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Reforming the IMF: Long Term Lessons from Short Term Crises

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Abstract: There is a danger that reform of the International Monetary Fund (IMF) will be dominated by its experience in the context of the East Asian financial crisis. Although there are clearly lessons to learn from this, it would be unwise to allow recent events to dominate the reform agenda. In many respects the crisis only provides a further specific example of more general and fundamental issues spanning the design and implementation of conditionality, exchange rate policy in developing countries and countries in transition, the ability of the Fund to mobilise and manage other financial flows, the size of IMF lending, the international lender of last resort function, and capital account liberalisation. Moreover, to focus on the Fund's role in better off developing countries is to ignore its role in low income countries. There is a problem of attention bias. Reforming the IMF for the 21st century requires that all these issues are addressed.

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Introduction

With the financial crisis in East Asia in 1997/98 the International Monetary Fund (IMF) has again become the focus of close attention. In the context of the crisis, it has

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performed the roles of both an adjustment institution - encouraging client countries to pursue measures to strengthen their balance of payments - and a lending institution, providing foreign exchange to help finance current account balance of payments deficits. In both roles it has been exposed to considerable criticism.

Although predictably the crisis dominated contemporary media discussion, for a long time the Fund has played a significant role in a wide spectrum of developing countries and emerging markets; in this role it has been no stranger to criticism from all shades of economic and political opinion. Its involvement in East Asia is merely the most recent chapter in a story spanning a number of years. It is, of course, a chapter that contributes to the broader story, but it needs to be seen as part of the Fund's evolving relations with developing countries as a whole. There are long-term lessons to be learned from the East Asia crisis, which enable the wide-ranging debate about the Fund's future to move forward.

If the objective of policy-makers is to identify reforms that will enhance the effectiveness of the Fund in the 21st century it is these long-term lessons that are important.

Background

Following the collapse of the Bretton Woods system in the early 1970s the Fund seemed destined to become relatively insignificant on the global stage. The world had moved to generalised flexible exchange rates. Alongside this, a much heavier reliance was being placed on private capital markets to provide balance of payments financing. The systemic role of the Fund had essentially been written out. Why after all did the world need the principal Bretton Woods institution if it was no longer operating the Bretton Woods system.

Moreover, reflecting these developments the question of international reserve inadequacy, which had preoccupied international monetary reform and the IMF during the 1960s, rapidly disappeared from the reform agenda. Although during the 1970s the Fund formally approved the idea of establishing its own Special Drawing Right (SDR) as the principal international reserve asset, the reality was that foreign exchange, and in particular the US dollar, continued to dominate. Other currencies took on a minor reserve asset role, but the SDR faded into obscurity.[1]

In addition to this, international macroeconomic co-ordination which the IMF had, in effect, orchestrated through the old par-value Bretton Woods exchange rate system broke down. In ascendancy was the view that flexible exchange rates allowed countries to insulate themselves from the rest of the world economy, ruling out the need for policy co-ordination and thereby ruling out a role for the IMF.

However, a series of global economic events since the end of the 1970s have allowed the Fund to reassert itself.

First there was the Third World debt crisis of the 1980s (itself not unconnected with a lack of international macroeconomic policy co-ordination), in which the Fund played a prominent systemic role in trying to avoid widespread default and the resulting destabilisation of international financial markets by (initially) encouraging the banks not to precipitously stop lending.

Second, in the early 1990s there was the fall in Communism and the move from centrally planned to market-based economies in Central and Eastern Europe. Here the IMF was active in providing both finance and adjustment 'advice.' More generally, the Fund's policy-advisory role was one element in the so-called 'Washington Consensus' which influenced the design of economic policy in many developing and emerging economies throughout Latin America, Africa and Asia, as well as in Central and Eastern Europe.

Third, and more recently, there have been the international financial crises in Mexico (and the related difficulties in Latin America) in 1994/95 and in East Asia in 1997/98. In the context of these crises the Fund's explicit role as a policy adviser has again come under close scrutiny, alongside its more implicit role in underwriting private international financial transactions.[2]

Both the Mexican and East Asian crises have highlighted the problems associated with the volatility of international capital, and have raisedquestions about how the Fund can help. These issues have, for example, been on the agendas for G7 (G8, if Russia is included) meetings. At the time of the G7/G8 Summit in 1998, protests in Jakarta, Indonesia, were being indirectly attributed by some of the media to the IMF-based programme which had been put in place. As it had in the past, the IMF was being accused, in some quarters, of contributing to social and political unrest. The East Asian financial crisis has thus focused attention on both the design of IMF conditionality and on the amount and nature of IMF lending.

The crisis has raised questions about the 'political' dimensions of Fund activity, and about the wisdom of the Fund's drive towards systemic capital account liberalisation. If financial crises have become a feature of the global economy in the late 20th century, what is the Fund doing to minimise the likelihood of future crises, and to minimise the costs of dealing with those that it is unable to prevent?

It has been the financial crises that have focused attention on the Fund, since there have been few other obvious problems with the global economy to spark interest in reforming it. Global economic performance indicators have shown low and falling inflation, and reasonable rates of economic growth, following the recession of the early 1990s. World trade began to grow strongly following the completion of the Uruguay Round. Unemployment has not been a world-wide problem, and has generally been attributed to the inflexibility of European labour markets rather than to any shortcomings in the international monetary system. Generalised flexible exchange rates have not appeared to have strong anti-trade or anti-investment effects, while the effective collapse of Europe's Exchange Rate Mechanism in 1992/93 warned against any rapid return to a quasi-fixed exchange rate system. Even the question of international macroeconomic policy co-ordination seemed to become less compelling as global macroeconomic performance improved and as the severe overvaluation of the US dollar and the global mismatch of fiscal policy in the early 1980s became a more distant memory.[3]

So, by the end of the 1990s the debate surrounding the Fund no longer hinged on the nature of the global exchange rate system or international macroeconomic policy co-ordination. Instead it had returned to the 'staple diet' issues of IMF conditionality, the choice of exchange rate policy in developing countries and transition economies, the catalytic effect of IMF lending, and the international lenders of last resort function. The international financial crises in Mexico and in East Asia have important messages for all of these issues. What are they?

