Policy Recommendations: Privatize the IMF and World Bank

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Over four and a half years ago a Congressional advisory commission, dubbed the Meltzer Commission, presented to Congress a list of recommendations for major reform of both the IMF and World Bank.[1] As a member of the commission, I am disappointed but not surprised that so little reform has occurred and that so little is likely to occur. These institutions have their detractors from both the left and the right of the political spectrum but they have proven to be ineffective as a force for reform.

Going forward the Congress and the President have several policy options. They can accept the status quo and the attendant costs to taxpayers. They can renew their efforts for reform. They can withdraw U.S. support, effectively abolishing the institutions. One

[1] Report of the International Institution Advisory Commission, Allan H. Meltzer, Chairman, March 2000

option that has not been considered but deserves a serious look is privatization. There are many advantages to privatization, not the least of which is that it may be politically achievable.

Institutional Problem. Both the IMF and the World Bank have problems associated with their main function, lending. Start with the IMF. It has no clear mission with respect to lending. It lends for whatever purpose it deems important. There is lending to achieve narrow political purposes as well as long- term lending to developing countries. Then there is short- term lending for liquidity assistance or "crisis management" lending.

A number of problems arise from unrestricted lending by an entity not governed by a profit motive. First, the credit quality of the loan portfolio is weak. When a country has difficulty paying the loan, additional funds are made available or maturities are extended to insure that no default occurs. It also insures that countries will borrow for long periods of time.[2] Seventy countries have been indebted to the IMF for 20 years or more.[3] If a commercial banker were caught lending funds to cover interest payments he would end up in jail.

Second, IMF lending induces more risk taking than underlying economic conditions warrant. The IMF often prevents or reduces losses to international lenders, thereby encouraging those lenders to engage in more lending than they otherwise would. One consequence of this moral hazard is that the number of international financial problems will continue to grow.

[2] O'Driscoll, Gerald Jr., and Schaefer. "IMF Promotes Poor Banking Practices", Executive Memorandum, The Heritage Foundation, April 26, 1999.
[3] Ibid. p.28.

Third, IMF lending harms the development of financial institutions, including a home grown lender of last resort, in the countries in which they lend. If the IMF provides the international funding to a country and its commercial banks then there is little incentive for commercial banks to seek international commercial banking counterparts. In short, integration into international financial markets is delayed or reduced.

Finally, the IMF often seeks additional funds from member governments, the biggest donor being the US. As more funds are provided the costs to the taxpayers in the member countries continues to rise. The estimated annual cost to US taxpayers is between $1.5 and $2 billion. The cost does not appear in the U.S. budget. The major part of that cost is the risk of default by a large debtor – Indonesia, Argentina, Brazil and Turkey account for about 70 percent of IMF debt.[4]

All of the lending functions undertaken by the IMF are already being done by other institutions. Lending for political purposes can and is done directly with country to country loans. For example, in the U.S. numerous government agencies provide loans to aid development as well as to fund military and agricultural sales world wide. Even the Federal Reserve, with its “swap lines”, and the Treasury Department with the Exchange Stabilization Fund, are in on the game. Doing country loans thru the IMF is a dodge to get around the formal approval process of legislatures that may not be disposed to approve them.

Loans to developing countries are done in international financial markets. Most of the countries that receive IMF loans can borrow in the market but they must pay the market rate, not the subsidized IMF rate. If a country can borrow in the market let it do so. If it

[4] Meltzer, Allan H., “IMF and World Bank Reform 2004”, Testimony before the Senate Committee on Banking, Housing , and Urban Affairs, May 19, 2004.

can not borrow in the market then it is too poor or too limited institutionally to satisfy a lender. A country in this fix does not need a loan it needs a grant or it needs help building institutions.

Other IMF lending is for emergency assistance in time of financial "crisis." The IMF is not needed as a crisis manger nor is it equipped to be one. Some of us believe that the world does not need another lender of last resort. Countries that mismanage their economic and financial affairs need market discipline not IMF required reforms. A financial "run" on such a country is rational just as a run on an insolvent bank is rational. And in neither case is "contagion" the usual outcome. Market arrangements and firewalls usually limit the damage. If one country's problem does threatens to bring down other financial sound countries then a friendly central bank steps in, often prematurely, and stems the panic. The Fed did so in the 1997-1998 East Asian "crisis" by lowering interest rates.

