception to this rule is countries that are prepared not just to fix the exchange rate but to lock it in for the foreseeable future.<sup>8</sup> Such countries will be few in number. Locking in the exchange rate means abolishing the central bank and its discretionary monetary powers. It means making those steps difficult to reverse. The currency board will have to be created by a parliamentary law or constitutional amendment that can be overturned only by a supermajority. It means starting down that path only when there exists broad and deep support for putting monetary policy on autopilot, rendering it a very low probability event that a supermajority can be marshaled to reverse the policy. Otherwise, when times are tough, speculators will anticipate mounting public opposition to monetary austerity, perhaps leading to abandonment of the currency board and the exchange rate peg, and thereby giving rise the generic pegged-rate problem of self-fulfilling speculative attacks.

The idea that more than a few countries in exceptional circumstances will be prepared to fix the exchange rate once and for all flies in the face of theory and evidence. Since the mid-1970s, the share of developing countries with managed or floating exchange rates has risen from 10 percent to more than half the total (see figure 7.1). The trend is more impressive still if one calculates the share of developing country GDP (measured at purchasing power parity) accounted for by each arrangement (see figure 7.2). There are reasons to expect the trend to continue. For one thing, international capital mobility sharpens the tradeoff between domestic and international objectives. Capital controls and transaction costs that once insulated the domestic economy from financial conditions

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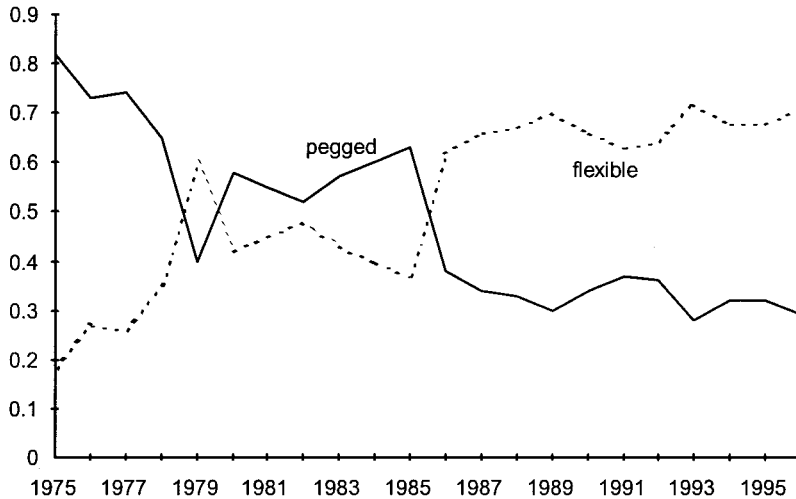
8. The discussion here of currency boards is necessarily abbreviated. For the definitive study see Williamson (1995).

**Figure 7.1 Evolution of exchange rate regimes, 1975-97**  
(percentage of total number of developing countries)



Source: Eichengreen (1998).

**Figure 7.2 Evolution of exchange rate regimes, 1975-96**  
(output-weighted share of total output of developing countries)



Source: Eichengreen (1998).

abroad now do so to a much lesser extent. A fixed exchange rate, in conjunction with high capital mobility, means that a country must rigidly conform to the monetary and financial conditions prevailing in the rest of the world. In addition, the liberalization of financial markets and the growth of international capital flows heighten the need for a lender of last

resort, a service the central bank can provide only if it is not constrained by the need to defend a fixed currency peg. Both factors create strong pressure for greater exchange rate flexibility.