IMF Conditionality

a) Design

Studies of IMF conditionality in the 1970s often criticised it for being too narrow. A caricature was that it sought to reduce the complexity of economic reform to a small number of 'performance criteria' which almost always included a ceiling on credit expansion and usually involved devaluing the domestic currency. The focus on controlling monetary aggregates was often taken as an indication that the Fund favoured a monetarist explanation of balance of payments deficits. The Fund was accused of ignoring the supply side and of failing to prioritise economic growth.[4]

During the 1980s and early 1990s there was a noticeable shift in conditionality. Although the 'hard core' elements relating to tight monetary and fiscal control were retained, these were now supplemented by structural conditionality, with the consequence that the number of 'performance criteria' and preconditions associated with IMF programmes increased quite sharply. In addition, and in particular in relation to adjustment in economies with high inertial inflation such as those in Latin America and Central Europe, the Fund modified its attitude towards exchange rate policy, and began to see potential advantages associated with exchange rate based stabilisation.

These changes in conditionality reflected the broader sweep of the 'Washington Consensus' which comprised not only macroeconomic stabilisation - the traditional focus of the Fund - but also microeconomic efficiency and openness. IMF-backed programmes in East Asia represented a continuation of this trend towards greater conditionality by incorporating microeconomic and openness conditions alongside the conventional elements relating to budgetary deficits, interest rates, credit expansion and exchange rates.

During the second half of 1997 the IMF signed stand-by agreements with Thailand, Indonesia and South Korea - it already had an extended arrangement with the Philippines. Although the amounts of finance involved were frequently misrepresented in the media the loans were certainly large by normal standards. The programmes were similar in terms of their basic ingredients, involving financial support to enable debt obligations to be fulfilled and exchange rates to be stabilised, fiscal rectitude aimed at creating balanced budgets or surpluses, restrictive monetary policy and interest rate increases, restructuring of the financial sector, involving the closure of some financial institutions and the tightening of financial supervision, as well as other measures aimed at liberalising trade and investment and increasing competition (including privatisation) and reducing corruption.

Two questions emerge. First were the policies favoured by the Fund well-designed in the context of the East Asian economies?[5] And second, how interventionist should the Fund be? Should conditionality deal with the detailed microeconomics of pricing policy and taxation, industrial structure, and even levels of corruption, or stick to macroeconomic stabilisation?

There is a presumption that a programme of economic reform aimed primarily at correcting a balance of payments deficit will be better designed where it matches the causes of the deficit.[6]

The causes of the East Asian crisis were complex. They included both external and internal elements. Amongst the external elements were the large appreciation of the US dollar *vis-á-vis* the Japanese yen which had occurred between 1995-97, deteriorating export performance which was in part related to the real exchange rate appreciation of East Asian economies, but was also related to increasing competition from Mexico and China, and in Korea's case, to the slump in the world market for semi-conductors, and capital volatility, where an initial loss of confidence was self-perpetuating. Amongst the internal elements were exchange rate policy, which allowed real exchange rates to appreciate, the way in which capital inflows were managed in terms of their repercussions for the exchange rate and monetary growth, and the extent to which foreign borrowing was used to finance extensions of domestic private sector credit for high risk domestic investment.

Although the data suggest that prior to the crisis fiscal policy had been relaxed slightly in some of the East Asian economies, and inflation had shown some signs of beginning to accelerate, East Asia did not represent the 'typical' developing country scenario encountered by the Fund where fiscal deficits and inflation play a prominent causal role. In East Asia it was excessive (risky) investment by the private sector rather than excessive expenditure by the government that was significant.[8]

While almost all countries which turn to the Fund are in a balance of payments crisis when they do so, the East Asian crisis was not typical. And yet the East Asian economies received fairly typical IMF advice. Indeed, as noted above, they all received qualitatively similar conditionality even though their individual circumstances varied. Thailand had, for example, tended to have higher interest rates and a stronger commitment to a pegged nominal exchange rate than Indonesia or Korea, and yet all were advised to tighten monetary conditions.

As far as microeconomic efficiency and openness were concerned the atypicality of East Asian economies was yet more pronounced. Economies which had frequently been held up as role models for other developing countries were now presented by the Fund as suffering from fundamental supply-side weaknesses. Conditionality incorporated supply-side measures which reflected the Fund's analysis.

However, the real point here does not relate to the specifics of 'optimal' conditionality in the case of East Asian economies. Instead, it is that economic circumstances differ between countries which turn to the Fund. In some cases macroeconomic stabilisation based on tighter monetary and fiscal policy may be all that is needed. In other cases more comprehensive economic reforms may be necessary, spreading over into microeconomic efficiency and openness. Conditionality needs to reflect these differences; it needs to be made-to-measure and not off-the-peg. There is no reason to believe that today's fashion for more comprehensive reform and conditionality is universally more appropriate for all the Fund's clients, than was yesterday's fashion for more limited conditionality. The lesson is for greater flexibility rather than the superiority of one particular form of conditionality.[9]

But how interventionist should the Fund be? The brief answer is no more interventionist than it needs to be; although there are a number of strands to this basic answer. First, there is the idea that the Fund lacks the 'moral right' to dictate economic policy to sovereign governments. Although technically governments have the option of not signing up to an IMF-backed programme, in crisis conditions there are rarely many alternatives. Indeed, where alternatives exist countries tend not to turn to the Fund. While arguments about morality are always likely to be difficult and nuanced (can, for instance, the Fund have a legal right to conditionality at the same time as lacking a moral right; does this imply that international law lacks morality?), there does seem to be a moral argument for avoiding excessive conditionality.[10]

Second, if the prime purpose of IMF conditionality is to guarantee that loans are repaid in order to comply with the Fund's Articles of Agreement, should conditionality go beyond ensuring that this purpose is achieved? A distinction therefore needs to be drawn between Fund advice and Fund conditionality, where the latter is mandatory advice. It is mandatory advice that should be kept to a minimum, certainly where there is a track record of sound economic management.

