REVIEW ESSAY

Understanding the IMF Debate

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The International Monetary Fund (IMF) was established along with the World Bank during the international negotiations at Bretton Woods, New Hampshire, near the end of World War II to oversee the operation of the postwar international monetary system and to 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 allowed the IMF to operate in relative obscurity. Over time, however, the system of adjustable exchange 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 1970s.

During the decades preceding the breakdown, the IMF had become so closely identified with the exchange-rate regime over which it had presided that many observers assumed that the end of that exchange-rate regime would also spell the end of the IMF. The pessimists expected a catastrophe to result—a return to the economic warfare of the 1930s. The optimists, in contrast, expected that floating exchange rates would take care of all international monetary problems and that an organization such as the IMF would no longer be needed.

Both views were wrong. We experienced neither a catastrophe from nor a solution of all the problems. Both predictions were flawed because they were based on a

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lack of understanding of the full range of the IMF's activities. Those activities included discouraging the use of competitive depreciations, which had added greatly to the costs of the Great Depression in the 1930s, and providing 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. Therefore, although the IMF's roles have evolved substantially over time, the organization has not yet become obsolete.[2]

Whether the IMF has been doing a good enough job is another issue. In many developing countries, where the IMF has long been a household word, it is infamous for forcing countries into austerity programs. In recent years, this IMF role as the bad cop who forces countries to live within their means and offers meager amounts of financial assistance in exchange for the adoption of macroeconomic stabilization and market liberalization policies, has been played within the former communist countries now struggling to adjust to the ways of the market. Although finance ministers and reform-minded economists in developing countries have often seen the IMF as a valuable friend, many politicians in those countries seek political advantage by vilifying the organization. Many citizens in emerging economies and on 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 small group of experts, interest groups, and policy officials. Lately, however, many on the far right in the United States have joined in condemnation of the IMF, and leftists have taken to the streets in public demonstrations against the IMF as an agent of globalization. Combined with widespread concerns about the IMF's failure to prevent the rash of international financial crises that plagued the 1990s and increasing fears about the effects of globalization, attacks on the IMF have begun to receive extensive attention, including heated debates in the U.S. Congress. In March 2000, the IMF joined the World Trade Organization (WTO) as a poster child for the evils of globalization when the same group of nongovernmental organizations (NGOs) that had created such havoc at the WTO meetings in Seattle converged on Washington, D.C., to attempt to shut down the IMF during the meeting of its oversight committee from national governments.

What should national policymakers and the general public make of this phenomenon? We might be inclined to suspect that anything viewed as bad by both the far right and the far left must be terrible indeed. Giving us pause about this interpre-

1. Of course, a completely free, market-determined depreciation would not be a problem, but nearly all flexible exchange rates are subject to some degree of government management. On the political incentives for governments to adopt destabilizing economic policies, see Willett 1988.

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

tation, however, is that most of those in the middle do not share this opposition to the IMF. Indeed, looking closer, we see that the far right and the far left agree on this issue only because they have vastly different perceptions of what the IMF actually does. The two groups cannot both be correct in their perceptions of 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.3 Instead, the comfort of strong ideological commitments and a few anecdotes consistent with their views give many on each side all of the information they think they need.

One might think that the strong attacks for opposite reasons coming from both sides would 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 it may safely ignore the ideas espoused by the other.

Defenders of the IMF can make (and have made) a case that the opposition from both the far left and the far 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 in the middle of the spectrum of underlying preferences. Accordingly, the Fund can point to the attacks of the left and the right as balancing out one another.

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

The IMF needs strengthening, not abolition, but calls for sensible reform have received relatively little attention in the public media. Such calls are much less dramatic than protests in the streets. Informed discussion colored in 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. During the last year or so, several groups of experts have prepared important public reports on the IMF. As one would have expected, there is less than complete agreement among these reports, and most of them contain minority dissents, but on a substantial core of

3. I say few, not none. There are, of course, some very strong and knowledgeable critics on both sides of the political spectrum.

issues there is extensive agreement. In this article, I highlight a number of major areas of widespread agreement and discuss some of the most important remaining disagreements.