Only countries in which investors harbor exceptional distrust of discretionary monetary policy, where the economy is sufficiently flexible and resilient to adapt to whatever monetary and financial conditions are implied by a fixed exchange rate, and where there exists deep-seated public support for the policy, however painful its consequences, can sustain the currency-board alternative. Argentina can, given the profound distrust of discretionary policy that exists there as a result of the country's repeated bouts with hyperinflation, which in turn provides broad-based public backing for its "convertibility law."<sup>9</sup> Hong Kong can, given the province's highly internationalized banking system and flexible labor markets, the economy's extreme openness to international trade, and the Hong Kong Monetary Authority's insulation from political pressures. But in few other countries is public support for putting monetary policy on autopilot as deep and broad.<sup>10</sup> Again, the implication for the IMF is that it needs to push the vast majority of its members to install regimes of greater exchange rate flexibility. The failure of recent official reports on measures to enhance the stability of the international financial system to make this point shows a regrettable lack of consensus and political will.<sup>11</sup>

## Fiscal and Monetary Policies

The IMF came under withering fire for asking Thailand, Indonesia, and South Korea to hike interest rates and tighten fiscal policies following the onset of their crises. It was accused of blindly taking a page from its Latin American debt crisis cookbook, where the setting was one of budget

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9. Another popular explanation for the viability of the Argentine currency board is the country's increasingly effective prudential supervision and regulation, which the authorities have strengthened precisely in order to render their fixed exchange rate more defensible.

10. In Asia, the flash point for this debate was the question of whether a currency board was appropriate for Indonesia when the country was in the throes of its crisis. Fear of inflation and distrust of the monetary authorities were there, but the IMF and other commentators questioned whether the other conditions for fixing the exchange rate and putting monetary policy on autopilot were in place. For one thing, the banking system was weak, and if investors tested the authorities' commitment to the peg, the government might not have been able to sustain the higher interest rates needed to defend it at the price of further bank failures and financial distress. For another, there was the question of whether the public would support these official efforts, especially if exchange-rate stabilization was seen as a temporary expedient to support the rate only until the ruling elite had succeeded in removing their assets from the country.

11. Thus, G-7 (1998, 5) speaks only of the need to consider "the elements necessary for the maintenance of sustainable exchange rate regimes in emerging economies."

deficits and inflation, making monetary and fiscal retrenchment necessary parts of the solution. It was criticized for neglecting the fact that Asian countries entered their crises with high savings, low inflation, and government budgets in balance or surplus, hardly suggesting that excessively expansionary policies were at the root of the problem and that monetary and fiscal austerity were needed for its solution. In fact, the critics argue, the IMF should have encouraged Asian governments to employ all of their available macroeconomic-policy instruments to prevent the onset of recession or to minimize its severity.

## **Fiscal Policy**

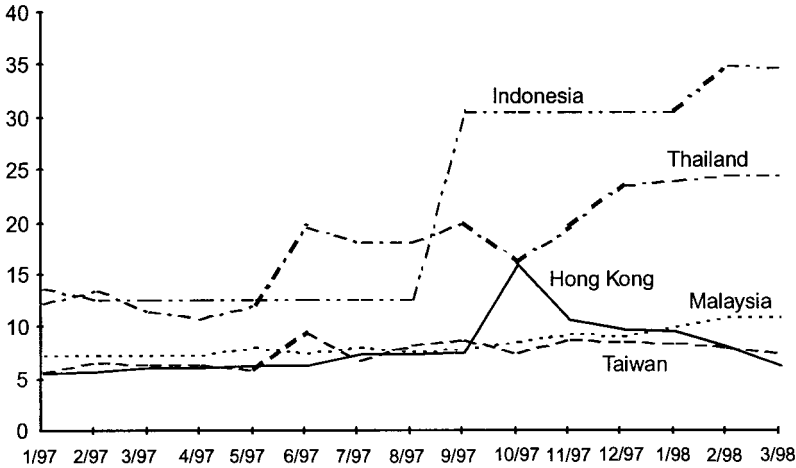
There is no question that absorption had to be reduced once capital stopped flowing in and it became necessary to eliminate the current-account deficit. It being undesirable for the entire burden of adjustment to fall on the private sector, there was a presumption in favor of fiscal cuts. In addition, there was the need to recapitalize the banking system. Bonds might be issued to spread those costs over time, but additional tax revenues would still be needed to service the additional obligations. Business cycle considerations notwithstanding, this pointed to the need for a significant tightening of fiscal policy. And to the extent that it anticipated some slowdown in Asian economic growth, the IMF saw the need to temper that advice.