Third, leading on from this, and as established above, conditionality should be designed to reflect the causes of balance of payments problems. It is useful here to distinguish between illiquidity and insolvency problems. In the East Asian case most of the crisis economies (at the time of the crisis) had large short-term private foreign-currency-denominated debts relative to international reserves, although they did not have large foreign debts relative to their GDPs. They were illiquid rather than insolvent. The same may be said about Mexico in 1994/95.[11] In such circumstances fundamental reform may be unnecessary in terms of alleviating the crisis, and conditionality should instead focus on liquidity-related measures. The Fund used to possess a low conditionality facility in the form of its Compensatory Financing Facility (CFF) which was designed to provide resources to countries encountering temporary export shortfalls. Here, financing was seen as more appropriate than adjustment, even though in the long run countries vulnerable to such shortfalls were well advised to try to reduce their vulnerablity to future shortfalls through export diversification. In the East Asian case a reasonable presumption is that the crisis was brought about by (temporary) capital outflows following a loss of confidence and that the logical solution did not require wide-ranging and deep-seated IMF conditionality.

Moreover, Thailand and Korea had a track record of sound economic management and success.[12] The presumption was surely that given time (the illiquidity issue again) their governments would devise appropriate packages of economic reform without the need for heavy IMF involvement. With little doubt such reforms include reforming domestic banking systems, but the Fund's shock tactics of including rapid reform as part of its conditionality probably eroded confidence still further and this is not wise in the midst of financial crisis.

Unlike the case of the transition economies, where there was a strong argument for shock therapy, this was not the case in East Asia. Appropriately sequenced reform which concentrated in the short run on restoring confidence and on stemming capital outflows was what was needed. Conditionality should therefore have focused on this near-term objective.

This is not to say that conditionality should always have a 'light touch.' In cases where the problems are of a more fundamental insolvency type, as may be the case in many African economies, conditionality has to be more wide-ranging. But again flexibility is what is needed. Even where conditionality is wide-ranging the Fund cannot know more than there is to know. Conditionality by its very nature is advocating reforms about which there is less than universal scientific agreement. Fundamental disagreements exist between new classical and new Keynesian economists about the effectiveness of a whole range of macroeconomic policy measures including fiscal policy and exchange rate policy, which lie at the very heart of IMF conditionality, while there are similar disagreements about the appropriate role of the state.[14] Does government expenditure, for example, crowd out or crowd in private investment? To the extent that, in the current state of economic science, a distinction can be drawn between what we know (or at least things on which there is a reasonable consensus), and what we don't know (where no consensus exists), it would seem sensible for conditionality to focus on the former and avoid the latter.[15] The evidence on the effects of IMF conditionality is also far from compelling, suggesting that there is no universal policy panacea.[16] This again argues for a minimalist approach to conditionality.

Additional reasons also endorse such an approach. Wide-ranging conditionality covering a host of macro and micro policy measures creates a greater chance that there will be disagreement between the Fund and its client country governments, and a higher probability that, once negotiated, programmes will break down (see below). Breakdowns then themselves send out adverse signals to private capital markets which will make the situation worse.

Furthermore, the Fund's original reluctance to move beyond a small number of performance criteria stemmed from its concern about becoming too heavily enmeshed in domestic politics. In practice, the political dimension has turned out not to be purely domestic. The Fund's pressure on Korea to liberalise its regulations relating to foreign direct investment and to liberalise the capital account of the balance of payments have, for example, been interpreted by some commentators as showing the Fund to act as an agency for its principal shareholders and for the vested interests of financiers in industrial countries.[17]

A final argument against excessive conditionality is in terms of the behavioural response it induces in potential clients. In contemplating turning to the Fund, countries will consider the conditionality that they are likely to encounter. The stricter the conditionality, the greater the incentive to postpone turning to the Fund. The result is that countries only turn to the Fund in a crisis when they have no other alternative. This was certainly the case in East Asia. But there is a vicious circle at work here. Late referral in the midst of a crisis tends to lead to strict conditionality which endorses the expectations of the borrower and re-enforces the preferences of potential borrowers to avoid the Fund if at all possible. While countries remain creditworthy they will borrow from private capital markets rather than the IMF because they can avoid conditionality. However, capital inflows can easily be destabilising and can finance excessive consumption (Mexico) or investment (East Asia). Eventually capital inflows therefore lead to current account balance of payments deficits which undermine the confidence of foreign creditors who then withdraw their finance leading to a liquidity crisis. Circumstances then force the country to adjust and it is at this stage in the cycle that the Fund becomes involved. How can the IMF encourage countries to better manage capital inflows or take earlier action in the event of an incipient current account deficit. Otherwise overly slow adjustment to capital inflows results in overly rapid adjustment to capital outflows. The challenge is to break the vicious circle and convert it into a virtuous one within which early referral permits conditionality to be less strict, which then encourages early referral.[18]

The East Asian crisis will have done nothing to give IMF conditionality a softer image. Indeed to the contrary it will have given an extra twist to the vicious circle.

But how can countries avoid Fund conditionality? One part of the answer is that they can build up their own international reserves, not only as an insurance policy against balance of payments crises, but also as a way of enhancing their creditworthiness.[19] The question is whether it is a sensible thing for relatively poor countries to use scarce foreign exchange in this way. Insurance is after all a luxury good. Can foreign exchange not be used more productively? Reserve acquisition carries a high opportunity cost for developing countries. In this manner IMF conditionality may be at odds with one of the purposes of the Fund as stated in its Articles of Agreement.

b) Implementation

The above discussion about the design of conditionality has implications for its implementation. IMF programmes exhibit a high propensity to breakdown, with this often occurring quite quickly; the pattern has been replicated in East Asia. So why do IMF programmes break down? The Fund's favoured explanation is that there is a lack of political will on the part of the relevant government. But this is an unsatisfactory explanation not only because it rules out other factors such as inappropriate programme design, and exogenous shocks, but also because it is overly simplistic in terms of the underlying political economy of policy reform.[20]

A political economy model of the failure to fully implement IMF programmes can usefully start by specifying the objective functions of the Fund and the relevant client governments. Assume for a moment that the Fund wants to eliminate current account balance of payments deficits within a reasonably brief time span (months rather than years). Secondary objectives relate to economic growth, inflation, and the protection of 'vulnerable groups' in society, but the balance of payments is the primary objective.

Assume that the government, on the other hand, wishes to retain power and , in order to do so, wants to raise living standards in the near term (where this may be defined by the proximity of elections or by the period of time over which it can confidently expect to maintain totalitarian control). The government's ability to raise living standards will be constrained by the balance of payments. A current account deficit raises living standards in the short term but it may not be sustainable. The objective functions of the Fund and the government differ significantly. What is an objective for the Fund is a constraint for the government.