Recent Reports

Two of the recent reports are official. One was commissioned by the IMF itself (International Monetary Fund 1999) and was prepared by three leading outside experts who canvassed the views of a broad range of officials, academics, and private-sector experts. The second official report was mandated by Congress and was prepared by the International Financial Institution Advisory Commission (2000), chaired by Allan H. Meltzer and hence known as the Meltzer Commission. This group, consisting of six experts picked by the Republicans and five picked by the Democrats, included academics, leaders of policy institutes, and former government officials and members of Congress. It held a number hearings and solicited the views of a wide range of experts and interested parties. The third report came from a task force commissioned by the Council on Foreign Relations (1999). This task force was chaired by Carla Hills and Peter Peterson. Morris Goldstein, a former senior IMF official now with the Institute for International Economics, served as its project director. The group consisted of prestigious academics, leaders from the private sector, and other members of the policy community.[4]

When the Meltzer Commission's report was issued, the press made much of the fiery rebuttals contained in the minority (Democrat) statement. That reporting created the impression that the commission's efforts had produced little more than a statement of divergent partisan views. The minority report did sometimes resort to heated language, for example, accusing the majority (Republicans) of reliance on "misinterpretations of history and faulty analysis" (International Financial Institution 2000, 119).

Some of the minority criticisms have substance. The majority report is somewhat too negative when it characterizes research on the effectiveness of IMF programs as having found that "IMF interventions . . . have not been associated, on average, with any clear economic gains to recipient countries" (International Financial Institution 2000, 40).5 Certainly, the left widely perceives the IMF as hurting the countries it is supposed to help. Much of that criticism arises from an excessive focus on the short

4. I also refer to a report by four leading academics, De Gregorio, Eichengreen, Ito, and Wyplosz (1999), and to a report by a task force for the Overseas Development Council (2000) that focuses on the role of the IMF in economic development. I do not attempt here to cover systematically all of the recommendations of these reports, but I emphasize several of their major themes. For a more detailed review of these reports, see Williamson 2000.

5. For recent reviews of and references to the recent literature on the IMF, see Bird 1996; Killick 1995; Killick, with Gunatilaka and Marr 1998; Ul Haque and Khan 2000.

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 stabilization policies that in the short run do cause recession and hurt growth. But maintenance of the status quo would not have been viable. There is considerable evidence that bringing inflation under control is necessary if countries are to reach their growth potential (Burdekin, Salaman, and Willett 1995; Burdekin et al. 2000; Sarel 1996)—short-term pain for long-term gain. Thus, the common criticism that IMF policies are in general bad for growth is not well founded.6

In some areas, primarily in the international dimension, IMF programs have tended to have good effects on average. Generally, IMF programs have been associated with the adoption of more realistic exchange rates and with improvements in the balance of payments. However, the available research does not find that the positive effects of IMF programs have been nearly as strong as they should have been. The program effects were weak not primarily because the IMF recommended bad policies, but because the policies on which the IMF and national governments agreed were often not carried out.

The IMF does not usually act stupidly. Of course, it sometimes makes mistakes, but it often learns from its mistakes. In fact, its record of policy advice is enviable, despite the frequency with which one hears that its policies worsened the Asian crisis.7 Most IMF staff members are highly competent (as such highly paid professionals should be), and IMF advice usually occupies a position in the mainstream of the best economic analysis.

The opposite impression is so widely entertained because there is so much controversy among macroeconomists. Economics is far from an exact science, and some macroeconomists, like the lay critics of the IMF from the far left and the far right, have ideological commitments to particular schools of thought. Whereas I conclude that a good deal of uncertainty must surround the subject because many very bright economists are reaching opposite answers, others suppose that they know the correct answer and that all those who disagree are suffering from ideological bias.

The IMF is frequently accused of having doctrinaire commitments to particular macroeconomic theories, but it is interesting to note once again that such charges do not all come from the same direction. On the left, the Keynesians see the IMF as much too monetarist. But on the right, the supply-siders see it as 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 macroeconomists.

