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THE IMF AFTER FIFTY YEARS AND THE MEXICAN CRISIS

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A prominent theme at the 1994 conferences celebrating the fiftieth anniversary of the IMF and World Bank was that the globalization of capital markets has created a world very different from that envisaged at Bretton Woods. But the implications for the role of the Fund remained fuzzy.

The issues stand out more clearly after the Mexican crisis, often described as the first financial crisis of the twenty-first century. Faced with an almost total loss of investor confidence after its December 1994 devaluation, Mexico was able to avoid a debt default and/or the imposition of capital controls only with the help of massive financial aid from the United States and the IMF. The United States lent $20 billion. Acting with unprecedented speed, and concerned about the consequences of default for Mexico and the contagion effects in other emerging markets, the IMF agreed to lend Mexico nearly $18 billion, almost seven times the country's Fund quota. The normal cumulative lending limit for a country is three times its quota.

The debate that followed focused on two issues. First, what can be done to prevent future Mexican-style crises? And second, how should the international community deal with such crises if they do occur? In particular, does the international community have the resources to deal with future Mexicos?

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Surveillance

The international community's answer to the question of how to prevent future crises is to strengthen IMF surveillance--of member economies, and of international capital flows. Under current procedures, each year the IMF staff prepares a comprehensive report, the Article IV consultation report, on the economy of each member. The report is discussed in the Executive Board, and is thereby disseminated to member governments, but it is not published. Through the six-weekly Board discussions of world economic and market developments, the twice-a-year discussion by the Board and publication of the World Economic Outlook, and the annual International Capital Markets report, the IMF also monitors and reports on the global economic scene.

By warning countries of the risks confronting their economies, and of the dangers of particular policies, surveillance should help prevent crises. The process appears simple: better informed governments would make better decisions about their own economies; the Fund could bring pressure to bear on countries pursuing inappropriate policies; and individual governments, armed with the results of IMF surveillance, should be able to give better advice to fellow governments.

Discussion in the Fund's Executive Board following the Mexican crisis, has led to the conclusion that the practice of surveillance could be improved, by focusing it better, by improving Fund procedures, and by paying greater attention to the capital markets. The IMF's policy-making Interim Committee, meeting in April, endorsed these conclusions.

The first recommendation is that greater attention be paid to the economies of key countries, where economic shocks or policy failures could have implications for other countries. Mexico, the major developing country recipient of international capital flows, and the country whose debt served as the benchmark for developing country debt, fit this description. This emphasis also requires special Fund attention to the larger industrialized economies, even though the influence of Fund recommendations and peer pressure on these countries may be more subtle than in developing countries.

The second recommendation, also driven home by the Mexican case, is that the Fund needs to pay more attention to the structure of members' external financing, and the soundness of their financial sectors. For much of its existence, and by its original design, the Fund concentrated on the current account of the balance of payments. As capital markets have been liberalized and the international capital markets have developed, Fund surveillance has to focus more on capital account transactions and their impact on the macroeconomy.

The third set of recommendations relates to the Fund's internal procedures. Until recently, surveillance for non-program economies--countries not borrowing from the Fund--was built around the annual Article IV consultation. This meant that Fund involvement with that economy was intensive for three to four months a year, and less so for the remainder of the year. Surveillance needs to be more flexible, timely and continuous, and there needs to be a more continuous policy dialogue between the IMF and members. Procedures are being put in place to make that happen.

Fourth, the Fund needs to be less polite, or at least more direct. The surveillance relationship is a complicated one: the Fund is reporting on a country, on which it is relying to provide data and a frank discussion of the policy issues. Fund staff would not be human if they did not occasionally pull their punches in the interests of friendly relations with member governments. The same applies to discussions within the Board, where a tacit mutual non-aggression pact may operate. It is possible to be both direct and sympathetic, and both Fund staff and Executive Directors should be seeking that balance.