Many people believe a world lender of last resort is necessary. They need to find another horse to ride besides the IMF as it is not equipped to deal with a significant world financial crisis should it occur. Only central banks can deal with a true world liquidity based crisis. Only they can create unlimited quantities of money. The IMF has limited funds, $157 billion, which is an insignificant amount should a true liquidity crisis occur. As the former chief economist of the IMF, Kenneth Rogoff, put it: "in a nutshell, the Fund's current resources of $150 billion seem like enough to cause moral-hazard problems (that is, to induce excessive borrowing) without being enough to deal with a really deep global financial crisis."[5] Plus the IMF is slow because it needs to gain

[5] Rogoff, Kenneth, "The Sisters at 60", The Economist, July 22, 2004.

permission from its political masters and time is the penultimate element in a financial panic.

A better lender of last resort option would be to link the five major central banks – Federal Reserve, European Central Bank, Bank of England, Bank of Japan, and the Swiss National Bank - under the auspices of the Bank for International Settlements. These central banks have lender of last resort responsibility for the vast majority of banking assets in the world and they can act fast as they are more independent from politicians than the IMF. One possible arrangement would be for the BIS to accept a request from one of the five for concerted action to stem a potential liquidity crisis. A simple majority would determine that all five would act in concert. If the request was voted down, the requesting central bank would be free to go it alone. Such a decision could be made in hours by telephone while the political IMF decision- making apparatus would take weeks. Or as Rogoff states: “The Fund is just too politicized to be a consistently effective lender of last resort…”[6]

In sum, IMF lending is redundant. It is poorly done and creates moral hazard. The IMF does not have the ability to be lender of last resort since it cannot create money. The U.S. and the world would be better off without the IMF.

The World Bank (including the development banks) has a mission of alleviating poverty yet it is not using its resources in a fashion consistent with that mission. The vast majority of its lending goes to 11 countries with easy access to the capital markets. Lending to these countries does little to help the poor. Really poor countries have limited or no access to capital markets. They do not need a loan; they need a grant or an

[6] Ibid.

institution building program that enables them to participate in international capital markets.

The Meltzer Commission recommended that the World Bank stop lending and instead provide grants to the poorest of nations. It also recommended that the Bank change its name to the World Development Agency, to better reflect its mission. The Bank, including the development banks, has a loan portfolio of around $300 billion and lends $50 billion a year and employs 17,000 people. This World Bank lending is largely redundant with that of private financial institutions yet it has none of the discipline of an entity seeking profits. It has no accountability for the results of its lending. In short, it makes questionable loans for dubious projects to countries that are not the poorest and that can borrow in capital markets.

Privatize Them. Attempts to abolish or reform have born little fruit because politicians, the IMF and World Bank bureaucracies and beneficiaries like the status quo. Politicians can use these two institutions for their own interest without seeking formal approval of fellow politicians. Beneficiaries can also add to election campaign coffers of supportive politicians.

Beneficiaries include major financial institutions engaged in international lending that benefit from the country specific information provided by both institutions. The IMF helps private lenders in other ways as well. Often lenders will not lend in a country that does not gain the approval of the IMF. Also IMF involvement in a country reduces the size of loss lenders might suffer if a country hits the financial skids. IMF and World Bank bureaucracies aid and abet both politicians and beneficiaries to insure their own growth and survival.

If reform is to work it would need a firm commitment by the U.S. President. Yet in the past Presidents have invested little in IMF and World Bank reform. Abolishing or withdrawing from these institutions would benefit the U.S. and world financial stability but it is difficult to see an effective coalition being formed to do so.

Privatization may have some appeal since it does not cast the President and Congress as wanting to kill these two institutions. Let the market kill them if they cannot compete. Also many member countries tire of IMF efforts to make them privatize their own industries. There may well be a group of countries that would like to see the IMF swallow its own medicine.

In the case of the IMF, the objective should be to seek an agreement to do an IPO with the proceeds going to countries based on their share of contributions. No further government support either implicit (shades of Fannie May) or explicit is permitted. The IMF does have value – its portfolio, its information gathering abilities and surveillance function as well, perhaps, its advice. Buyers could break it up and sell the components or run it as a going concern.

The World Bank group would stop lending, sell its loan portfolio at a huge discount and become a non-profit private organization with a mission of alleviating poverty by encouraging economic development with grants. Governments as well as private entities could continue to contribute. If the organization is effective it will compete successfully for funds in the non-profit arena. If the sharp pencils on Wall Street begin to see profit opportunities in privatization the details of how to make it happen will not be far off.

Each of these options faces significant difficulties. The easy option is to do nothing. But, in the long run, doing nothing is the most costly action of all.