International Monetary Fund Reform

By Corbin Cowley

Recent expansions in trade, investment, and technological capability to transfer financial resources internationally, have led to much larger capital flows. But the major economic problems in many countries, raise questions about the IMF's capacity to handle larger-scale economic crises and widespread investor panic, such as were rampant among international markets in 1997 and 1998. The IMF was created to ensure stability of exchange rates and support international trade and investment, not to manage economic problems of such magnitude. IMF practices generate "moral hazards" inhibiting financial prudence and needed reforms, and tend to involve massive subsidies to borrowing countries. IMF decision making lacks transparency, and the IMF is not really acting as a "lender of last resort." This essay analyzes these problems and proposes major changes.

INTRODUCTION

While serving as a trade intern for Senator Orrin G. Hatch (R-UT) from August to December 1998, I studied in depth, the economies of many countries and the possible effects that the International Monetary Fund (IMF) has on them. Research has led me to believe that the IMF, even with its sound policies, needs to change certain aspects to keep up with an ever-changing world economy. Recent events have raised significant questions about the IMF's ability to slow down a global financial crisis. The international economy has changed drastically since the time the IMF was created and implemented into the global financial system. As international trade, investment, and technological capabilities have grown exponentially and have led to much larger capital flow, more pressure has been placed on developing economies. The IMF does not seem to be able to keep up with the pace of the growth and does not have the resources to help many struggling countries. It is not clear that it should be expected to have an effect on financial markets around the world when faced with widespread investor panic, as we saw in 1997 and 1998. This raises a number of questions regarding how to minimize volatility in the international financial markets, which is considered to be critical in ensuring long-term global economic stability.

This essay discusses these questions, drawing upon recent economic and political thought about the ongoing problems that the IMF has faced. Research for the essay has mainly involved journal and newspaper articles, IMF documents, and especially documents from the U.S. Congress.

Corbin Cowley earned a Bachelor of Arts Degree in Economics from the University of Utah, and currently works for Fidelity Investments.

HISTORY AND PURPOSES OF THE IMF

The IMF was created in 1944, to help countries with balance of payments problems during a time of fixed but adjustable exchange rates. One of the major goals of the Bretton Woods agreement was to ensure the stability of exchange rates to support international trade and investment. Another goal was to provide financial resources for countries with short-term balance-of-payments problems. When countries faced heavy demand for their own currencies, the IMF was available to provide short-term liquidity. This supported fixed exchange-rate values and domestic economic policies, reinforced confidence in the global financial system, and provided the foundation for growth in free trade and investment worldwide (Hornbeck 1998b,1).

While war was still raging in Europe and Asia, representatives from the United States, Great Britain, and other Allied countries met at Bretton Woods, New Hampshire, in 1944 to reach a final agreement on the postwar international monetary system. The delegates at the conference were very well aware of past international monetary systems that had failed. These delegates were convinced that only within an unprecedented degree of international monetary cooperation, could countries hope to forestall a repeating of the condition of the 1930's. The outcome of their conference was the establishment of the International Monetary Fund, an international agency to administer a code of fair exchange practices and provide compensatory financial assistance to member countries in balance of payments trouble (Root 1990, 459).

At the close of World War II there was a desire to reform the international monetary system to one based on mutual cooperation and freely convertible currencies. The agreement required that each country fix the value of its currency in terms of gold. This was done to establish the "par" value of each currency and was to ensure parity across currencies. The U.S. dollar was the key currency in the system, and $1 was defined as being equal in value to 1/35 ounce of gold. Since all currencies had a defined gold value, all currencies were linked in a system of fixed exchange rates (Melvin 1985, 43).

For 25 years after World War II, this international monetary system was based on stable and convertible exchange rates, with occasional devaluation of individual currencies to correct "fundamental" disequilibria in the balance of payments. "This system had many strengths, but it also had many flaws that would sooner or later prove to be fatal." The Bretton Woods agreement, because of mounting pressures in the 1960s, collapsed in 1971 (Root 1990, 458). The IMF situation changed in 1971 when the dollar gold standard was abandoned and the exchange-rate system that the IMF was intended to support came to an end. Soon after, countries started to develop and adopt various types of exchange-rate regimes. Most of the industrial nations opted to float their currencies (Hornbeck 1998b, 1). Many new problems arose for developing countries because of some of the exchange rate arrangements that were implemented. In many cases, they adopted crawling peg exchange rates as part of their stabilization programs. This entailed pegging their currencies to a major world currency such as the U.S. dollar, the Japanese yen, or the German deutschmark. This system was required because of inflation differences between the two countries involved. This policy helped countries reduce high inflation, but it required that other macroeconomic policies be supportive of the exchange rate (Hornbeck 1998b, 2).