The problem was that the Fund failed to adjust for the cycle. It failed to anticipate the severity of the Asian downturn or see that the restrictive fiscal policies it recommended would themselves make that downturn worse. Once this realization dawned, it modified its advice. Subsequent adjustments to its initial programs acknowledged the need for governments to use fiscal policy to provide countercyclical stimulus to neutralize the deepening recession and to provide a social safety net for the poor. In Indonesia, for example, the second program of January 1998 revised the target for fiscal policy from a surplus of 1 percent of GDP to a deficit of 1 percent of GDP; the second revision widened it to 3 percent of GDP, the third to 8.5 percent. The 4 March 1998 revision of the Thai program excluded the 3 percent of GDP interest costs of the financial-sector cleanup. Successive revisions of the South Korean program adjusted the deficit target from essentially 0 to 2 percent of GDP (Cline 1998, table 2; World Bank 1998, table 2.9). With hindsight, it is nevertheless clear that the Fund's fiscal targets were too tight and that larger deficits should have been encouraged.<sup>12</sup> The Fund now appears to have acknowledged its error, which provides some reassurance that it will not be committed again (e.g., Neiss 1998).

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12. In fact, there may have been some cases where the IMF pushed for larger budget deficits than governments themselves were prepared to accept.

**Figure 7.3 Short-term interest rates, January 1997-March 1998**



Source: The Economist, *Emerging Market Indicators* (various issues).

## Monetary Policy

In each country, the IMF recommended sharp increases in interest rates to restore investor confidence, stem capital flight, and stabilize the currency. This, it argued, was the only way for the authorities to quickly reassure investors, given the time needed to push through other reforms. Only if they signaled their resolve to defend the exchange rate by rendering short-term money-market instruments more attractive could confidence be restored.

That the medicine did not work is clear. The IMF's own explanation is that governments did not push up interest rates and hold them there with adequate resolve (see figure 7.3). Indonesia raised rates to 30-40 percent in August but reduced them to 20-30 percent in September despite the rupiah's continued decline. South Korea maintained an official ceiling on interest rates as late as December despite the deterioration of the foreign-exchange market. These half-hearted measures, it is argued, were insufficient to restore confidence.

The Fund's critics argue that interest rates were not too low but too high. High rates plunged Asia's highly geared corporations into bankruptcy. As failures cascaded through the manufacturing sector and banks were rendered insolvent by the inability of their customers to service their loans, the exchange rate weakened, reflecting this further damage to the financial system. Flight capital, rather than being attracted back by higher yields, was repelled by additional defaults. Thus, higher interest rates weakened the exchange rate rather than strengthening it as the IMF had forecast.

The effect of interest rates on the exchange rate, while an empirical question, is one on which there exists exactly zero convincing evidence, forcing both the Fund and its critics to rest their cases on arguments rather than statistics. Both sides can agree that in theory there exists an “interest rate Laffer Curve.” While modest interest rate increases are likely to strengthen the currency, if taken to excess they may so damage the financial condition of banks and firms that confidence deteriorates and the currency weakens. The empirical question is where the point of inflection lies and whether IMF-inspired policies surpassed it. It is plausible that the critical turning point should be lower in Asia than in less debt-dependent countries, given the high gearing ratios of corporations in the region. Reflecting the underdevelopment of the equity market and its bank-centered financial system, South Korea’s ratio of debt to GDP, for example, is 30 to 50 percent higher than in the United States (e.g., Wade and Veneroso 1998). The capacity of nonfinancial firms to absorb increases in debt-servicing costs is consequently more limited.