However, in conditions of balance of payments crisis, the differences are sharply reduced because the balance of payments is now a binding constraint for the government. The Fund will be in a strong position to coerce governments which need financial assistance into accepting its conditions, and governments will, in any case, themselves be forced to prioritise the balance of payments with or without the Fund. An IMF programme is therefore negotiated and signed.

Things now either do or do not get better. As far as implementation is concerned it does not seem to matter much. If they get better, and the balance of payments strengthens, the government is no longer faced with a binding balance of payments constraint and it may be tempted to abandon the programme, especially when it knows that it can negotiate another one in the future without penalty. If things do not get better there will be no benefits to offset against the costs of the programme, and, on the assumption that it was the expected benefits that encouraged the government initially to agree to the programme, it may now choose to renege on its initial commitment and try to renegotiate with the Fund.

The probability of programme breakdown rises as the gap widens between the Fund's and the government's favoured reforms. Bearing in mind the earlier discussion, breakdown will be more likely if a government perceives its balance of payments problems as being illiquidity-based, but the Fund treats them as if they involve insolvency. Once the liquidity crisis has been overcome (which may be helped by the initial instalment of the IMF loan), the government will opt to pull out of the programme.

Another perspective on the political economy of implementation may be derived from the theory of bureaucracy. In the context of this theory the Fund seeks to maximise its power and influence by maximising conditionality.[21] Or it may be that it perceives this as the best way of meeting the interests of its principal shareholders upon whom it depends for its resources. However, the Fund's bargaining strength *vis-á-vis* client countries varies according to the availability of alternative sources of finance. As commercial lending evaporates during a balance of payments crisis the Fund is able to exploit its increased bargaining strength by extending and deepening conditionality. The borrowing country does not regard the programme as its own (there is a low degree of 'ownership') but rather perceives that it has been coerced into implementing it. Directly creditworthiness is restored, it will therefore seek to abandon the programme and substitute its preferred alternative set of economic policies. Countries that can generally maintain their creditworthiness will only occasionally turn to the IMF when there is a crisis which means that they temporarily lose their access to commercial lending.[22] Turning to the Fund provides no strong indication that they will turn to it in the future; although in a non-crisis scenario they might well be able to negotiate less strict conditionality.

On the other hand, countries that are not deemed creditworthy will tend to be 'Fund-recidivists' and will always encounter strict conditionality because of their perennially weak bargaining position.

The Fund's involvement with developing countries, emerging markets, and transition economies is largely consistent with the above analysis. African economies encounter persistently very strict conditionality, largely under the auspices of the Fund's Enhanced Structural Adjustment Facility (ESAF). The East Asian economies encountered marginally less strict conditionality, although it seems likely that earlier referral by them to the Fund before the crisis had become established would have carried with it less strong conditionality.

The lesson on the implementation of conditionality is similar to the one associated with its design. The Fund needs to work hard to gain the commitment of governments to reform. It will do this most effectively by trying to accommodate as best it can the preferences of governments rather than impose its own. The Fund's constraint here should be that of ensuring that it will be repaid. Such modifications are best facilitated in a non-crisis environment. But, for as long as conditionality is perceived as strict and excessive, countries will be reluctant to turn to the Fund in circumstances other than a crisis. The East Asian crisis presented the Fund with a good opportunity to break out of the vicious cycle of late referral and strict conditionality, but it did not take it.[23]

Exchange Rate Policy

Having gone through a period when there was some debate about appropriate exchange rate policy in developing countries characterised by disagreements over nominal anchors and real targets, the East Asian crisis, along with the Mexico peso crisis before it, has created a stronger consensus in favour of the real targets approach.[24]

Particularly in Thailand, a pegged nominal exchange rate was (unwisely) combined with high domestic interest rates. Capital inflows contributed to accelerating inflation and real currency overvaluation which then weakened the current account of the balance of payments. The Thai crisis therefore had more of the elements of a conventional currency crisis than were experienced in Korea, or even in Indonesia; although in the case of Indonesia and other South East Asian economies the sharp depreciation in the value of the baht, in crisis conditions, spilt over to affect them.

By combining a pegged exchange rate with high domestic interest rates Thailand created excess credibility and therefore excess capital inflows. When the bubble burst and capital inflows diminished Thailand still attempted to retain its pegged exchange rate, financing its current account balance of payments deficit by running down international reserves until it became illiquid and could forestall a fall in the value of the baht no longer. The crisis in Thailand re-emphasises the problems of currency misalignment which are associated with pegged exchange rates.

The lessons from East Asia are that persistent real exchange overvaluation will drive the current account into deficit, that devaluation is a powerful balance of payments tool for eliminating currency overvaluation, and that it is a tool better used early than late when, in the throes of a speculative crisis, the value of the currency will probably be driven below its equilibrium value, thus threatening additional inflation (as in Indonesia).

If IMF conditionality is to concentrate on what we know, the Mexican and East Asian crises have confirmed what we know about that importance of exchange rate policy. Pegged exchange rates are not a sound long term choice for countries which are vulnerable to shocks as are most developing countries. Where they use a pegged rate they should, in stages, move to the adoption of a more flexible exchange rate regime.

For the Fund there are two problems which remain. The first is how to persuade countries to take such advice about the exchange rate before a crisis occurs. It was unsuccessful in this regard in both Mexico and Thailand, even though it was pressing for earlier devaluation. The second is at what point is it optimal for developing countries to shift from a pegged exchange rate to a more flexible one; the so-called 'exit problem'. Neither problem has a clear cut or straightforward answer.

To some extent the first problem could be ameliorated by earlier referral. Exchange rate policy might reasonably remain one of the elements in minimalist conditionality. However, the reluctance of Mexico and Thailand to devalue earlier than they did reveals that there are important political economy dimensions to devaluation which the Fund needs to recognise and address. Devaluation is a political as well as an economic phenomenon. If the political dimensions are not considered, conditionality which incorporates devaluation will not induce early referral.[25]

The exit problem also has an important political economy dimension to it since changing the exchange rate regime will have distributional consequences as well as consequences for inflation and employment (which in turn have distributional consequences). To the extent that Thailand (and Mexico in the early 1990s) suffered from excess capital inflows which then contributed to the crisis, there is an argument that pegged exchange rates should be abandoned in coincidence with capital inflows, thereby exposing foreign investors to an exchange rate risk, which should diminish the inflows. The downside, of course, is that the related currency appreciation will weaken the current account of the balance of payments and will have Dutch disease effects. Furthermore, the abandonment of the exchange rate nominal anchor will probably need to be complemented by the adoption of another, such as the firm control of monetary aggregates.