The IMF is "designed to support global trade and economic growth by helping maintain stability in the international monetary system, primarily by providing technical assistance and financing to countries with balance of payments problems." The IMF initially served primarily industrialized countries by supporting currency convertibility and providing financing needed to defend their pegged exchange rates (Hornbeck 1998a).

The mission of the IMF is different from that of other international economic institutions.

> The IMF is not a development bank, such as the World Bank, Asian Development Bank (ADB), and other regional development banks that focus primarily on lending to poorer nations for specific development projects. It also differs from the Bank for International Settlements (BIS) which is an international bank that is owned and controlled by central banks. BIS provides specialized central banking services, promotes cooperation among central banks, and fosters financial stability among the major industrial countries. The IMF also has a different mission from the World Trade Organization (WTO) which deals primarily with trade in goods and services (Nanto 1998, 11).

In Article I of its Articles of Agreement, the goals given the IMF are defined:

> "1. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
>
> 2. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
>
> 3. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
>
> 4. To assist in the establishment of multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
>
> 5. To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in the balances of payments without resorting to measures destructive of national or international balances of payments of members" (quoted in Root 1990, 459-60).

The IMF was established to help economies on the verge of economic meltdown. However, as international trade, investment, and technological capabilities have grown exponentially, more pressure has been placed on the IMF. With current policy, the IMF does not seem to be handling this new economy very well.

THE IMF AND THE NEW INTERNATIONAL ECONOMY

The IMF continues to adapt itself to a much different international economy from what it faced when it was created. At one end of the spectrum, some believe the IMF is simply dwarfed, if not made irrelevant, by large private capital markets operating in a world of floating exchange rates. Many suggest reducing the role of the IMF by simply abolishing it. Others believe that it should be merged with the World Bank in recognition of its increased support of developing countries (Hornbeck 1998a, 6).

As Martin Wolf (1998) said in his writings to the *Financial Times*, "the IMF is, it seems, doomed to unpopularity." The responses by the IMF to the Mexican crisis and the recent Asian crises have been very counterproductive. The suggestion that the IMF's capital and facilities should be expanded to permit it to engage in more such activity in the future seems to me very troubling. The IMF is in need of definite reform. Most observers, including UK Prime Minister and head of the G7 group of leading industrial countries Tony Blair, agree that reform is essential (Wolf 1998).

The world needs a set of rules and principles to guide economic policies; a vehicle for spreading best practices; a source of technical support; and a body capable of collecting information and providing high quality analysis. These are things the IMF must continue to offer. Since the Fund was created, it has been the only international agency that has been able to successfully help economies in need. The function of the IMF is simply too important at this time to abolish it completely (Wolf 1998).

Many people believe that critics of the IMF are isolationists. On the contrary, the opposite is the case (Fuelner 1998, 3). Former Secretary of State George P. Shultz (1998) says, "I am very skeptical of what the IMF has done." Along with him, former Treasury Secretary William E. Simon, former Chairman of Citicorp/Citibank Walter B. Wriston, Nobel laureate Milton Friedman, and 1996 Vice Presidential candidate Jack Kemp among others have asserted that the IMF needs reform and that money should not be added to the Fund. None of these men can be described as isolationist. On the contrary, each is a longtime advocate of "responsible U.S. global leadership." These experts believe completely that the IMF has done more harm than good through its actions, and that people would suffer less in the long term, in a world without the market distortions currently created by the IMF. "Like these men, critics of the IMF in general support sound economic principles and responsible international engagement" (Fuelner 1998, 4).

IMF BAILOUTS ARE MORE LIKELY TO CAUSE FINANCIAL CRISES THROUGH EXACERBATING "MORAL HAZARD," THAN TO PREVENT OR CURE THEM

"Bailouts" seem to be very misguided. In basic economics we learn the "guiding principle of a well-functioning market economy is that those who undertake risks should either lose or gain according to the outcomes produced by those decisions" (Calomiris 1998, 1). Charles W. Calomiris, a Columbia University Business School professor and member of NBER (National Bureau of Economic Research), and of the American Enterprise Institute, asked the question, "What have been the costs of violating that guiding principle through government absorption of financial losses?" Three kinds of costs figure prominently. Number one is an "undesirable redistribution of wealth from taxpayers to the politically influential in developing economies." Second is "the promotion of excessive risk taking and inefficient investment." Finally occurs the "undermining of the natural process of deregulation and economic and political reform which global competition would otherwise promote" (Calomiris 1998, 1).

While bailouts entail loans from the IMF and foreign governments at subsidized interest rates to developing country governments,

> the people who are most directly affected by IMF interventions—the world's poor—are those who can least afford it. If the goal is to help developing countries progress economically and to promote a liberal global economy, then the least [that] rich countries can do is deny further funding for the IMF (Vasquez 1998, 2).