6. It does not follow, of course, that IMF policies have been the best possible for promoting growth over the long term.

7. For examples of such charges, see Furman and Stiglitz 1998; Radelet and Sachs 1998. For an IMF response, see Boorman et al. forthcoming.

The IMF's point of view on macroeconomic issues is located where it should be, in the mainstream of professional opinion. This stance does not guarantee that IMF analysis will always be correct, however. Like most economists, the IMF economists failed to give sufficient attention to the serious financial-sector problems in Asia, and hence they failed to foresee the depth of the recession that followed the financial crisis there. That recession in turn invalidated the IMF's initial recommendation of fiscal tightening. Although I have spent considerable time trying to convert the IMF to particular policy positions in areas in which I have done research, and I have felt frustration when my efforts have been unsuccessful, I have found the IMF's management and staff as a rule much more open-minded than 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 lack an understanding of local conditions and treat local officials arrogantly. The interviews conducted by the IMF's external evaluation teams (IMF 1999) suggest that such deplorable behavior is not the norm, but it occurs frequently enough to hurt the Fund's effectiveness. Creating stronger disincentives for such behavior needs to be a priority for IMF management and senior staff.

Obviously, the implementation of IMF programs ought to be held to higher standards, and there is substantial agreement about how improvements should be made—agreement often missed in the press coverage of the Meltzer Report. Indeed, that agreement is stressed at the beginning of the minority statement.[8] Nevertheless, a healthy discounting of extreme views from the left and the right is not sufficient to give the IMF a clean bill of health. In the following sections, I discuss a number of the most important areas in which improvements are needed.

Implementation of IMF Programs Must Be Improved

There is widespread agreement that IMF programs have not been working well enough. Although critics on the left blame the IMF for 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 within IMF programs. Indeed, many critics on the right have claimed that the financing accompanying IMF programs has typically allowed countries to delay adjustments more frequently than such programs have promoted adjustments. Many examples of delays of adjustments might be given. Even though, on balance, IMF programs have done a good deal more good than harm, the record is far from perfect. Failures to strongly enforce policy conditionality have occurred both because of internal IMF incentives for staff not to

8. Other points of widespread agreement (including in both the U.S. Treasury and the IMF itself) are that national governments and the IMF (and the World Bank) need to sharpen their focus on and ability to analyze financial-sector issues and that national governments need to do a better job of monitoring international financial flows and of 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 financial contagion following the Mexican and Asian crises.

rock the boat if they wish to continue to advance up the career ladder (IMF 1999; Meltzer 1998, 1999; Vaubel 1996) and because of pressures by major industrial countries to use the IMF as a slush fund to achieve geopolitical objectives (De Gregorio et al. 1999; International Financial Institution 2000; Willett forthcoming). These political-economy problems have come to have extremely serious consequences. The public's money has been poorly utilized, and needed policy adjustments have been avoided. Moreover, the credibility of the IMF seal of approval has suffered (Willett 2000).

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 in encouraging capital inflows. IMF programs have such stabilizing effects on private financial flows, however, only if implementation of the programs is likely. Some slippage is inevitable, but the IMF must do much better. The credibility of its seal of approval has been seriously damaged, but not fully destroyed. Although the IMF has been heavily criticized (in some cases fairly, in other cases unfairly) for its handling of the Asian crisis, the countries with IMF programs did undertake a substantial amount of adjustment. This accomplishment gives the IMF a good base on which to build.

It is not clear to what degree top officials in the IMF and in national finance ministries recognize the seriousness of the challenge to the effectiveness of the IMF. The majority of the Meltzer Commission views the organization's problems as so serious that they would limit its role merely to emerging-crisis lending for which a set of preconditions has been met. Most experts have not given up completely on IMF policy conditionality (an exception is Killick, with Gunatilaka and Marr 1998), but they agree that continuing to do business as usual is not feasible. The IMF has responded by making a commitment to set up independent evaluation groups that would 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 not admitted that the continued abuse of the IMF as a political slush fund threatens to undermine its effectiveness seriously.