On exchange rate policy, as well as on policy directed towards managing aggregate demand, the East Asian crisis also illustrates the power of contagion effects.[26] These appear to be particularly relevant across geographically proximate countries, and the fund needs to show a greater awareness of the fallacy of composition in designing its conditionality. Devaluation and the compression of aggregate demand which might have a powerful effect on the balance of payments when pursued independently in one country may have a more muted effect when pursued across a regional group of countries. Furthermore, in these circumstances spill-over effects need to be internalised into the design of conditionality.

The Catalytic Effect

IMF conditionality comprising exchange rate devaluation and interest rate hikes may at first glance be expected to have a positive effect on private capital flows as higher interest rates raise the return to foreign capital and devaluation reduces the probability of further exchange rate depreciation. Certainly the Fund has claimed that the 'new' theory of conditionality relates to its signalling role and its catalysing properties.[27] However, the East Asian crisis provides theoretical and empirical evidence which casts doubt on the positive catalytic effect of IMF lending, even though a stated aim of the Fund's involvement in the region was to calm international capital markets. In this respect evidence from East Asia reinforces recent studies of the catalytic effect covering the 1980s and early 1990s.[28]

From a theoretical perspective a discrete devaluation may increase expectations of further devaluation rather than decrease them. Similarly, increasing domestic interest rates may deter foreign investment where these are seen as leading to recession, defaults, bankruptcies, and domestic financial instability. Far from instilling confidence, the involvement of the IMF provides a clear indicator of economic failure and crisis.

From an empirical perspective the negotiation of Fund-backed programmes in East Asia was initially associated with additional capital outflows and declining bond and credit ratings. Although in some ways this might be the expected corollary of reduced current accounts deficits upon which Fund programmes focus, there is certainly no evidence that the programmes immediately calmed market anxieties. An important point to which we return later is that in the case of Korea capital flows were only stabilised when the Fund shifted its stance towards encouraging foreign banks to reschedule Korea's short term debts. The interesting thing is that more comprehensive studies of the catalytic effect covering a longer time span suggest that the Fund only had a significant positive effect on private capital flows in the immediate aftermath of the debt crisis in 1982 when it was coercing the banks to continue lending.[29] A lesson seems to be that coercion works (at least for a time) while signalling does not. If the Fund is seeking to influence private capital flows it needs to do more than simply rely on the effects of its conditionality.

However, the broader lesson is that analysis of the catalytic effect needs to be more sophisticated, distinguishing between different countries and different types of financial flow. IMF conditionality may, for example, be expected to have a greater catalytic effect on aid flows in Africa, where donors are merely looking for some indication of a change in governmental attitudes towards economic reform, than on private capital flows in Latin America and East Asia where foreign investors are estimating the expected rate of return.

Certainly in the East Asian crisis the Fund did little to instil confidence in foreign investors by publicly interpreting the crisis as one of insolvency that required fundamental reform. The far-reaching aspects of IMF confidentiality sent out negative signals in the form of both the extent of the reform which the Fund assessed as being necessary, and the chances that conditionality would be implemented which this implied.

Moreover, catalytic effects are quite possibly asymmetrical. Negative remarks by the Fund on a country's economic situation may have stronger effects than positive remarks. The Fund may therefore have a more powerful influence in discouraging excessive capital inflows than in stemming capital outflows, particularly in the midst of an economic crisis. In any event, the Fund needs to ensure that its public pronouncements stay within the bounds of what is scientifically justified; this may be quite limited given the lack of scientific consensus on many aspects of economic performance and reform.

The Size of Fund Lending

Is Fund lending adequate? The answer is for what? In the case of Mexico and East Asia the Fund made available large (and 'exceptional') amounts of finance in excess of its normal maxima as dictated by IMF quotas, and yet inflows from the IMF only partially offset huge outflows of private capital. The role of the Fund in countries which are normally creditworthy should not be to try and replace capital markets but only to lend as much (or as little) as is needed to restore confidence. Without the restoration of confidence a lot of Fund money will go only a little way to meeting the financing needs of these countries.

In low income countries, on the other hand, a little finance goes a long way. Here the Fund's lending role is different because low income countries do not have access to private capital. Fund finance should be sufficient to ensure that appropriate adjustment programmes can be carried through. In low income countries the Fund needs to replace rather than augment private capital markets, and inadequate Fund lending can jeopardise successful adjustment.

However, an enduring criticism from some observers continues to be that even in low income countries the Fund has over-lent. 'Variant One Moral Hazard' (VOMH) maintains that the availability of concessionary finance encourages governments to induce the crises which justify borrowing from the Fund by deliberately mismanaging their domestic economies. However, VOMH finds no support in East Asia where the countries involved in the crisis were anxious to avoid the Fund if possible, and were prepared to pursue painful policies in order to do so (for example, Singapore and Malaysia). Indeed, if anything, countries are excessively reluctant to turn to the Fund for financial support.

The justification for Fund lending derives from its public good characteristics. Private capital markets fail in terms of both the pattern and volatility of capital flows and Fund lending needs to be sufficient to offset these sources of market failure.[30]

The International Lender of Last Resort Function

While the East Asian crisis provides no evidence to support VOMH, it does lend some support to Variant Two Moral Hazard (VTMH). This arises where the Fund intervenes in a crisis to provide client countries with foreign exchange which then enables either the government or private debtors to meet their outstanding foreign currency obligations. The moral hazard dimension arises from the behaviour which this induces in foreign creditors who, anticipating an IMF bail-out in the event of a crisis, lower their perception of the risks of lending. They, therefore, overlend. Overlending then creates macroeconomic instability by driving up the real exchange rate, either by increasing the nominal rate or by leading to domestic monetary expansion which causes the domestic rate of inflation to accelerate. Currency overvaluation weakens the current account of the balance of payments, and opens the way for a speculative currency crisis. What is more, capital inflows may be used to finance risky investment projects, with the consequence that risky long term assets are juxtaposed against short term foreign currency denominated liabilities creating illiquidity problems (and potentially insolvency problems as well).