Finally, there is the question of data. Well-informed markets work better than those confronted with delays in the publication of key data. Provision of core data, on a regular and predictable basis, by all members to the IMF will help to identify emerging tensions at an early stage. Beyond that, it is each country's responsibility to publish information for the market. The Fund is working toward the establishment of standards for the provision of data to the public, and stands ready to help countries prepare, publish, and present them.

A cautionary note

While better surveillance would certainly reduce the frequency of crises, we should not exaggerate. Mexico was not only aware of the risks of the policies that it was following, it was also warned of the dangers of its course by the IMF and the United States Treasury. Better surveillance will help, but it will not prevent all crises.

It is sometimes suggested that surveillance would be more effective if the Fund shared its appraisals with the private markets. Certainly the Fund will encourage member countries to publish timely data, frequently. But it would not be appropriate for the Fund to make public statements that could be self-fulfilling about the risks of a country's policies. That would saddle the Fund with the responsibility for dealing with the domestic economic consequences of a crisis, a task which it is not able to carry out.

IMF resources in light of the surveillance debate

What should happen when a crisis strikes? One suggestion is that the Fund should have procedures that permit an orderly debt workout for countries hit by capital outflows. While formidable difficulties stand in the way of this interesting idea, it deserves further consideration.

In the meantime--and in all likelihood even if the workout mechanism is possible--the Fund will have to stand ready to make financial resources temporarily available to members to enable them to avoid unnecessarily severe adjustment measures, and to prevent the contagion effects seen in the Mexican and other crises.

Critics of the recent Fund action in Mexico point to the moral hazard created by the availability of Fund financing. Surely, they argue, policymakers and investors will be less careful if they know that the Fund will help out in the event of a crisis. Moral hazard is indeed a relevant issue, but one that is easily overplayed. It is hard to imagine policymakers standing in line to share the political and economic difficulties that Mexico is now experiencing despite the Fund's assistance. And the great majority of investors in Mexico and Latin America did not escape the Mexican crisis unscathed. The dilemma posed by moral hazard should not be an excuse for forcing a country into a deep and long-lived recession in order to teach its policymakers and investors the toughest possible lesson; nor should it be an excuse to allow the contagion effects of a crisis to impose unnecessary damage on other countries.

So the Fund should have the resources to help mitigate future crises. While the Fund's liquidity is adequate for the present, challenges further ahead and the inevitable lags in the process of increasing the Fund's resources require action now.

The management of the IMF has proposed four ways to strengthen the institution's financial resources. The Fund's basic and essential source of financial strength, its quotas, need to be increased. The last increase, which came into effect in November 1992, raised total quotas to SDR 145 billion (about $ 220 billion), although only about SDR 45 billion currently represents uncommitted resources that could be used in lending operations. The 1992 quota increase made it possible for the Fund to provide support for the stabilization efforts of the economies in transition (including credits approved in April for Ukraine totaling SDR 1.25 billion and for Russia of SDR 4.3 billion), and to act forcefully to deal with the situation in Mexico. The need to maintain Fund quotas at an adequate level--and the need to preserve the Fund as a quota-based institution--warrant a doubling of quotas.

Secondly, given the sudden crises and disruptions that will remain a permanent risk in globalized capital markets, the Fund needs quick access to sizable resources, even if on a temporary basis. Fund management looks forward to an increase in the resources of the General Arrangements to Borrow (currently SDR 18.5 billion, including an associated credit arrangement with Saudi Arabia) and a possible broadening of the GAB membership.

Thirdly, under the ESAF (Enhanced Structural Adjustment Facility), the Fund has the ability to provide balance of payments support on concessional terms to the poorest countries. The membership has agreed that the Fund should be able to continue to provide such support. Management would like to make ESAF permanent, and to that end has suggested a mechanism that could involve very limited sales of part of the IMF's holdings of gold, along lines consistent with suggestions by the Chancellor of the Exchequer.

Finally, the Fund will be undertaking a major study of the future role of the SDR.

This is an ambitious but realistic set of measures, which will strengthen the international financial system. It will receive the attention of the G-7 at the Halifax Summit, and the Interim Committee at the Fund's annual meetings in October.