While there is no question about the fact, its implications for the interest rate/exchange rate nexus are uncertain. Assertions that interest rates were pushed to the point where they weakened the exchange rate rather than strengthening it remain just that—assertions.

Some of the harshest critics of IMF policy, while insisting on the need for lower interest rates for domestic reasons, acknowledge that these would not have lured back flight capital and strengthened the exchange rate—to the contrary. The right choice may have been to reduce rates in order to relieve the distress among heavily indebted firms and reflate the economy, but there would have been a price, namely the need to suspend service on the external debt and impose Malaysian-style capital controls. Lower interest rates might have been the right remedy for South Korea, for example, but they would have rendered the country unable to roll over its maturing debts. Robert Wade and Frank Veneroso (1998, 13) are explicit about this tradeoff: “Why should not Korea, for one, not just declare a debt moratorium and set about exporting it way out of trouble?” they ask. “The vast increase in the servicing and repayment costs of foreign loans due to the devaluation is a national disaster, the costs of which should be borne collectively. Let belts be tightened, to the extent of refusing any new reliance on external finance.”

This is the unfortunate reality: there was a choice between reducing interest rates on the one hand and maintaining capital-market access on the other, and governments could not have it both ways. Lower rates might have facilitated much-needed domestic deflation, but they would have also required countries to suspend service on their external debts. And that last step was something that governments, in their wisdom, were reluctant to take. Their belief was that debts, once suspended, are difficult to restructure, and that, in the interim, access to working capital

and trade credits will be disrupted. Thus, calls for the IMF to amend its advice to encourage lower interest rates in crisis economies will remain impractical absent other changes in capital markets to make the process of restructuring and renegotiation more efficient.

## Measures to Encourage Debt Restructuring

The most important changes to facilitate restructuring and renegotiation, as noted in chapter 5, are the incorporation of sharing, majority-voting, minimum-legal-threshold, nonacceleration, and collective-representation clauses into loan contracts. This is a task for national regulators. But there is also a role for the IMF. By lending at relatively favorable rates to governments that incorporate such provisions into their own loan contracts and that require domestic banks and corporations to do so and by making a commitment to adopt such clauses a condition for the continued disbursement of financial assistance, the Fund can provide incentives for contractual innovation.<sup>13</sup> By lending after a country has suspended debt payments and before it has cleared away its arrears, the Fund can encourage recalcitrant creditors to come to the bargaining table. Insofar as the large number of creditors and rules requiring their unanimous assent to the terms of a restructuring plan create problems of collective action that hinder negotiations, lending into arrears can jump-start the process. To be sure, the Fund should lend into arrears only when a government is prepared to make a serious adjustment effort and to engage in good-faith negotiations with its creditors.<sup>14</sup> But insofar as sovereign debtors and the international community generally see the temporary suspension of payments as too difficult and costly a route to pursue, the IMF needs to use its lending power to tip the balance, opening up restructuring negotiations as a viable alternative to regular IMF rescues designed to avert default.

## Transparency

The difficulty of developing reliable early-warning indicators is the obvious reason why it is unrealistic to ask the IMF to be more transparent about its own views—to more aggressively “blow the whistle” on coun-

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13. In a hypothetical world, one might wish the Fund to lend only after countries' adoption of the relevant provisions. The problem is that demanding immediate action of this type from countries in a crisis would likely alert the market to their institutional shortcomings and disrupt their market access.

14. When these conditions do not hold, the policy will delay crisis resolution, not expedite it. This is why lending into arrears should be considered on a case-by-case basis.

tries courting financial crises. Its capacity to predict crises being imperfect, the Fund will inevitably blow its whistle in error. Failing to warn of crises is one thing, but warning of crises that might not otherwise happen is more serious still.

In contrast, bank regulators detecting balance-sheet problems in domestic financial institutions are able to blow the whistle because they can halt the operation of the problem bank; otherwise, their warnings would provoke a depositor run. Because the IMF possesses no analogous powers vis-à-vis its members, by blowing the whistle it could therefore precipitate a crisis.