VTMH would not be a problem if there was substantial uncertainty surrounding the likelihood of IMF bail-out since foreign lenders would therefore need to factor in the probability of a bail-out, which could be substantially lower than 100 per cent.

However, the evidence from recent international financial crises suggests that the probability of a bail-out is close to 100 per cent in countries which are globally significant. Thus, the East Asian crisis engendered a similar response from the IMF as had the Mexican crisis two and a half years before. Indeed, there is no recent evidence to suggest that bail-outs will not occur in such cases. The literature on the Third World debt crisis in the 1980s suggests strongly that foreign lenders are psychologically myopic. While, therefore, they will realise that financial crises can and do occur, they will also believe that they can escape from these relatively unscathed. They are therefore unlikely to reduce their foreign lending except in the period during and immediately following a crisis when uncertainties do exist.

Moreover, to the extent that IMF bail-outs are motivated by a desire to serve the interests of foreign banks and other investors located in those industrial countries which form the Fund's principal shareholders, there is a reasonable assumption that the past will be a good guide to the future.

The VTMH argument is therefore that the IMF has exacerbated the volatility of international capital movements not only by failing to stem capital outflows during a crisis, but also, and more pertinently from the moral hazard perspective, by encouraging excessive lending in the period before the crises occurs. In this regard the Fund has actually helped cause the very crises which it then seeks to overcome.

A counter-argument is that capital inflows in the form of portfolio investment or foreign direct investment, or even lending to the private sector will mean that the creditors carry the risk and will not be bailed out by the IMF. Furthermore, is it reasonable to assume that lenders make such subtle calculations? In the East Asian case was it not simply the case that they were carried away on a wave of optimism, and were excessively enthusiastic. In any case, infusions of finance from the Fund are likely to be small relative to a country's external obligations, such that not all lenders can expect to be fully bailed out.

VTMH is clearly complex. If the Fund's involvement in countries exerts little catalytic effect on private lending, can the *prospect* of it in the event of a crisis legitimately be expected to encourage *ex ante* lending. Is there an *ex ante* catalytic effect in the absence of an *ex post* catalytic effect? By offering some degree of insurance in circumstances where the future is uncertain it may be reasonable to conclude that private lending will be greater in a world with the Fund than without it. Moreover, to the extent that private lending is influenced by psychological bandwagon effects, increased lending by those who would directly benefit from an IMF bail-out may induce increased lending by those who would not. Although even here the presumption that the Fund may play a positive role in stabilising economies in the event of financial crises will, in effect, lower the risks associated with private lending. It is, therefore, not logically inconsistent to argue that the Fund's role in recent financial crises will encourage over-lending by private capital markets at the same time as arguing that Fund involvement in a country, and particularly persistent involvement, will have a negative effect on private lending. The former is a partial insurance against the lenders' costs associated with severe economic distress in a country to which loans are made. The latter is an indicator of contemporary economic distress and, in the case of recidivist countries, may be a lead indicator of future economic difficulties.

While, therefore, VTMH is apposite in the context of both the Mexican and East Asian crises, it does not apply to low income developing countries which have not had access to private international capital. The Mexican and East Asian crises were associated with large surings in private capital movements which created short term illiquidity problems. Low income countries rely much more heavily on official flows which are generally more stable. Although low income countries experience severe balance of payments difficulties, these do not share the characteristics of major international financial crises. Furthermore, of course, low income countries do not fulfil the observed necessary conditions for an IMF bail-out. They are not globally significant, and therefore do not pose any systemic threat. And because they have not attracted private capital they do not induce the degrees of politicisation of Fund lending which occurs in the case of richer developing countries. In low income countries Fund involvement is a badge of economic failure. The likelihood of the Fund's future involvement may in this case exert a negative effect on private capital inflows.

The lesson from VTMH in the East Asian crisis is that the Fund needs to develop a system of risk-sharing with private lenders. Two options exist. The first is for it to fulfil the lender of last resort function only on an occasional, spasmodic, and unpredictable basis, in order to create an element of uncertainty. But in order to achieve this objective the availability of IMF bail-outs would have to be random and this makes no sense.

The alternative is to view the Mexican and East Asian financial crises as co-ordination failures. Banks withdrew their lending because individually they did not want to be the only ones left. Uncertainty from the perspective of individual lenders could, in these circumstances, be minimised by getting out as quickly as possible. There was therefore a rush for the exit which exacerbated the basic problem of illiquidity. If you expect everyone else to rush for the exit the optimal strategy is to try to be there before them, guaranteeing that you can get out rather than get trampled in the stampede.

An illiquidity problem can be ameliorated by persuading creditors to reschedule their loans. But how can they be so persuaded? Rescheduling has to be co-operatively orchestrated. Much as there have been a series of proposals for some form of international bankruptcy procedures within which creditors and debtors are brought together and an orderly work out agreed to deal with international debt problems, a similar institutional structure involving the IMF would be helpful in dealing with international financial crises of the sort experienced in Mexico and East Asia. It would be through such arrangements that the Fund would be able to exert a catalytic effect on lending, although the catalysis would work through co-operation rather than coercion as it did in the years following 1982.

A positive sign is that in the case of Korea this was the sort of approach adopted by the Fund in December 1997 following the breakdown of the initial Korean programme which had been based on the bail out philosophy. The lesson is that orderly work-outs are better than disorderly bail-outs. The role of the Fund should not therefore be that of an international lender of last resort underwriting the loans of the private sector, but rather that of a co-ordinator of creditors prepared providing relatively small amounts of bridging finance. Given the size of the Fund's resources, and the continuing reluctance of industrial country governments to increase them substantially, this reform not only makes economic sense but it is also consistent with the political realities. The Fund needs to ensure that from its limited resources it retains adequate finance to support longer term structural adjustment in low income countries which do not at present enjoy access to international capital markets.

Where Does Capital Account Liberalisation Fit In?

It is natural that most of the commentary about the IMF's involvement in the East Asian crisis focused on the details of the programmes pursued in Thailand, Korea, and Indonesia. However, adopting a broader perspective allows some important longer term lessons to be drawn from recent international financial crises. These lessons help delineate key areas in which the Fund could be constructively reformed, in part reducing the probability of future crises.