Calomiris also addresses this problem when he maintains the

> IMF and the U.S. Treasury in most cases are repaid. But these loans provide powerful justification for increased taxation to repay them. When the crisis has passed, the big winners are the wealthy, politically influential risk takers, and the biggest losers are the taxpayers in countries like Mexico or Indonesia.

Studies by the World Bank and the IMF have documented some 90 episodes of severe banking crises over the past two decades. In more than 20 of those cases, the bailout costs to developing country governments have exceeded 10 percent of Gross Domestic Product (GDP). Moreover, in half of those 20 cases, losses to a country have been around 25 percent of its GDP (Calomiris 1998, 1).

In contrast, defenders of the IMF argue that the IMF's hard-currency loans have prevented the financial problems from reaching epidemic proportions, while its stringent loan conditions will help cure the disease and prevent it from recurring. While this may be the case in some instances, critics disagree with this for the most part and argue that the rescues invite reckless financial behavior by borrowers and lenders, creating what economists call a *moral hazard* (Helfer 1998, 1).

Ricki Tigert Helfer of the Brookings Institution defines moral hazard as:

> a well known problem in the world of banking and insurance. Policymakers seek to contain it for banks–which benefit from deposit insurance and central banking services–by requiring some portion of their assets to be backed by capital, or shareholders' funds, and by supervisory restraints on risk taking. Insurers seek to contain risk taking by requiring their insured to absorb some of the first dollars of their losses (deductibles) or by issuing insurance only up to some limit (Helfer 1998, 2).

Most economists recognize that international financial rescues inevitably entail some sort of moral hazard and feel that it is unlikely that international financial crises will disappear. However, a key challenge for policymakers is to balance the benefits of rescues when such crises occur against the costs associated with the distorted incentives that these rescues create.

Bailouts unfortunately shield investors and politicians from the consequences of their poor decisions by "socializing" risks and reducing the cost of failure associated within investment. Risks are socialized because everyone ends up paying for individual investors' errors. IMF bailouts encourage speculation of the sort that investors would not participate in if the IMF were not there to shield them from failure. Bailouts send signals to governments that they will not have to bear the costs of failing to reform their economies (Fuelner 1998, 4).

Former U.S. Treasury Secretary Robert Rubin even recognizes that if the IMF continues to bail out countries, we will almost certainly expect countries to slip into crises in the future because it encourages risky behavior on the part of governments and investors. This is a problem in that countries in crisis will fully expect that if any thing goes wrong, the IMF will come to their rescue (Vasquez 1998, 2).

Allan Meltzer, a professor with Carnegie Mellon University and member of the American Enterprise Institute (AEI), argues that the global moral hazard encourages potential borrowing countries to pursue policies that make them more vulnerable to currency runs. IMF rescues have played a major role in the nearly 90 to 100 banking crises that have occurred in the developing world in the last 15 years. He claims that without these rescues, banks would have "'behaved far more prudently'" (quoted in Helfer 1998, 2).

We have also seen this moral hazard problem in the past just as we are seeing it today. For example, with every election cycle, Mexico has experienced a currency crisis caused by irresponsible monetary and fiscal policy. Each time, the U.S. Treasury and the IMF have performed bailouts while increasing the amounts loaned. Unfortunately, in Mexico, everybody has come to expect a financial rescue at the end of each presidential term. Even though the IMF and the U.S. Treasury claim that the last bailout of Mexico was a success, its legacy has been the Asian crises of today. The Mexican bailout was a signal to the world that if anything went wrong in emerging economies, the IMF would come to investors' rescue. There is no other way that we can explain the near doubling of capital flows to East Asia in 1995 alone (Vasquez 1998, 2).

Calomiris (1998) claims that the "explanation for this new instability is the roller coaster of risk produced by the choices of banks in developing economies [,] choices that are the byproduct of government subsidies." "The presence of moral hazard tends to increase dangerous risk taking in the private sector" (Eatwell and Taylor 1998).

Governments in Asia were not discouraged from maintaining flawed policies as long as lenders kept the capital flowing. Lenders behaved imprudently with the knowledge that government money would be used in case of financial troubles. That knowledge by no means meant that investors did not care whether a crisis erupted, but it led to the mispricing of risk and a change in the investment calculation of lenders. Thailand, Indonesia, and South Korea shared some common factors that should have led to more investor caution, but unfortunately did not. Some of those factors included borrowing in foreign currencies and lending in domestic currency under pegged exchange rates; extensively borrowing in the short term while lending in the long term; lack of supervision of borrowers; balance sheets by foreign lenders; government-directed credit; and shaky financial systems. "The financial crisis in Asia was created in Asia, but the aggravating effect of moral hazard was extensive" (Vasquez 1998, 2).