The same objection applies to the idea that the IMF should publicly rate its members' vulnerability to currency and banking crises (e.g., Kaufman 1998a, b). If there is value in such ratings, there is nothing to prevent their sale by commercial agencies less subject to political pressure. There is an argument for the Fund to assume a rating-agency role only if one believes that it has better access to information than the markets and that this additional information has significant value for predicting crises.<sup>15</sup> Neither premise is transparently correct.

None of this is to deny that the Fund can and should be more forthright in its assessment of financial problems. But it must walk a fine line between swallowing its fears and exciting already skittish markets.

Nor does any of this weaken the general case for greater IMF transparency. Without transparency there cannot be accountability, and without accountability there will be neither political support nor additional funding for the IMF. At present, summaries of Executive Board discussions appear only once a year in the Fund's *Annual Report*, and program documents can be embargoed for 30 years.<sup>16</sup> Such confidentiality is excessive. At the same time, no one would suggest that all IMF staff analyses should be placed on the world wide web as soon as written or that Executive Board meetings should be broadcast on cable television, because this would simply shift all meaningful conversations between staff and management to the telephone and all Executive Board decision making to the cloakroom. Immediate release of all program documents is not feasible either; when these contain financially damaging information, as in the case where confidential IMF documents leaked to the public revealed that

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15. And even then there is the objection that governments will withhold such information if they believe that the Fund is prepared to release it to the public or to publish credit ratings based upon it.

16. Some countries—Thailand, Indonesia, and South Korea, for example—choose to release letters of intent voluntarily, at which point the Fund posts them on its website. In addition, the Fund now releases “press information notices” (PINs) summarizing the conclusions of Article IV consultations, but only with the authorization of the member. In its first year of operation, roughly half the members subject to Article IV consultations authorized the release of a PIN.

the Bank of Korea had tied up a substantial share of its foreign-exchange reserves by loaning these to foreign branches of domestic banks, the effect can be destabilizing.

Here, the US Federal Reserve Board, which has struck a balance between confidentiality and transparency, offers a model to follow. The Open Market Committee releases minutes of each meeting with a lag of about six weeks. (Full transcripts, with a small amount of confidential information regarding foreign central banks, businesses, and persons deleted, are released with a lag of five years.) The six-week lag prevents market participants from using the minutes as a source of inside information on future interest rate movements but at the same time forces governors to articulate the rationale for their decisions. Perhaps summaries or minutes of Executive Board discussions should be released with a somewhat longer lag on the grounds that while decisions to change discount rates are implemented when taken, the decision to disburse IMF assistance will in contrast be stretched out over a period of weeks and months. But a lag of 52 weeks is excessive. The same is even more true of 30 years for program documents.

The IMF should also regularize the external review and evaluation of past programs (see Sachs 1998b, 21). It has already constituted an Evaluation Group, chaired by a member of its Executive Board, which commissions ad hoc external evaluation exercises with the consent of the Executive Board. To date, these have focused on broad issues: the first evaluated the IMF's enhanced structural adjustment facility; the second, announced on 30 June 1998, seeks to evaluate the effectiveness of the IMF's surveillance over members' policies under Article IV of the Articles of Agreement; and the third, announced in December, will review the Fund's research function. This process should be regularized and should no longer require the approval of the Executive Board. It should accompany each country program, and it should be initiated within a fixed period of time.