Of concern in this context is that the principal reform which the Fund is currently pursuing is capital account liberalisation. The justification offered by the Fund is that this will allow a more efficient allocation of global savings, with benefits for world economic growth and welfare, along similar lines to the argument that trade liberalisation allows a more efficient global allocation of real resources.[31]

In fact the comparison with current account liberalisation is inappropriate since it is only within the context of the capital account that speculative currency crises occur. Capital movements, much more than movements of goals and services, are susceptible to mood swings and elastic expectations. Most of the benefits claimed for capital account convertibility are associated with long term direct investment which is why some reform proposals - most notably the idea of a tax on international currency transactions - try to discriminate between short term and long term capital movements.[32]

Where the capital account is liberalised, governments frequently have to assign the interest rate to the objective of restraining capital outflows or encouraging capital inflows. This may lead to an incompatibility between domestic and balance of payments targets. High interest rates designed to attract or retain foreign capital may cause domestic recession and may lead to company bankruptcy and financial instability which then deters both portfolio and foreign direct investment. There may, in effect, be an interest rate Laffer curve, where interest rates can be too high as well as too low. Raising interest rates will, therefore, not always have a beneficial effect on the capital account. The dangers of adopting a narrow approach to interest rate policy in the context of a liberalised capital account were aptly illustrated in the East Asian crisis, where large increases in interest rates failed to prevent capital outflows, but did exert a negative impact on economic growth and unemployment with consequential contagion effects.

However, a prime lesson from the East Asian crisis is that it is better to avoid crises if at all possible. This is an important lesson that reform of the Fund needs to take on board. Given the recent experience of financial crises it does not appear to be a particularly propitious time for the Fund to be pursuing capital account liberalisation.

Given the contradictory evidence of herd behaviour and contagion, doubts must exist about whether free international capital markets will ensure that capital is allocated to where its rate of return is highest. Indeed premature capital account liberalisation seems likely to exacerbate the volatility of capital movements and increase the incidence of financial crises.

Concluding Remarks

The IMF was criticised for its role in the highly indebted countries in Latin America in the 1980s. It has been criticised for its role in Africa and in Countries in Transition. It is hardly surprising therefore that it has also been criticised for the part it has played in the East Asian crisis.

However, in reforming the Fund it is important not to become exclusively preoccupied with the contemporary focus of attention. While the moral hazard critique of IMF bail-outs has become fashionable in an East Asian context it has little relevance when discussing the role of the IMF in Sub-Saharan Africa. On the other hand other themes are more pervasive and persistent.

If reform of the Fund is excessively driven by the current focus of attention, it will be partial and *ad hoc*. Recent financial crises certainly provide new insights when analysing the role of the Fund, but the problems encountered in Mexico and East Asia differ sharply from those found in low income countries, and it is in these countries that the Fund has the majority of its programmes.

Perhaps the most important message for the IMF from the East Asian crisis is that economic problems are very different in different countries. A flexible approach is the one that is needed involving different combinations of financing aid adjustment and variations in the design of conditionality. The Fund's principal policy response has been to pursue the idea of capital account liberalisation. However, this is largely irrelevant in the case of low income countries and potentially counter-productive in the case of those countries exposed to the threat of financial crisis. The Fund would be better advised to explore the ideas of reforming conditionality as a modality for encouraging economic reform since it has become overly invasive and increasingly ineffective, and of providing more finance to low income countries embarking on structural adjustment while co-ordinating the actions of debtors and creditors in the aftermath of financial crises in those developing countries that have had access to private capital.

NOTES

[1] Bird (1998a) provides an account of the rise and fall of the SDR explaining how politics and economics both had a part to play. It also examines the recently renewed interest in the SDR although the conclusion is reached that the SDR is most unlikely to become established as an important international reserve.

[2] For a rather more detailed analysis of the Fund's marginalisation during the 1970s and its subsequent reinstatement as a major player on the international financial scene, see Bird (1995).

[3] Bird (1996) assesses the chances of international monetary reform in the light of global economic performance and concludes that fundamental reform is unlikely. However, this does not rule out the scope for modest reforms to the IMF.

[4] Two early studies which examined IMF conditionality in some detail were Williamson (1983) and Killick et al (1984). A more recent investigation into conditionality which covers the changes briefly alluded to in the main text of this paper is Killick (1995). A survey of the Fund's involvement in developing countries which examines both its lending and adjustment roles is Bird (1996).

[5] For a detailed analysis and critique of the East Asian programmes during this period see Feldstein (1998) and Radelet and Sachs (1998). Both these sources are critical of the heavy reliance placed on discretionary measures to sharply reduce fiscal deficits in circumstances where private saving rates were high and recession would automatically ease the fiscal position, as well as on significant increases in interest rates which would exacerbate the effects of the crisis on economic growth and employment. Radelet and Sachs note that in the subsequent Korean programme an easing in the severity of fiscal adjustment was associated with an improvement in capital flows. They are also critical of the sharp and dramatic conditionality relating to financial restructuring which they argue only served to reinforce investor panic. In this paper more attention is paid to broader issues relating to conditionality drawing on the East Asian experience rather than the details of the East Asian programmes themselves.

[6] This is not a presumption that would necessarily be supported by the IMF which has historically argued that causation is largely irrelevant in the design of adjustment programmes (Killick et al. 1984). This simple point has far-reaching consequences for the design of conditionality.

[7] Krugman (1998) accounts for the Asian crisis very largely in terms of a moral hazard problem in which domestic financial institutions were, in effect, encouraged to lend excessively for high risk and often speculative investment projects. Other commentators on the crisis while not denying this as one important factor have favoured a multi-faceted explanation along the lines adopted here. Radelet and Sachs (1998), for example, identify 'three pillars' comprising instability and contagion in international financial markets, external macroeconomic shocks, and weaknesses associated with domestic financial systems. Some newspaper commentary at the time ascribed the crisis to the failure of the 'Asian model' under which low yielding investment was permitted.