The IMF Lacks Transparency

"Prompt, unbiased (or at least, admittedly biased) information is . . . important for international organizations such as the IMF to perform their assigned duties" (Fuelner 1998, 5). Article VIII of the IMF Articles of Agreement, on the "General Obligations of Members," specifically states that each member is required to provide information "as [the IMF] deems necessary for its activities, including . . . the minimum necessary [financial information] for the effective discharge of the Fund's duties."

Even though the IMF recognizes the necessity of timely, unbiased information to its successful operation, it fails to acknowledge the necessity of giving such information on its own organization and operation to its member governments and their citizens. The IMF refuses to release the vast majority of its information on economic policies, past performance, and internal meetings to the press or the interested public. In fact, the culture of secrecy is so inculcated in the IMF that it actively discourages and often prohibits access even to public records. The Fund's refusal to grant congressional offices free access to its records is totally unacceptable (Fuelner 1998, 5). Representative Jim Saxton (R-NJ), Chairman of the U.S. Congress' Joint Economic Committee, says that the IMF will withhold any information it wishes from its member governments—and the U.S. Congress, which may wish to conduct an informed debate of the organization–while at the same time demanding that those governments contribute billions of dollars to it. The U.S. Treasury Department, which seems to be a co-conspirator, offered Chairman Saxton a copy of IMF documents only on the condition that he keep the documents and their contents confidential and thus hidden from public scrutiny (Saxton 1998h).

This incident led the Joint Economic Committee to conclude that:

> Both the IMF and U.S. Treasury bailout policies remain overly secretive, ambiguous, and ill-defined. Because these policies are seldom explained to the public, unnecessary misunderstanding, resentment, and opposition often result. A good deal more transparency is called for from both of these taxpayer-financed institutions. Explicit specification of the IMF's objectives, for example, should be accompanied by clarification of the procedures and practices by which it accomplishes these objectives. At a minimum, full explanations of the conditions, lending terms, subsidies involved, and the rationales as to why such lending is necessary are essential. Additionally, those entities actually receiving taxpayer subsidies should be identified (Saxton 1998b).

This complaint was also emphasized by Jack Kemp in a letter written to Representative Dick Armey (R-TX) saying, "I urge you to put off a vote in the House on any additional funding for the IMF at least until that organization complies with all outstanding congressional information requests" (Kemp 1998).

Secretary Shultz, in a hearing before the Joint Economic Committee about the IMF and international economic policy, specifically declared,

> You have an organization without any real restrictions in a charter that says, here is what you are supposed to do. It nominates itself to do various things. . . and it seems to me a real question whether we want to put in place an international bureaucracy with that much leeway and that much money

> just to do whatever it thinks is right, particularly when its track record shows that it has done a lot of things that are not right. If there is going to be an IMF, it seems to me there ought to be a look at its basic charter, and there should be some statement about what this organization is for, and what it is not for. It is not an all purpose organization, but it is operating that way (Shultz 1998, 6).

To combat these problems and allegations the IMF is trying to reform and resolve its transparency issues. In a press release on November, 6, 1998, Rep. Saxton said,

> Over the last year the outside pressure on the IMF to become more transparent has intensified, resulting in some progress that has been long overdue. The long process of congressional debate, hearings, and financial legislation on these IMF reforms do seem to be having a positive effect. Only yesterday, the IMF published for the first time its most relevant monthly data on its financial position. This release will include some information reflected in the IMF operational budget, which the IMF treats as a classified document. Though the IMF still has a long way to go, it appears that it is taking the first steps to implement the new reforms.

Still, Britain's Prime Minister Tony Blair insists, "'There is a need for greater openness and transparency in international dealings and there needs to be a greater promotion of the transparency of information regarding member countries' economic data and policies'" (quoted in Fidler and Peston 1998; Platt 1998).

IMF Loans Provide Massive Subsidies to Borrowing Countries

The IMF has a number of different facilities for extending financial assistance to its member countries. They range from extremely short-term Stand-by-Arrangements, which are typically extended over 12 to 18 months and repaid within five years, to long-term assistance, such as the Enhanced Structural Adjustment Facility (ESAF), which is repaid over ten years and includes a five-year grace period. IMF assistance is usually extended at a conditional, or below-market rate of 4.5 percent; the ESAF loans are nearly free, with an annual interest rate of only one-half of 1 percent (IMF 1998). The IMF extended most of its loans to Indonesia, South Korea, and Thailand at subsidized rates (between 4.5 percent and 4.7 percent). These same countries were required to pay approximately 14.5 percent on comparable government bonds to access credit in the private sector (Fuelner 1998, 7). David Sachs of the Independent Institute and Peter Thiel of Thiel Capital International LLC estimate that because of IMF subsidies, "over three years, South Korea, Thailand, and Indonesia will have received a direct wealth transfer of at least $35 billion, mostly from U.S. and Western taxpayers" (Sachs and Thiel 1998).