## **The Fund and the Capital Account**

Many criticisms of the IMF reflect more fundamental doubts about its response to the emergence of an increasingly integrated international financial market. Since its creation, the Fund's core responsibility has been to oversee the operation of the international monetary system, which for many years meant focusing on its members' policies toward the current account. With the growing integration of financial markets, however, the international monetary system is now increasingly shaped by international capital flows. IMF staff has long favored openness to capital flows, arguing the case for capital mobility by analogy to the case for free international trade. In 1996 the Interim Committee requested that the Fund

analyze the costs and benefits of capital flows and consider changes to the Articles of Agreement that would give the IMF jurisdiction over its members' policies toward the capital account. In April 1997 the Interim Committee concluded that there would be benefits from amending the Articles to enable the Fund to promote the orderly liberalization of capital movements, a view that it reiterated at the September 1997 Annual Meetings of the World Bank and IMF in Hong Kong, where it stated that capital-account liberalization should be made one of the "purposes" of the Fund (Camdessus 1998b, 1).

These statements look less than astute in the wake of the Asian crisis, which unleashed a barrage of criticism of IMF-led efforts to encourage capital-account liberalization. The analogy with current-account liberalization, many critics now insist, was fundamentally flawed. While the positive effects of trade liberalization for economic growth have been extensively documented, the evidence of comparable benefits of capital-account liberalization is more limited, if it exists at all (see Bhagwati 1998).<sup>17</sup>

It is easier to levy criticisms at this level of abstraction than it is to suggest concrete alternatives. Practical recommendations must acknowledge the powerful forces promoting the growth of capital flows. The information and communications revolutions, and the manifest desire of governments to partake of the advantages of liberalized domestic financial markets, mean that administrative controls, in order to retain their effectiveness, will have to become increasingly onerous and distortionary. At the least, governments seeking to shape the extent and composition of international capital flows will have to do so in more market-friendly ways.

## **Prudential Regulation of the Capital Account**

To say that there are pressures for the liberalization of international financial transactions and that there is something inevitable about the process does not mean that these transactions should be left unregulated. In the domestic context it is understood that banks are fragile, prompting governments to impose prudential regulations on financial intermediaries' transactions and positions in assets whose liquidity and risk characteristics have implications for systemic stability. Such regulations are especially strict where the techniques of risk management are least well developed, where auditing and accounting practices leave most to be desired, and where financial disclosure is least adequate, weakening market discipline.<sup>18</sup>

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17. The question is debated at length by the contributors to Kenen (1998).

18. The existence of systemic risk has also led governments to provide deposit insurance and lender-of-last-resort services (mechanisms "for converting highly illiquid portfolios into liquid ones, in extraordinary circumstances," in the words of Greenspan [1998b, 4]). Stronger

These same grounds justify the regulation of international financial transactions even more strongly than they justify the regulation of domestic transactions. Information asymmetries are more pervasive in international financial markets. The difficulties of raising liquidity in emergencies is greater, as is the scope for contagion. And insofar as the liabilities of banks and other borrowers are denominated in foreign currency, the domestic central bank (not being able to print foreign currency) has limited ability to undertake lender-of-last-resort operations.

This does not mean that international financial transactions should be prohibited but that their cost should be influenced by regulation that takes into account their implications for systemic risk. As explained in chapter 4, banks should be required to purchase cover in currency forward or futures markets for their open foreign positions, better aligning the private and social costs of foreign funding. They should be required to close their open positions by matching the currency composition of their assets and liabilities—when borrowing in foreign currency, making only loans denominated in foreign currency.<sup>19</sup> Capital requirements should be adjusted to take into account not just the implications for systemic risk of banks' investments but also the special risks of foreign funding. Banks borrowing abroad should be required to put up additional noninterest-bearing reserves with the central bank, while banks lending abroad (notably US, European, and Japanese banks) should be required to attach higher risk weights to short-term claims on banks in emerging markets. And where there is reason to doubt the effectiveness of supervision and regulation in containing systemic risk, the authorities should reinforce these other measures by imposing taxes or nonremunerated deposit requirements on capital inflows.