The political manipulation of the IMF has concerned some scholars so much that they have recommended that it be given much greater formal independence along the lines of the Federal Reserve and the European Central Bank (De Gregorio et al. 1999). Alternatively, I myself have proposed that the major industrial countries establish a geopolitical fund in order to take pressure off the IMF (Willett 1999).

The recent fiasco surrounding the appointment of a new IMF managing director has generated considerable official interest in a number of IMF governance issues. 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 considerable 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 be headed by a European and the World Bank by an American. Because the previous two IMF managing directors had been French, the Germans apparently thought that now their turn had come. The incident gave rise to widespread criticism of the formal appointment process and of the informal exclusion of candidates from the developing countries. Other major governance issues include the distribution of formal voting power in the Fund, charges that the United States has exerted informal clout, the tendency for the Fund's Executive Board to avoid formal votes, and a widespread perception that the average quality of national appointments to the Executive Board has declined over time. So far, however, the major national governments have shown no willingness to consider radical restructuring of IMF operations and governance procedures.

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, the expansion was necessary, but in many cases the scope of policy issues covered fell far outside the range of IMF expertise and raised questions about both the 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 in the IMF's traditional core areas of 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 United States and other industrial countries to use financial crises to force trade liberalization on emerging-market countries. Although such pressure is understandable when viewed in terms of real politics, it runs the risk of seriously damaging IMF legitimacy.

Other pressures toward mission creep, especially into the areas of labor-market and environmental policy, have come from NGOs in the industrial countries and even from recipient-country governments themselves. Economic and financial officials often attempt to use IMF programs to help them get policies approved by their legislators. Much of the mission creep also reflected 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 strong negative response to the recommendation of the IMF's external surveillance report

that the mission creep be reversed. Fortunately, the new managing director, Horst Köhler, has given initial indications that he takes the criticism of mission creep 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, it is involved in crises of political economy, not just in economics. Its mandate includes helping countries to avoid crisis by adopting better economic policies, and most of those 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 approved by the legislature. Where reform and stabilization enjoy strong support, IMF programs have the potential to help to tilt the domestic political equilibrium in that direction. Thus, the IMF can often be a finance minister's best friend.

Some critics view this IMF role as representing inappropriate external manipulation and as undermining domestic democratic processes, but it can be defended much as independent regulatory agencies and central banks are defended. Some types of issues are best kept out of day-to-day politics lest short time horizons and rent seeking by interest groups lead to macroeconomic instability and microeconomic pork barrels.

From my perspective, a 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 considerable scope for improvement on this score. The recent IMF negotiations with Argentina suggest that officials within the Fund are taking this lesson to heart.

Another key is that the IMF must be prepared to say "no" much more often. Doing so will not be easy. IMF officials have a natural tendency to think that, even with weak programs, they will be able to exert some influence for good, whereas with no program at all IMF influence is likely to fall drastically. That understanding is probably correct in the short run, but not necessarily in the long run. In any event, however, the threat to the credibility of IMF programs is now so great that a major reorientation of IMF lending programs is needed.

It would be helpful if the IMF required preconditions rather than promises before initiating its lending. National officials probably will not go so far as the majority of the Meltzer Commission recommended, but a substantial tilting in this direction would be desirable and, indeed, has already begun. The international community should make clear that the recent conduct of IMF programs has been unsatisfactory, and future increases in IMF funding should be made conditional on substantial improvements in this area.

To foster the desired improvements, the IMF needs to develop a better capacity for political analysis. This change might help not only to increase the likelihood that IMF programs will be effectively implemented, but also to 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 Fund to hire more senior staff with national policy experience. That reform should be complemented by also hiring and utilizing more political scientists and economists trained in political economy.

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. In the light of this orthodoxy, it is interesting to note the differences in the lessons experts draw about the effects of the growth of 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 official programs can no longer be large enough to be effective.