Interest rates usually are determined by the borrower's riskiness and credit worthiness. However, the IMF does not seem to consider these factors when making lending decisions. In fact, it actually rewards high-risk countries with poor credit records. The IMF reverses the normal banking standards of good lending and "rewards failure and punishes success. It rewards poor governance and excessive risk taking by investors" (Fuelner 1998, 7). Vasquez (1998) says,

> the Fund's money goes to governments that have created the crisis to begin with and that have shown themselves to be unwilling or reluctant to introduce necessary reforms. Giving money to such governments does not tend to promote market reforms, it tends to delay them because it takes the pressure off of governments to change their policies.

Rep. Saxton said in a press release on October 8, 1998,

> an end to IMF interest subsidies in its standard loans would be a good beginning in IMF reform. A thorough IMF reform would combine an end of interest subsidies, limits on loan maturities to under one year, collateral requirements for borrowers, a requirement that countries establish minimum capital standards for IMF membership, and the elimination of intrusive and often counter productive loan conditions.

IMF Policies Lead Developing Countries to Postpone Real Reforms, and to Incur Economic Stagnation and Recession

According to Edwin Fuelner, data collected over the last 30 years demonstrate that most-less developed countries (LDC) receiving IMF loans have per-capita wealth today that is the same as or lower than they had before they received the loans. Many are actually worse off. For example: Of the 89 LDC's that received IMF loans between 1965 and 1995, 48 are no better off economically today than they were before receiving IMF loans. Of these 48 countries, 32 are poorer than they were before receiving IMF loans. Of these 32 countries, 14 have economies that are at least 15 percent smaller than they were at the time of their first IMF loans (Fuelner 1998, 7).

The IMF continuously enters agreements with countries that have a history of violating their previous contracts with the Fund. Once again we can look at Mexico as an example of this. We can also look at the recently troubled Russian economy. As we have seen with Russia over the past several years, a country that does not stick to IMF conditions risks having its loans suspended. When these loans are cut off, the recipient governments tend to become more serious about reforms. The IMF then encourages misbehaving governments to introduce reforms by cutting loans off; it is the cut-off of credit that induces policy change. Unfortunately, when policy changes do come forth, the IMF resumes lending. Indeed, it has a bureaucratic incentive to lend. "It [IMF] simply cannot afford to watch countries reform on their own because it would risk making the IMF appear irrelevant. The resumption of financial aid starts the process over again and prolongs the period of reform" (Vasquez 1998, 3).

The Fund's pressure in order to keep borrowers current on previous loans and able to ask for more money is well documented. "The IMF's bureaucratic incentive to lend is also well known by both recipient governments and the IMF itself, making the Fund's conditionality that much less credible" (Vasquez 1998, 3). Although the IMF sets conditions for its loans, it usually focuses on narrow accounting measures–currency devaluation, for example–that often bring borrowers' economies to a halt. Doug Bandow (1998), a senior fellow at the Cato Institute, feels that the IMF lends too easily. He says, "the Fund is shamelessly eager to lend; it responded to Indonesia's recalcitrance by promising 'considerable flexibility' and by constantly renegotiating its loan agreement." Calomiris (1998) adds to this, "if foreign investors are protected by the IMF, they will be less discriminating about where they place their funds and thus provide less of an incentive for reform in developing economies."

The IMF is Not Acting as a True Lender of Last Resort

The IMF seems to be acting more like a lender of first resort than of last resort. The IMF had financial arrangements worth over $38 billion with 58 countries as of January 31, 1998 (IMF 1998). The IMF is currently giving financial assistance to a third of its entire membership, which is a quarter of the world's nations. Fuelner asks if we are

> seriously to believe that every one of these 58 countries is in such dire financial straits that it is unable to secure private loans or investment, obtain foreign exchange through exports, or cut government expenditures sufficient to meet its debt obligations? Or that they are incapable of negotiating debt terms with their creditors? The very fact that they are in debt indicated that they were able to secure credit (Fuelner 1998, 8).

Wolf (1998) says about the lender of last resort problem,

> the argument for an international lender of last resort and official supplier of liquidity in a panic rests on two pillars. That financial markets are prey to herd behavior that can create all sorts of outcomes, good or bad, generated by self-fulfilling expectations, and in a world of extreme exchange-rate variability, panics threaten whole countries, not just financial institutions within them.

