WHAT FUTURE FOR THE IMF?

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Having lost its Bretton Woods role as a regulator of exchange rates and source of short-term balance-of-payments assistance, the IMF has since been an organization in search of a reason for it to exist. Had it been content to serve its members by keeping records of their monetary and economic progress and conducting research as a basis for proffering advice, the IMF could have continued to play an honorable and trouble-free part of its own devising in international affairs.

Such a modest undertaking, however, was not what the IMF craved. It sought a bigger part on the world stage, with the support of the U.S. Treasury Exchange Stabilization Fund. The U.S. Treasury for many decades has fostered the culture of loans to troubled low-income countries, coordinating its loans with those extended by the Export-Import Bank, the Agency for International Development, the Commodity Credit Corporation, regional international development banks, and the IMF. The IMF for its part lends to governments, monetary authorities, and corporations.

I first comment on the IMF's recent involvement in international rescues. I then discuss problems with the IMF's bailout model. I conclude by asking whether there is a future for the IMF.

THE IMF AS AN INTERNATIONAL RESCUER

The IMF emerged as a big lender in the 1995 Mexican bailout along with the Treasury. It has since been the conceit of these two players that the bailout was a huge success. The only flaw each acknowledges is moral hazard. The official lenders indemnified the domestic and foreign investors in Mexico so they suffered no loss when the peso became unhinged from its dollar peg. To the Asian countries that experienced financial distress in 1997 the IMF and its associates offered a package that is a multiple of the Mexican bailout. The Russian bailout continues on the same path.

Although only a few observers challenged the verdict that the Mexican bailout served that country well, many more challenge the bailout model in the case of the Asian and Russian rescues. There is clearly no verdict of success in these cases. The proposal to institutionalize bailouts for countries in future conditions of financial distress has aroused even more dissent.

Since Bretton Woods ended, two changes have characterized IMF operations. Whereas it began its existence as a revolving fund, giving short-term assistance to member countries with balance-of-payments deficits, its credits have gradually shifted to long-term multi-year commitments. For that reason the fund can no longer rely on a stream of repayments to enable it to respond to new requests for accommodation. A second change, related to the first one, is the proliferation of loan facilities it has made available, with different conditionality arrangements and different interest rate concessions. Originally, the IMF focused on misguided macroeconomic policies that created balance-of-payments deficits. More recently, it also is concerned with structural problems that impede economic growth. As a result, there does not appear to be a difference between the IMF's and the World Bank's mandate. Are two agencies needed to do the same job?

PROBLEMS WITH THE IMF'S BAILOUT MODEL

There are compelling reasons, in addition to the moral hazard it creates, to oppose official bailouts. A bailout appears to be designed simply to make risk-free cross-border investments by Americans and others, as was without doubt the motive in the Mexican case. A country engulfed by a financial crisis has a recourse that excludes a bailout. That recourse is today's world of deep capital markets that are ready to lend to liquidity-constrained countries at interest rates that reflect true credit risk. That's one reason bailouts are not needed.

Another reason is that a bailout does not deal with a fundamental problem of a financial crisis. That problem is default on interest and principal of an international loan. Only the private parties involved in the loan contract, not the IMF, can restructure the original terms of the loan. If the IMF did not bail out either the debtor or the creditor, market discipline would restrain cross-border lending by Americans and others and the willingness of borrowers to assume debts.

An IMF austerity program is not needed. Market forces themselves would impose belt-tightening in a country with an unsustainable current account deficit because it had borrowed too much and not made prudent use of the capital inflow.

The IMF acts as the creditors' collection agent by providing foreign currency early in a crisis. Politically well-connected creditors, whether local or foreign, escape market discipline. Who the favored claimants are who receive the money the IMF provides is confidential, and the IMF itself may not know. Official funds it makes available may be stolen, but there is no accounting of either the basis for the total amount the IMF lends or the detailed disbursement. Finally, it is not evident how the bailout serves the ordinary people of the IMF's country client.

The IMF justifies bailouts on three grounds: (1) they prevent contagion; (2) they buy time to allow the country it is supervising to implement reforms; (3) they enable the country to gain early access to the capital market. Each of these grounds is questionable.

Contagion occurs when external shocks impinge on countries independent of their condition. In the recent examples investors recognized that the set of countries that was affected all shared problems. Investors then withdrew their capital. There was no contagion. Implicit in the notion of contagion is that an individual country that has mismanaged its affairs can precipitate an international financial crisis. The individual country's loss of creditworthiness is said to have a tequila effect. The supposed tequila effect is that other countries without the problems of the troubled country are unfairly tarnished and also subject to those problems. In this way, it is said, contagion spreads the crisis from its original source to other innocent victims. But is it true that markets fail to discriminate between a country with sound and a country with unwise policies? None of the countries whose stock market values have declined or currency exchange rates have weakened in recent weeks meets the test. If there is no contagious international transmission, bailouts cannot be defended on this score.

Does a bailout buy time for reforms to be implemented by a country that the IMF has assisted? The country may pledge reform but renege. The IMF may threaten to withhold an infusion of funds unless the pledge is kept, but its leverage is uncertain. The record shows little evidence that reforms follow a bailout. The countries with troubled financial systems will either adopt the measures to correct policy and structural mistakes, or they will not. To do so requires political resolve, not the IMF.

In the absence of a bailout, would a country be denied access to world capital markets? Creditworthiness does not depend on a bailout. A country that offers collateral, as Mexico did in 1995 by pledging oil revenue to the Federal Reserve and the ESF, and is willing to pay a market rate of interest that included a risk premium, as when it borrowed from German banks to repay its U.S. loans, can find a warm reception in capital markets. The market evaluates borrowers on the basis of their financial prospects, not on the basis of subsidized IMF bailouts.

THE FUTURE OF THE IMF

If the record of the IMF operations were a series of successful intervention in solving low-income country problems, it would be reasonable to give it a green light to proceed. In fact, however, it has a poor record. It is weak on crisis prevention. Short-term renewable loans denominated in foreign currencies were the undoing of Mexico in 1994, yet Asian countries welcomed the same form of credit two years later. The IMF defense is that it warned the Asian countries against such policies, but they rejected its advice. The bailout of Russia also seems fruitless. If the moral authority of the IMF as a source of sound advice cannot win the respect of its client members, it is in the wrong business.

The argument has been made that it would be a shame to end the IMF because so many excellent economists work for it. It sometimes appears that the real mission of the IMF is to offer well-paid employment to economists. In order not to deny excellent economists the opportunity to exercise their craft, a suggested solution is that the IMF should be folded into the World Bank since there seems no difference between their lending activities.

Another suggestion is to replace the IMF with the BIS as international lender. But if bailouts are not needed and may be injurious to the health of the recipient countries, why should any international lender by required?