Each of these seemingly contradictory reactions contains elements of truth. In a fundamentally unstable situation, no official program can be big enough to offset private capital flows. But that condition is not to be regretted. In such circumstances, official lending programs should not be conducted anyway.

The Council on Foreign Relations Task Force argued that IMF programs should be smaller. Until the credibility of the IMF seal of approval is substantially strengthened, however, such diminishment could be dangerous. Instead, the typical emergency IMF program should be enlarged to help assure that markets will be calmed, but 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. In these cases, IMF lending has strayed far from its original mission and looks much more like World Bank aid. Both the majority and minority reports of the Meltzer Commission agree that this type of IMF program should be stopped, although they disagree about whether such funding should be stopped entirely or transferred to the World Bank.

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 decision to lower the interest rate on borrowings from the new Contingent Credit Line (CCL). This response is inadequate,

however. Outside observers are virtually unanimous that the CCL is a badly constructed innovation, designed in haste to give officials political cover from the charge that they should put more effort 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, that world no longer exists. 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 cannot do the job. Fortunately, its flaws are so obvious that, to date, it has remained unused. Although officials will probably tinker with it in order to save face, the IMF's credibility would be better served if the CCL were eliminated and its creators started over with a better design.

The Meltzer Commission majority proposal for the design of such a facility is much too stringent to secure official acceptance, but it should not be dismissed out of hand. It contains a number of good ideas that should be incorporated in a reformed facility. For example, the minority claimed that the majority's proposed design fails to include provisions for sound monetary and fiscal policies, but this oversight might easily be remedied. In evaluating the appropriate degree of stringency of conditions, credibility must be given considerable weight. If preconditions are made too stringent, they are unlikely to be credible. This consideration puts the design of emergency facilities in the realm of political economy, but just economics. It is unfortunate that the tight deadline Congress imposed on the commission did not allow for more meeting of the minds between the majority and minority on this important topic.

Just Say No to Pegged Exchange Rates

Understandably, officials in most countries prefer to adopt neither perfectly fixed nor freely floating exchange rates. The theory of optimum currency areas explains why their preference is quite rational on economic as well as on political grounds. According to this theory, there is no ideal exchange-rate regime for all countries (Willett forthcoming; Willett and Wihlborg 1999). Any exchange-rate regime has substantial costs as well as benefits. The ratio of costs to benefits for any particular regime varies systematically across countries, depending on a number of factors, including economic size. A flexible exchange rate is likely to be best for a large country such as the United States, whereas a fixed rate is much better for a tiny country such as Estonia.

Most countries are intermediate cases, however, and would prefer intermediate exchange-rate regimes. The problem is that compromise regimes, such as the adjustable-peg system adopted at the Bretton Woods conference in 1945, are unworkable in a world of substantial capital mobility. They are subject to the so-called one-way speculative option. Market participants may not know if a major change of the exchange rate will occur during a particular period, but they know the direction that any change will take.

Therefore, both prudent international investors and the gnomes of Zurich have an incentive to move money out of weak currencies, thereby increasing the likelihood of crisis.

This process caused the breakdown in the Bretton Woods system in the early 1970s, but it is apparently difficult for some national officials to learn the lesson. They act as though, with some minor tinkering, they will be able to escape the dilemma. The evidence runs against them. In 1992, George Soros took almost a billion dollars at the expense of British taxpayers because the British finance minister had not learned the 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 rates that were insufficiently flexible. Hence, a major recommendation of the Council on Foreign Relations Task Force is "just say no to pegged exchange rates." The Meltzer Commission concurred.

The U.S. Treasury has strongly advocated that the IMF discontinue lending to countries with adjustable pegs, and IMF First Deputy Managing Director Stanley Fischer has registered substantial agreement, but a number of IMF Executive Board members have not yet been convinced. Part of the disagreement stems from how the proposition is phrased. The most extreme form is that the IMF should lend only to countries with either permanently fixed or highly flexible exchange rates. This formulation can be criticized on the grounds that for many countries neither of these extremes is attractive, and in a number of cases more flexible versions of intermediate regimes, such as crawling bands, have proved workable (Williamson 1998).