He also says that the

> lender of last resort is the obvious solution [to the current financial crises]. Such a lender would stand ready to provide liquidity in support of any country deemed structurally sound that was running out of reserves or was suffering a currency collapse. But if this is the demand, the IMF cannot meet it. IMF bailouts are small in relation to the sums that can rush into or out of countries without controls. The Fund also phases the release of its money in tranches [a series of installments the IMF lends through various financing facilities] in order to monitor conditionality. In consequence, the IMF cannot stop a panic. On the contrary, its arrival often signals crisis, while the small pot of money it offers is an inducement for creditors to rush for cash before it runs out (Wolf 1998).

A Recent Case of IMF Failure

The performance of IMF over the Russian package was poor at best. The IMF rushed to assemble a $22 billion package for Russia, supposedly conditional on the Russians suddenly discovering how to collect taxes to replace the $5-6 billion per month that they had been borrowing from the global financial markets. When the initial $5 billion tranche from the IMF was dispensed to Russia after July 13, 1998, Russian oligarchs, anxious to convert rubles into hard currency, immediately used the loan money for their own purposes. The Russians then expected to receive more funds from the IMF by threatening devaluation and default. Even the IMF saw that further funds would simply be consumed by the same clique moving funds out of Russia, and the Russians unilaterally devalued and defaulted (Makin 1998, 2).

The Russian episode is hardly an example of free market operation and free and unfettered flows of capital. The IMF essentially expropriated resources provided by industrial countries and irresponsibly allocated those funds to a country that had absolutely no hope of meeting the conditions allegedly attached to the IMF program. Russian technocrats such as Anatoly Chubais openly chortled to the Russian press that they had "conned" the IMF and its chief negotiator, Stanley Fischer. The Russian episode, not to mention the IMF performance in South Korea, Indonesia, and Thailand, reflects the actions of people who face no accountability for their performance. If the IMF managing director and deputy managing director had been managing funds in the private sector in the same way, they would have long ago been bankrupt and forced out of business (Makin 1998, 2).

In a luncheon that the author attended in Washington, DC on September 9, 1998, Dr. Andrei Illarionov, the Director of the Institute of Economic Analysis, and Former Chief Economic Advisor to Former Russian Premier Victor Chernomyrdin, spoke on what happens when the IMF gives money to the Russian government. The government has ties to oligopolies, which are owned by corrupt individuals who end up getting the money. He said that the government consumes about 60 percent of the GDP. None of the money is used to boost the economy and help the people. "The shelves are almost empty in the stores. . . . There is an element of hunger," he said. He also mentioned that IMF packages are based on wrong economic information. Dr. Illarionov states that the IMF should not raise expenditures, but raise revenue instead. He ended his speech by saying very emphatically, "stop the financial system, the only thing that it is doing is spoiling the Russian leaders" (Illarionov 1998).

Ideas for Reforming the IMF

Many long term solutions are being proposed aimed at managing financial crises better. All focus on reducing the volatility present in the international capital markets, and establishing guidelines or conditions for unsound financial management before the onset of crisis and attendant need for IMF rescues. A major component that is absent from the global financial system, and hence the subject of numerous research efforts, is credible financial regulation. What makes the Federal Reserve System a viable lender of last resort in the

United States is a solid financial regulatory system. This aspect is missing at the global, and in many cases, national levels. National financial systems are often at the center of financial problems so that when investor sentiments change, there is little systemic capacity to fall back on. The IMF cannot be a realistic replacement for sound national financial systems. For many, this fact argues for reevaluating both national and global financial systems and for finding alternatives to a strategy based on the IMF loans and reforms for countries that find themselves in very bad financial situations (Hornbeck 1998b, 4).

In September 1998, Prime Minister Tony Blair suggested that the global economic and financial turmoil–which has spread from Southeast Asia to Russia and South America– highlight the shortcomings of the IMF. He says, "'The existing system has not served us terribly well. The Bretton Woods institutions are 54 years old and were set up when international capital flows were smaller.'" One of the ideas presented by the UK government stated that there should be a partial merger of different areas of the IMF and World Bank. This would allow a system in that there is no single institution in charge of supervising and regulating the world economic system, but three or more separate entities to keep each other in check (Fidler and Peston 1998).

SOLUTIONS TO THE MORAL HAZARD PROBLEM

To address the problem of moral hazard, we need to let the economy work in the free market. Fuelner (1998) points out that financial hardship and defaults occur every day in the U.S. economy.

> Bankruptcy is the market's method of reallocating capital to more productive uses, or away from managers who failed to create wealth for investors or improve the well-being of consumers. As assets are purchased at a reduced rate by the highest bidder, both parties to an ill considered lending or investment decision suffer a loss; but the overall economy profits because new, presumably better managers will now control the capital.