## Sequencing

The implications for sequencing the liberalization of capital-account transactions flow from the potential for dangerous interaction between international capital movements and domestic banks. The most important point is the risk of precipitous liberalization, namely liberalization that precedes the removal of blanket government guarantees for the banking system and the implementation of international standards for auditing and accounting, financial disclosure, corporate governance, and supervision and regulation. FDI should be liberalized first, politics permitting, because

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prudential regulations are then seen as necessary to mitigate the tendency for financial-market participants to take on additional risk in response to the provision of this safety net.

19. Additional measures would be required to the extent that this only transformed currency risk into credit risk (in other words, to the extent that banks were still vulnerable because their customers were no better able to manage foreign-exchange risk than the banks themselves, raising the specter of loan defaults, as explained in chapter 4).

inward FDI is unlikely to immediately turn into outward FDI in response to a deterioration in macroeconomic and financial conditions. This can happen, to be sure, but FDI tends to be less responsive to the conjuncture than financial capital, given the costs of liquidating tangible assets, and therefore has a lesser tendency to precipitate a crisis.<sup>20</sup> Foreign investment in equity and bond markets should be liberalized before, or at least not after, the removal of barriers to offshore funding by the banking system. Thailand's and South Korea's experiences in 1997 provide ample warning of the dangers of removing restrictions on inflows into the banking system while retaining those on sales of domestic stocks and bonds to foreign investors.

### **Is There Still a Case for Amending the Articles of Agreement?**

Where does all this leave proposals to amend the Articles of Agreement to make capital-account convertibility a goal of IMF policy and to give the institution authority to encourage the orderly liberalization of capital flows? There is no contradiction between using taxes and tax-like instruments to manage capital flows and the desideratum of capital-account convertibility. Convertibility means shunning prohibitions and quantitative restrictions that prevent market participants from undertaking certain transactions at any price but is compatible with taxes that better align private and social costs. A blanket prohibition on foreign borrowing is more distortionary than a capital-import tax, which still permits those with especially attractive investment projects to finance them externally so long as they are willing to incur the additional costs of a public policy designed to make them internalize the implications of their decisions for systemic stability.

This is the same distinction the IMF has traditionally drawn regarding the current-account. Current-account convertibility is a goal of IMF policy under the Articles of Agreement. But while current-account convertibility is defined under Article VIII as freedom from restrictions on payments and transfers for current international transactions, that article does not proscribe the application of import tariffs and taxes to the underlying transactions. Correspondingly, capital-account convertibility, while implying the removal of controls and prohibitions, does not mean abjuring taxes and tax-like levies on the underlying transactions.

In principle, amending the Articles of Agreement to give the IMF jurisdiction over the capital account would enable an enlightened Fund to encourage its members to implement this important distinction. It would

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20. The empirical results of Frankel and Rose (1996) clearly support this conclusion.

position it to give guidance to its members on the optimal speed and sequencing of capital-account liberalization. It could lend legitimacy to taxes and tax-like instruments designed to limit the level and shape the term structure of foreign debts. And it would give the Fund leverage to encourage countries utilizing taxes on inflows to accelerate financial-sector reforms. Against this should be weighed the danger that an IMF with expanded powers might push its members to liberalize prematurely and that it would oppose any and all tax and tax-like policies toward capital flows. It might require countries seeking to adopt Chilean-style holding-period taxes to first obtain the authorization of the Executive Board, or it might authorize countries to restrict capital-account transactions on prudential grounds only after it was convinced that other, more capital-account-friendly measures were not available.<sup>21</sup> If the amendment to the Articles of Agreement giving it jurisdiction over capital-account policies regarded taxes and controls on inflows as permissible only when adopted temporarily or for a limited transitional period, IMF staff might then become knee-jerk opponents of the indefinite use of such measures for prudential reasons. Even if countries were permitted to limit capital flows as a form of prudential regulation, staff might argue that a measure had actually been adopted for other reasons (e.g., that a differential reserve requirement was in fact being used for purposes of monetary control) and was therefore not acceptable. As Jacques Polak (1998, 8) has put it, an IMF-given jurisdiction over capital-account restrictions might become “the enforcer of the new code, making sure at every step that any policy it recommends or endorses can pass the test of the new Article.”