The problem is that, over time, governments frequently succumb to political incentives to limit excessively the flexibility of these regimes. Such limitations are not just a trait of emerging-market countries. The evolution of the European Monetary System and the resulting crises in the early 1990s constitute a prime example. It would be difficult, if not impossible, to develop simple rules for determining whether a particular exchange-rate regime were sufficiently flexible. Of necessity, the IMF must be allowed to judge whether a country's exchange rate has sufficient flexibility to warrant IMF financial support. Although the IMF has excellent technical expertise to make such a judgment, it must guard against the bureaucratic and political incentives to support insufficiently flexible currencies.

Reducing Moral Hazard

Another major problem is the moral hazard that arises from explicit or implicit government guarantees against loss. Although sometimes serving worthy purposes and sometimes reflecting only cronyism, all such guarantees distort incentives for economic actors to take risk into account. In some cases, such as insuring a small bank's deposits, the costs are trivial, but in other cases they are enormous. Moral hazard can generate incentives for overlending and overborrowing that result in the inefficient allocation of investment, in 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 even an insider) to follow, in part because the participants frequently fail to clarify their claims. One version maintains that moral hazard was a quantitatively important cause of recent crises and needs to be dealt with by policymakers—a proposition for which there is massive support. Another version maintains that without moral-hazard problems none of these crises would have happened—a more questionable proposition. Compounding the confusion, debates rage about the extent to which the moral hazard generated by the Mexican bailout contributed to the Asian crisis (a question not easily answered) and more generally about the extent to which IMF programs have contributed to moral hazard (another question not easily answered).

The policies of national governments generate most of the moral hazard. Connected lending and pegged exchange rates have been two of the most important sources of moral hazard, but scarcely the only ones. The IMF enters the picture by providing funds to the governments of countries in financial crisis, thereby helping those governments make good on their explicit and implicit guarantees. At times, IMF loans to countries with pegged exchange rates have helped to delay needed exchange-rate adjustments, while private capital continued to flee the country; in effect, the IMF was subsidizing 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 in order to stop speculative runs. From a longer-term prospective, however, such responses will probably make future crises larger and more frequent.

Institutional reforms are needed to create better incentive structures in international financial markets. 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 (Eichengreen 1999; Mann 1999). 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 rollovers. Such reforms, in turn, would reduce the amount of IMF crisis lending. Indeed, theoretically, such mechanisms might be used as a full substitute for IMF crisis lending (Rogoff 1999). As reforms tilt further in this direction, however, the greater will be the discouragement of international capital flows.

Up to a point, that discouragement would be desirable. Prior to the recent crises, moral-hazard problems had probably generated excessive international financial flows to many emerging markets. Indeed, both the Meltzer Commission and Council on Foreign Relations reports argue that, prior to the crises, emerging-market countries had relied excessively on short-term foreign borrowing. There is much less agreement, however, about the best way to avoid a recurrence. In this regard, considerable interest has been shown in the so-called Chile tax, which discourages short-term capital flows (Eichengreen 1999; Willett and Denzau 1999). Advocates of this approach argue that it should not be thought of as a form of capital control, but rather as a cor-

rective 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 brought into the analysis. The conflicts between the interests of international financial institutions and broader social interests are often much smaller than alleged by populists of the left or the right, but in this area the divergence is likely to be substantial. So far, the official policymakers continue to pay lip service to the need for reforming the international financial architecture, but little progress has been made. To some extent, the slow pace of change reflects the complexity of the technical issues involved, but one cannot help but fear that the major financial interests are exerting their influence to slow progress.

Increases in Transparency

The reports agree that a substantial increase in transparency is needed to strengthen the operation of the international financial system. This increase can takes two forms. One is improvement in the coverage, speed, and accuracy of the data that national governments make publicly available. The second is increased transparency in the operations of the IMF itself. The first should help to strengthen national decision making, monitoring by international organizations and credit-rating agencies, and prudent risk management by international investors and businesses. The second is essential to improve IMF accountability.

