The IMF Strikes Back

By Kenneth Rogoff

FOREIGN POLICY MAGAZINE, January/February 2003

Reproduced with permission from FOREIGN POLICY 134 (January/February 2003) www.foreignpolicy.com. Copyright 2003, by the Carnegie Endowment for International Peace

Vitriol against the IMF, including personal attacks on the competence and integrity of its staff, has transcended into an art form in recent years. One bestselling author labels all new fund recruits as "third-rate," implies that management is on the take, and discusses the IMF's role in the Asian financial crisis of the late 1990s in the same breath as Nazi Germany and the Holocaust. Even more sober and balanced critics of the institution—such as *Washington Post* writer Paul Blustein, whose excellent inside account of the Asian financial crisis, *The Chastening*, should be required reading for prospective fund economists (and their spouses)—find themselves choosing titles that invoke the devil. Really, doesn't *The Chastening* sound like a sequel to 1970s horror flicks such as *The Exorcist* or *The Omen*? Perhaps this race to the bottom is a natural outcome of market forces. After all, in a world of 24-hour business news, there is a huge return to being introduced as "the leading critic of the IMF."

Regrettably, many of the charges frequently leveled against the fund reveal deep confusion regarding its policies and intentions. Other criticisms, however, do hit at potentially fundamental weak spots in current IMF practices. Unfortunately, all the recrimination and finger pointing make it difficult to separate spurious critiques from legitimate concerns. Worse yet, some of the deeper questions that ought to be at the heart of these debates—issues such as poverty, appropriate exchange-rate systems, and whether the global financial system encourages developing countries to take on excessive debt—are too easily ignored.

Consider the four most common criticisms against the fund: First, IMF loan programs impose harsh fiscal austerity on cash-strapped countries. Second, IMF loans encourage financiers to invest recklessly, confident the fund will bail them out (the so-called moral hazard problem). Third, IMF advice to countries suffering debt or currency crises only aggravates economic conditions. And fourth, the fund has irresponsibly pushed countries to open themselves up to volatile and destabilizing flows of foreign capital.

Some of these charges have important merits, even if critics (including myself in my former life as an academic economist) tend to overstate them for emphasis. Others, however, are both polemic and deeply misguided. In addressing them, I hope to clear the air for a more focused and cogent discussion on how the IMF and others can work to improve conditions in the global economy. Surely that should be our common goal.

The Austerity Myth

Over the years, no critique of the fund has carried more emotion than the "austerity" charge. Anti-fund diatribes contend that, everywhere the IMF goes, the tight macroeconomic policies it imposes on governments invariably crush the hopes and aspirations of people. (I hesitate to single out individual quotes, but they could easily fill an entire edition of *Bartlett's Quotations*.) Yet, at the risk of seeming heretical, I submit that the reality is nearly the opposite. As a rule, fund programs lighten austerity rather than create it. Yes, really.

Critics must understand that governments from developing countries don't seek IMF financial assistance when the sun is shining; they come when they have already run into deep financial difficulties, generally through some combination of bad management and bad luck. Virtually every country with an IMF program over the past 50 years, from Peru in 1954 to South Korea in 1997 to Argentina today, could be described in this fashion.

Policymakers in distressed economies know the fund will intervene where no private creditor dares tread and will make loans at rates their countries could only dream of even in the best of times. They understand that, in the short term, IMF loans allow a distressed debtor nation to tighten its belt less than it would have to otherwise. The economic policy conditions that the fund attaches to its loans are in lieu of the stricter discipline that market forces would impose in the IMF's absence. Both South Korea and Thailand, for example, were facing either outright default or a prolonged free fall in the value of their currencies in 1997—a far more damaging outcome than what actually took place.

Nevertheless, the institution provides a convenient whipping boy when politicians confront their populations with a less profligate budget. "The IMF forced us to do it!" is the familiar refrain when governments cut spending and subsidies. Never mind that the country's government—whose macroeconomic mismanagement often had more than a little to do with the crisis in the first place—generally retains considerable discretion over its range of policy options, not least in determining where budget cuts must take place.

At its heart, the austerity critique confuses correlation with causation. Blaming the IMF for the reality that every country must confront its budget constraints is like blaming the fund for gravity.

Admittedly, the IMF does insist on being repaid, so eventually borrowing countries must part with foreign exchange resources that otherwise might have gone into domestic programs. Yet repayments to the fund normally spike only after the crisis has passed, making payments more manageable for borrowing governments. The IMF's shareholders—its 184 member countries—could collectively decide to convert all the fund's loans to grants, and then recipient countries would face no costs at all. However, if IMF loans are never repaid, industrialized countries must be willing to replenish continually the organization's lending resources, or eventually no funds would be available to help deal with the next debt crisis in the developing world.

A Hazardous Critique

Of course, in so many IMF programs, borrowing countries must pay back their private creditors in addition to repaying the fund. Yet wouldn't fiscal austerity be a bit more palatable if troubled debtor nations could compel foreign private lenders to bear part of the burden? Why should taxpayers in developing countries absorb the entire blow?

That is a completely legitimate question, but let's start by getting a few facts straight. First, private investors can hardly breathe a sigh of relief when the fund becomes involved in an emerging-market financial crisis. According to the Institute of International Finance, private investors lost some $225 billion during the Asian financial crisis of the late 1990s and some $100 billion as a result of the 1998 Russian debt default. And what of the Latin American debt crisis of the 1980s, during which the IMF helped jawbone foreign banks into rolling over a substantial fraction of Latin American debts for almost five years and ultimately forced banks to accept large write-downs of 30 percent or more? Certainly, if foreign private lenders consistently lose money on loans to developing countries, flows of new money will cease. Indeed, flows into much of Latin America—again the current locus of debt problems—have been sharply down during the past couple of years.