Experience with Article VIII, which obliges members to establish the convertibility of their currencies for purposes of current-account transactions, does not suggest that the IMF will automatically become the rigid enforcer of a new code. In enforcing Article VIII, the Fund has in fact recognized a wide range of mitigating circumstances. Still, to reassure the skeptics, the IMF needs to articulate its strategy for capital-account liberalization, explaining its approach to the problem of sequencing and its policy toward the taxation of capital inflows. It needs to make clear that amending the Articles of Agreement does not mean eliminating Article VI, Section 3, which gives members the right to apply capital controls. Only then, having dismissed fears that it will push for precipitous liberalization and that it will oppose taxes on capital inflows as prudential measures, might its efforts to amend the Articles deserve support.

## Conclusion

The notion that the IMF should be abolished flies in the face of a century and more of experience with the operation of financial markets. Accidents

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21. Thus, one could imagine the Fund withholding its approval of a capital-import tax on these grounds in the case of a country that had not yet succeeded in meeting the Basle

can happen, and preventing fatal consequences requires the provision of a financial safety net. IMF loans can play a useful role in limiting the systemic consequences. But IMF resources will always be small relative to those of the markets. This, and the fact that government commitments to policy reform will always be uncertain, will limit the Fund's ability to extend standing lines of credit. But proposing that the Fund should loan only to countries that meet a long list of economic and financial preconditions assumes away the fact that crises in other countries can have serious adverse consequences for their neighbors and for the stability of the global financial system as a whole.

This means that there will remain a role for IMF lending and that when loans should be extended will remain a judgment call. This is not to deny that the IMF can go about this better. The Fund can make a more concerted effort to round up private credits to supplement its own. It can encourage the creation of private committees of creditors. And it can contribute to efforts to create a third alternative to ever-larger bailouts and devastating defaults. This means pushing not just for the creation of creditors' committees but also for the incorporation of new provisions in loan contracts, something it can do by lending on more favorable terms to countries agreeing to this step. It can lend into arrears as a way of providing debtor-in-possession financing and bringing the creditors to the bargaining table.

Of course, the IMF should continue to strengthen its surveillance of financial markets, institutions, and supervision. It should continue to cultivate contacts with market participants as a way of obtaining independent assessments of financial risks. It should continue to pursue its data dissemination initiatives, extending the coverage of economic and, particularly, financial variables. But it should not lull itself or market participants into the mistaken belief that improved surveillance and additional data will allow crises to be foreseen and prevented. The unexpected will still happen. Even the most reliable data will have to be revised in response to new developments.

Given the impossibility in this day and age of effectively segmenting domestic and international financial markets, the IMF's surveillance activities will ineluctably draw it deeper into issues of financial-market structure and regulation. To an extent this has already happened, rendering moot the objections of those who would have the Fund refocus on its traditional monetary and fiscal concerns. But the Fund has not dealt adequately with its resource constraint—that it lacks the personnel and expertise needed to provide detailed analysis and advice on bank regulation, auditing and accounting, insolvency and reorganization procedures, and corporate governance—or with the backlash that is understandably elicited by its ever deeper incursions into the domestic legal and economic arrangements

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Capital Standards, where in fact this is precisely the sort of country that most needs to resort to a capital-inflow tax.

of its clients. It needs to better articulate the case for involvement in these areas. It needs to approach them not by attempting to provide detailed advice on institutional reform to each of its members, something of which it is not capable and which its members would not accept, but by working more systematically with private-sector organizations and other multilaterals in the promulgation of international standards.

These changes in the way the IMF goes about its business will help, but they will not profoundly alter the international financial architecture. The most important changes—in the provisions of loan agreements, in exchange rate policies, and in policies toward the capital account—will occur elsewhere, at the national level and in the markets. It is there that the scope is greatest for reducing the risk of financial crises.