He also says, "a world without the IMF would have to observe the greater discipline of market forces." Countries would have to adopt transparent economic policies that lower risk for lenders and investors. Specifically, they would have to create fair and reliable bankruptcy laws, employ transparent and internationally accepted accounting procedures, allow minimal government interference in the allocation of credit, exercise prudent oversight of their banking systems, and encourage rather than prevent domestic and foreign banking competition (Fuelner 1998, 4-5). In finding solutions to the moral hazard problem, according to Ricki Helfer, "it is vital to distinguish whether a crisis is one of illiquidity (borrowers will be able to repay once any panic in the markets has dissipated) or of insolvency (economic fundamentals demonstrate that borrowers do not have the means to repay their debts)." In the case of illiquidity, temporary financing from a lender of last resort is very appropriate and should contain just a little moral hazard. When the problem has to do with insolvency, lending to borrowers will almost always lead to a moral hazard problem, which in turn can lead borrowing countries to ignore serious and persistent structural problems (Helfer 1998, 5). Bandow (1998) adds, "without an international bailout, countries like Indonesia would have to adopt all the changes necessary to reassure foreign bankers and investors." This would cause a reliance on the market's invisible hand and governments would have no one else to blame but themselves.

SOLUTIONS FOR THE IMF LACKING TRANSPARENCY

The IMF's lack of transparency surely needs to be changed. Calomiris (1998) seems persuasive in his argument that,

> IMF secrecy is contrary to its proper role as a source of independent, objective, and informed opinion about the economic performance and financial risks of member countries. In pursuit of its appropriate mission, any policies or conditions for assistance advocated by the IMF should be revealed publicly. That will encourage a lively debate about their merits, and permit critical evaluation of their effectiveness.

Rep. Saxton says (1998a) that even though some progress has made the IMF more transparent to the public, much remains to be done. The IMF operational budgets need to be publicly released in order to allow public and private sectors to analyze them, and make any appropriate redactions if necessary. Transparency, market interest rate, and other reforms should be implemented in keeping with the letter of the law. In a statement given on October 13, 1998, he stresses the fact that how these reforms are actually implemented will be extremely critical in determining their success. "Close monitoring of their enforcement, implementation, and application will be needed in the months and years ahead" (Saxton 1998g).

Rep. Saxton further argues that any new reform must provide for public release of important documents, including "letters of intent, memoranda of understanding [,] and also policy framework papers that are not currently routinely available to the public as a matter of policy." Although there are loopholes in regards to the release of minutes and documents, any effort to implement this reform will cause significant change in the culture of secrecy at the IMF (Saxton 1998f).

SOLUTIONS TO THE IMF PROVIDING MASSIVE SUBSIDIES TO BORROWING COUNTRIES

The third problem listed above is that the IMF loans provide massive subsidies to borrowing countries. Rep. Saxton argues in an October 9, 1998, press release that, "low interest rates are economically inefficient and exacerbate the moral hazard problem." Instead the IMF should be required to lend at rates that will be comparable to current market rates. This would allow a rate at which the borrower could borrow shortly before the onset of a financial emergency, plus an adjustment for risk. Along with this a floor provided would ensure that there would no longer be any deep interest rate subsidies. This would help countries that have balance of payments problems under quite typical circumstances to borrow from the IMF at an interest rate that reflects an adjustment for risk (Saxton 1998f).

Fuelner (1998, 7) suggests that requiring the IMF to charge market-determined interest rates on its loans would ensure that IMF loan recipients are held to the same standards for its loans, as are private individuals and companies. Moreover, this provision would minimize market distortions. It would help to reinforce market perceptions of risk and also eliminate the backdoor transfer of wealth from Americans to the governments of countries that made unwise economic decisions.

How the IMF can become a True Lender of Last Resort

In regards to the problem of the IMF not acting as a true lender of last resort, reform ideas are broad. Wolf (1998) says,

> One coherent reform would be for the IMF to become a true lender of last resort, with resources to match. This could be justified only if potential borrowers accepted higher standards of external oversight and discipline than now. These standards would have to cover financial regulation, disclosure of information, macro economic policies and exchange rates. Only if countries abided by the standards would they become eligible for non-conditional lending, in a panic.

Three changes are needed to overcome the problem. First, speedy and internationally accepted procedures are vital for calling a halt to the creditor "grab-race" and for implementing rescheduling, debt-write offs and corporate bankruptcy. Second, risk-creating lending by private financial institutions that are, in effect, guaranteed by the governments of rich countries, needs to be far more carefully policed and restricted. Finally, countries contemplating liberalization of debt-creating inflows must be clear about the risks and preconditions. They need a strongly capitalized banking system, with strict prudential controls over foreign liabilities and assets; access to substantial international reserves; and a strong fiscal position, with moderate inflation and either a fairly freely floating exchange rate or a politically and economically robust currency board (Wolf 1998).