[8] An enduring criticism of the IMF has been that its conditionality exhibits too little flexibility; see Killick et al (1984), Edwards (1989), and Killick (1995) for a more detailed analysis. The Fund claims that it is flexible through the use of different facilities, different quantitative targets, use of waivers and so on. But many studies find a fairly consistent reliance on certain limited policies as the hard core of IMF programmes. Where flexibility is found it is in terms of what conditions are added to this 'hard core.' Even research published by the Fund implies that the essence of conditionality is largely captured by traditional monetary and fiscal measures aimed at reducing aggregate demand (Knight and Santaella, 1997).

[9] The argument that the Fund lacks the 'moral right' to 'impose' conditions on sovereign governments and substitute its judgements for the outcomes of the national political process, has been made forcefully by Feldstein (1998). He argues that the legitimacy of IMF conditionality needs to be assessed according to three tests, first, that the reform is needed to restore access to capital markets, second, that it does not interfere with the jurisdiction of sovereign governments, and third, that the Fund would impose similar policies on industrial countries. Certainly developing countries have been critical of the extent to which industrial countries use the IMF to impose policies on them which the industrial countries would not pursue themselves. However, the extent to which IMF conditionality is inconsistent with national sovereignty, which is a rather softer variation on the moral right theme, would seem to depend on whether the Fund stays within the terms of its Articles of Agreement and the extent to which governments freely enter into agreements with the Fund. In this sense the IMF may suggest that 'good governance' is a prerequisite for programmes to be effective. The evidence, however, is unclear on this point. It is clearer in terms of showing that the Fund does not treat all its borrowing clients in the same way. Large 'important' countries can normally expect to cut a better deal in terms of conditionality than small, unimportant ones, unless a financial crisis weakens their bargaining position as was the case in East Asia. 'Excessive' conditionality is therefore likely to be more prominent in Sub-Saharan Africa than in Latin America and Asia. Whatever the legal and moral situation the perception by borrowing countries that they are being forced to subjugate national sovereignty can do little other than reduce their commitment to reforms favoured by the Fund.

[10] Excellent accounts of the Mexican peso crisis may be found in Sachs, Tornell and Velasco (1996) and Calvo (1996).

[11] Indeed, in substantial measure, it was the credibility for sound macroeconomic management that they had built up that helped them attract foreign capital. Pertinent to the design of the IMF programmes in the second half of 1997 is the observation that substantial economic success is perhaps more strongly related to maintaining macroeconomic stability than it is to any particular combination of liberalisation

measures (Rodrik, 1996). If this is the case the IMF programmes might have done better to focus on this aspect of reform more narrowly.

[12] For a discussion of what is meant by 'sound macroeconomics' in the context of attracting foreign capital see Bird (1999). For a useful discussion of the role of the state and the IMF's attitude towards it see Killick (1989).

[13] Mankiw (1997) provides a brief and useful summary of what we know and what we don't in terms of macoreconomics.

[14] A brief summary can be found in Bird (1996) with a more detailed treatment being provided by Killick (1995).

[15] This argument may be found in Feldstein (1998) and in Bhagwati (1998). Bhagwati attributes the Fund's support for capital account liberalisation to what he terms the Treasury - Wall Street complex, arguing that. 'Wall Street's financial firms have obvious self-interest in a world of free capital mobility since it only enlarges the arena in which to make money. It is not surprising, therefore, that Wall Street has put its powerful oar into the turbulent waters of Washington political lobbying to steer in this direction.' (p11) He argues that there is a network of ''like minds' spanning Wall Street, the Treasury Department, the State Department, the IMF, and the World Bank; a capital account Washington Consensus.'

[16] Bird (1995) discusses the idea of deferred referral in more detail, and ways to break out of it.

[17] Empirical studies confirm that credit ratings are positively associated with reserve levels (Ul Haque et al, 1996). Clearly countries which don't need to borrow can, and those which do need to borrow cannot.

[18] A more detailed critical assessment of the 'political will' explanation of programme breakdown may be found in Bird (1998b).

[19] This theory is analysed critically in Bird (1995) which also contains references to the literature.

[20] With little doubt Thailand, Korea and Indonesia were reluctant to turn to the Fund because they expected that Fund conditionality would be insupportive of the 'Asian model'. It is not unreasonable to assume that many East Asian governments had previously been to avoid macroeconomic disequilibria through the pursuit of tight fiscal policy in order to avoid exposing themselves to pressure from the IMF to liberalise their economies. During the crisis Singapore and Malaysia independently pursued strict demand management policies in an attempt not to be drawn into the Fund.

[21] See Killick (1995) for a brief discussion of the relationship between conditionality and ownership in the context of World Bank structural adjustment lending, and Killick (1998) for an extended and detailed investigation drawing on a range of case studies.

[22] This is discussed in more detail in Bird (1998c).

[23] Klein and Marion (1997) demonstrate that political factors are significant in explaining the duration of exchange rate pegs. Essentially, except during a honeymoon period after they have been elected (or come to power), incumbent governments regard devaluation as a badge of failure and, therefore, seek to avoid it.

[24] Calvo and Reinhart (1996) identify such effects. Following the Mexican pero crisis contagion was particularly strong in Latin America but it did also filter through to Asia. In part contagion can be explained through the conventional spill-over effects which are identified by open economy macroeconomics. These would focus on changes in aggregate demand, interest rates and exchange rates. But a powerful factor would also seem to be the psychology of investor confidence which reveals itself in regionalisation.

[25] A clear statement of the supposed signalling role of IMF conditionality and of evidence which is claimed to support it may be found in Dhonte (1997).

[26] A recent study which attempts to provide a comprehensive analysis of the catalytic effect of IMF lending is Bird and Rowlands (1997). They find only very limited and partial evidence in support of it. The effect is stronger for public flows than for private flows.

[27] Bird and Rowlands (1997).

[28] Bird (1995) provides a much more detailed examination of the underlying theory of Fund lending, as well as a fuller evaluation of VOMH which, it is argued, does not stand up to the evidence. An analysis which suggests that low income countries need enough Fund finance to ensure that structural adjustment is viable, but that, in this regard, Fund lending has been inadequate may be found in Bird (1997).

[29] Fischer et al (1998) provide a fuller discussion of the pros and cons of capital account liberalisation.

[30] For a wide-ranging discussion of these proposals see Kaul and Haq (1996), Eichengreen, Tobin and Wyplosz (1995), and Davidson (1997). Bird (1998d) suggests that while transaction taxes may do little to avert financial crises, they could generate a source of global revenue to finance resource transfers to developing countries.

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