

# RESHAPING THE GLOBAL FINANCIAL ARCHITECTURE: IS THERE A ROLE FOR THE IMF?

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## The Present State of the Debate

The future of the International Monetary Fund (IMF) in the new global financial architecture has received much attention. In May 1998, I testified on this issue to the Joint Economic Committee on a panel with George Shultz, Paul Volcker, and Lawrence Lindsey. My own testimony (Niskanen 1998) elaborated on the conclusion of an important paper by Columbia University economist Charles Calomiris (1998: 276) that, “The principal lesson of the recent bailout programs managed by the IMF and the U.S. government . . . is the vital need for all parties . . . to find a credible way to commit *not* to sponsor such counterproductive bailouts.” I observed,

The characteristic IMF response to this type of criticism, of course, is that the conditions for receiving IMF credit induce the type of reforms that are necessary to avoid a future crisis. In a few cases, this has been successful. The larger record, however, does not provide a basis for optimism. Most developing country governments, once the recipient of IMF’s subsidized credit, have become loan addicts. As noted earlier, most of these governments have relied on IMF loans for more than two decades, despite the conditions for receiving these loans and the usual two-to-five year maturity of these loans.

And I concluded,

Maybe we don’t need the IMF—that is now the judgement of former Treasury secretaries George Shultz and William Simon and the former chairman of Citicorp Walter Wriston. I am willing to defer judgement on this issue. In the meantime, Congress should not approve any *additional* funds for the IMF, at least until some of the broader questions are addressed.

At that hearing, there was broad agreement that additional funding should be conditional on a major reform of the IMF without much agreement on the details. Paul Volcker provoked the most controversy by asserting that the IMF would be more receptive to reform if Congress first approved the additional funding. As is often the case, the recent resolution of this issue was a compromise of those two positions: Congress approved additional U.S. funding of \$18 billion in exchange for a promise by the administration and the other major IMF member governments to seek specific reforms.

## The Case for Abolishing the IMF

Since that hearing, my views on this issue have evolved from no more funding without IMF reform—to no more funding, period—to no more IMF. For I have concluded that *the IMF cannot perform the role that the member governments expect of it*. As they sing over at the Birchmere, “Walk through this world with me.”

First, the IMF is institutionally incapable of being an effective lender of last resort. The IMF cannot create high-powered money or act quickly enough to prevent a liquidity crisis. And the IMF cannot have sufficient information to distinguish between an illiquid bank and an insolvent bank. As summarized in an article by UCLA economist Deepak Lal (1998: 18),

[The IMF] can lend only after lengthy negotiations with a country's government and with the approval of its board. [And] it has no way of sorting out the 'good' from 'bad' loans, for instance made by foreign banks to residents in the country, and to liquidate the latter. The lender of last resort function for the money centre banks involved in foreign lending must therefore continue to be provided by their parent central banks.

Second, the IMF has not proved to be generally effective in promoting the type of economic policies that are necessary to avoid a future financial crisis. Mexico, for example, has had a financial crisis each presidential election year from 1976 through 1994. And, as mentioned before, many developing country governments have relied on IMF loans for more than two decades. The IMF was first established to provide short-term balance of payment financing in a fixed exchange rate regime. Over time, the IMF has evolved into an international economic development consultant, using subsidized loans to induce developing country governments to adopt policies that are already presumably in their best interests. This bureaucratic mission creep might be satisfactory if the IMF had proved effective in its new role. But it has not. The difference in per capita incomes between the rich

and poor nations has continued to increase as have the frequency and magnitude of financial crises.

And third, the extended post-crisis negotiations over the conditions for receiving an IMF loan risk turning a liquidity crisis into a solvency crisis. If adequate IMF loans are not made quickly enough to maintain a stable exchange rate, domestic borrowers end up owing more in the domestic currency to meet the obligations of loans made in a foreign currency. For domestic borrowers, loans that were viable at the prior exchange rate become an unserviceable burden at the new lower exchange rate. One solution to this problem, as noted by Lal (1998), would be to require that all foreign loans be made in the domestic currency, shifting the exchange rate risk from the borrower to the lender; this would reduce foreign borrowing by increasing domestic interest rates by the amount necessary to compensate for the exchange rate risk but would substantially reduce the risk of bankruptcy by the domestic borrower. As long as domestic banks and other firms borrow abroad in a foreign currency, the only solution to this problem would be for the IMF and money center banks to make adequate loans quickly enough to avoid a collapse of the exchange rate.

## Conclusion

There may be a valuable potential role for the IMF—to act as an international lender of last resort in every role other than creating new base money. But this would require a profound change in the way that the IMF operates. The conditions for eligibility for IMF loans would have to be established on a nondiscriminatory basis and announced before a crisis, rather than negotiated on a discriminatory basis after the crisis; this would require that the IMF refuse to make loans to a government that did not meet these announced pre-crisis conditions. Consistent with Bagehot's time-tested advice, the IMF should then be prepared to make large loans quickly to any solvent but illiquid eligible borrower but at a penalty interest rate and matched by the borrower's best collateral.

But this seems like too much of a change of institutional culture. The IMF would have to replace most of its economists with bankers, to forego its economic consulting role in exchange for being the manager of an international discount window and, most difficult, to be willing to tell some of its member governments that they are not eligible for IMF loans.

One alternative would be to let the IMF go its merry way but with a clear signal that there would be no additional funds. But it is just that type of regulatory forbearance that led to the S&L crisis and a

large taxpayer bailout. A better alternative, I now conclude, is to abolish the IMF.

## References

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