A country must either be able to live within the norms of an integrated global financial system that possesses no lender-of-last resort, or it needs to limit the inflows that create the greatest risks. Since access to IMF resources cannot appreciably lower these risks, countries should design their policies as if those funds did not exist (Wolf 1998).

In a morning breakfast meeting at the Hotel Washington in Washington, DC, September, 1998, the author attended an address given by Lord John Eatwell, President of Queens' College, Cambridge, England, and Lance Taylor of the Center for Economic Policy Analysis, on their ideas for a new global monetary system. They called it the World Financial Authority (WFA). This organization would be complementary to the World Trade Organization (WTO). A central task of the WFA would be the development of policies to manage systemic risk. The objectives of the WFA would include the requirement to pursue policies to maintain high rates of growth and employment. The WFA would develop rules which would ensure, where appropriate, the internalization of externalities, and to oversee the development of a credible and effective guarantor and lender-of-last-resort function. The WFA would be not only a body that develops and imposes regulatory procedures, but also a forum within which the rules of international financial cooperation are developed and implemented. The goals of an efficient international financial policy can be achieved by effective coordination of the activities of national monetary authorities. The problem is that the means of achieving that coordination are at the moment very limited. The WFA would fill that gap. It would have the responsibility to ensure that once national policies have been agreed to by the WFA, states support each others' national policies. That mutual support is the key to success. The WFA would also be given the responsibility of ensuring transparency and accountability, on the part of international financial institutions such as the IMF and the World Bank. There is no present systematic evaluation of the activities of the Bretton Woods institutions. For this reason, the Bretton Woods institutions accountable to the WFA would introduce a "safety valve" of evaluation and accountability that would make the IMF more effective (Eatwell and Taylor 1998).

The IMF should be reorganized to take responsibility on behalf of the WFA for coordinating and partially funding international rescue operations when the need arises. There should be explicit consideration of how the IMF should be developed to deal with the problem of liquidity, and the development of a lender-of-last-resort function. Bailouts should be based on prompt injections of liquidity, instead of the current disastrous policy of prolonged attempts to restructure national economic systems, using conditionality-laden credit disbursements as bait (Eatwell and Taylor 1998).

In their paper, "A Checklist for IMF Reform," Bryan T. Johnson and Brett D. Schafer give three ideas on what types of reforms should be made. The first is that "no U.S. agency, official, or agent should be allowed to transfer any money to the IMF until the reforms specified by Congress are enacted." The second idea is that "the IMF must adopt mandatory voting on all financial and procedural decisions and make the voting record available to the legislative branch of its member countries and the public at large." The third is "all IMF documents are made available to the public" (Johnson and Schaefer 1998).

Sebastian Edwards (1998) has created a scheme in which three institutions should be formed to cover the IMF. The first would be a Global Information Agency whose role would be to provide timely and uncensored information on countries' financial health. The second institution would help prevent crises, by playing an active role in the world financial system, rather than a reactive one as the IMF currently does. This would be called the Contingent Global Financial Facility. It would provide sizeable contingent credit lines to countries that, although solvent, face temporary liquidity problems. The third would be called the Global Restructuring Agency. It would be in charge of cleaning up and would deal with those countries that in spite of every effort, run into a crisis.

CONCLUSIONS

In the United States, if a business has been overly risky or has not been managed well, it is usually allowed to fail. That is free market competition, Darwin's survival of the fittest, a weeding out of the bad. Whatever one will call it, it is this system that allows for the healthiest economy. This system needs to be practiced in the global economy as well. Instead of hanging on to national banks that have created a moral hazard, let them fail and start over again with new management, new capital, and a new risk averse, conservative approach to business. If companies know that because of bad policies they will go bankrupt, they certainly will be less likely to take the same risks. As the IMF continues to hand out more and more money to member countries, the moral hazard will continue to grow. Instead of investing in order to strengthen the economy as a responsible government should, they will use this money to invest in non-performing loans that their top banks have created by taking unnecessary risks.

A great example of this policy occurred in Chile. Chile was not loaned money from the IMF because it was not abiding by certain rules. Chile's economy collapsed and there was no additional capital coming from the outside. Through various steps the Chilean economy has been reformed without IMF help, and is now one of the strongest economies in South America.

This is the most significant reform that the IMF needs to make. It needs new policy that will once again make it a true lender of last resort. Transparency is needed so that we can see what type of policy recommendations the IMF is making and why. This is so other governmental agencies can better ensure that the IMF is performing according to everyone's best interest.

The IMF need not be abolished. However, definite reforms need to be made so that we do not continue experiencing the type of financial crises that we experienced during 1997 and 1998.

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