Examples of bad practices by national governments abounded 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 in 1997, the central bank fought speculative pressures by selling reserves in the forward market instead of in the spot market. Although publicly reported gross international reserves remained high, at about $30 billion, undisclosed sales in the forward market caused net international reserves to fall almost to zero. For a substantial period, that deterioration in the true reserve position remained hidden not only from the public but from the rest of the Thai government.

In Indonesia and Korea, short-term external borrowing by the private sector was much larger than publicly reported. The amount of nonperforming loans by banks was also substantially underreported. The poor quality of such reported information contributed to the failure of private financial markets to give adequate signals of impending crises. The appearance of more accurate estimates during the crises worsened confidence even further. In some cases, governments even falsely or misleadingly reported figures to the IMF. Both Russia and Ukraine have been accused of artificially inflating the figures they reported to the IMF on their reserve holdings.

Fortunately, major efforts are under way to remedy these problems. Of course, determining 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 make 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 with inadequate data provision.

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

To its credit, the IMF has taken this criticism to heart, and during the past few years it has made a remarkable amount of additional disclosure. Perhaps the most important remaining 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 (or merely threatening to make public) its criticisms in such circumstances would give the IMF a powerful weapon to induce countries to adopt better policies (see the statement by C. Fred Bergsten in the Council on Foreign Relations report [1999]).

Some fear that it is too powerful a weapon. Such announcements might easily leave the IMF open to the charge that it had caused any subsequent crisis. Adding this weapon to the IMF's arsenal might seriously diminish the frankness of confidential discussions between the IMF and national officials. Drawing the appropriate balance is a delicate matter, but it seems that the IMF should tilt at least a little further in the direction of offering more public warnings.

Conclusion

Contrary to some declarations, the IMF is not obsolete. Nor has it done more harm than good, on average. Many of the criticisms of the Fund reflect controversies about policy strategies and as a consequence often convey an exaggerated depiction of the frequency with which the Fund gives bad policy advice.

Nonetheless, the Fund needs to do a great deal better. It has not been the all-powerful dictator of policy in developing countries so often depicted. Rather, its record of effectively enforcing its policy conditions has been woefully weak, so much so that the traditional value of the catalytic effect of its seal of approval on private capital flows has become seriously endangered. Reform is not simply a matter of the IMF's getting tougher in enforcement. It must also return to its traditional focus on key macroeconomic and financial issues and fight the temptation 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 poor.

Such changes in orientation will not be made easily. Reformers must overcome bureaucratic incentives within the IMF and the tendency of the governments of the industrial countries to pressure the Fund for short-run political reasons. Yet, despite all the unavoidable 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 preconditions can yield a substantial improvement in the IMF's performance.

In a number of areas, substantial improvements have already been made. There has been a healthy increase of transparency at the Fund, and the new managing director, Horst Köhler, appears to be a strong supporter of the Fund's reversing its imposition of ever-more policy conditions. Just saying no to supporting Bretton Woods–style pegged exchange rates also enjoys growing support within the IMF.

Despite these promising signs, it is important to keep external pressure on the IMF and on 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 political pressures, little if any real progress has occurred. In other areas, a danger exists of backsliding once the spotlight of public attention has turned elsewhere. By and large, the public demonstrations against the IMF have been based on faulty reasons, but if they promote continued public scrutiny of the Fund, then they will have provided a valuable service.

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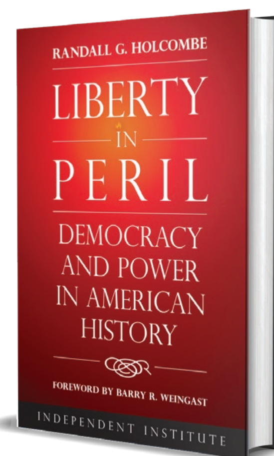

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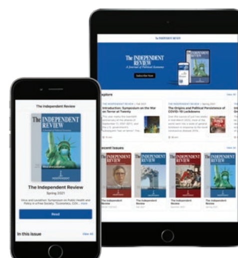

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