Private creditors ought to be willing to take large write-downs of their debts in some instances, particularly when a country is so deeply in hock that it is effectively insolvent. In such circumstances, trying to force the debtor to repay in full can often be counterproductive. Not only do citizens of the debtor country suffer, but creditors often receive less than they might have if they had lessened the country's debt burden and thus given the nation the will and means to increase investment and growth. Sometimes debt restructuring does happen, as in Ecuador (1999), Pakistan (1999), and Ukraine (2000). However, such cases are the exception rather than the rule, as current international law makes bankruptcies by sovereign states extraordinarily messy and chaotic. As a result, the official lending community, typically led by the IMF, is often unwilling to force the issue and sometimes finds itself trying to keep a country afloat far beyond the point of no return. In Russia in 1998, for example, the official community threw money behind a fixed exchange-rate regime that was patently doomed. Eventually, the fund cut the cord and allowed a default, proving wrong those many private investors who thought Russia was "too nuclear to fail." But if the fund had allowed the default to take place at an earlier stage, Russia might well have come out of its subsequent downturn at least as quickly and with less official debt.

Since restructuring of debt to private creditors is relatively rare, many critics reasonably worry that IMF financing often serves as a blanket insurance policy for private lenders. Moreover, when private creditors believe they will be bailed out by the IMF, they have reason to lend more—and at lower interest rates—than is appropriate. The debtor country, in turn, is seduced into borrowing too much, resulting in more frequent and severe crises, of exactly the sort the IMF was designed to alleviate. I will be the first to admit the "moral hazard" theory of IMF lending is clever (having introduced the theory in the 1980s), and I think it is surely important in some instances. But the empirical evidence is mixed. One strike against the moral hazard argument is that most countries generally do repay the IMF, if not on time, then late but with full interest. If the IMF is consistently paid, then private lenders receive no subsidy, so there is no bailout in any simplistic sense. Of course, despite the IMF's strong repayment record in major emerging-market loan packages, there is no guarantee about the future, and it would certainly be wrong to dismiss moral hazard as unimportant.

Fiscal Follies

Even if IMF policies are not to blame for budget cutbacks in poor economies, might the fund's programs still be so poorly designed that their ill-advised conditions more than cancel out any good the international lender's resources could bring? In particular, critics charge that the IMF pushes countries to increase domestic interest rates when cuts would better serve to stimulate the economy. The IMF also stands accused of forcing crisis economies to tighten their budgets in the midst of recessions. Like the austerity argument, these critiques of basic IMF policy advice appear rather damning, especially when wrapped in rhetoric about how all economists at the IMF are third-rate thinkers so immune from outside advice that they wouldn't listen if John Maynard Keynes himself dialed them up from heaven.

Of course, it would be wonderful if governments in emerging markets could follow Keynesian "countercyclical policies"—that is, if they could stimulate their economies with lower interest rates, new public spending, or tax cuts during a recession. In its September 2002 "World Economic Outlook" report, the IMF encourages exactly such policies where feasible. (For example, the IMF has strongly urged Germany to be flexible in observing the budget constraints of the European Stability and Growth Pact, lest the government aggravate Germany's already severe economic slowdown.) Unfortunately, most emerging markets have an extremely difficult time borrowing during a downturn, and they often must tighten their belts precisely when a looser fiscal policy might otherwise be desirable. And the IMF, or anyone else for that matter, can only do so much for countries that don't pay attention to the commonsense advice of building up surpluses during boom times—such as Argentina in the 1990s—to leave room for deficits during downturns.

According to some critics, though, a simple solution is staring the IMF in the face: If those stubborn fund economists would only appreciate how successful expansionary fiscal policy can be in boosting output, they would realize countries can simply wave off a debt crisis by borrowing even more. Remember former U.S. President Ronald Reagan's economic guru, Arthur Laffer, who theorized that by cutting tax rates, the United States would enjoy so much extra growth that tax revenues would actually rise? In much the same way, some

IMF critics—ranging from Nobel Prize–winning economist Joseph Stiglitz to the relief agency Oxfam—claim that by running a fiscal deficit into a debt storm, a country can grow so much that it will be able to sustain those higher debt levels. Creditors would understand this logic and happily fork over the requisite extra funds. Problem solved, case closed. Indeed, why should austerity ever be necessary?

Needless to say, Reagan's tax cuts during the 1980s did not lead to higher tax revenues but instead resulted in massive deficits. By the same token, there is no magic potion for troubled debtor countries. Lenders simply will not buy into this story.

The notion that countries should reduce interest rates—rather than raise them—to fend off debt and exchange-rate crises is even more absurd. When investors fear a country is increasingly likely to default on its debts, they will demand higher interest rates to compensate for that risk, not lower ones. And when a nation's citizens lose confidence in their own currency, they will require a large premium to accept debt denominated in that currency or to keep their deposits in domestic banks. No surprise that interest rates in virtually all countries that experienced debt crises during the last decade—from Mexico to Turkey—skyrocketed even though their currencies were allowed to float against the dollar.

The debate over how far interest rates should be allowed to rise in defending against a speculative currency attack is a legitimate one. The higher interest rates go, the more stress on the economy and the more bankruptcies and bank failures; classic cases include Mexico in 1995 and South Korea in 1998. On the other hand, since most crisis countries have substantial "liability dollarization"—that is, a lot of borrowing goes on in dollars—an excessively sharp fall in the exchange rate will also cause bankruptcies, with Indonesia in 1998 being but one example among many. Governments must strike a delicate balance in the short and medium term, as they decide how quickly to reduce interest rates from crisis levels. At the very least, critics of IMF tactics must acknowledge these difficult trade-offs. The simplistic view that all can be solved by just adopting softer "employment friendly" policies, such as low interest rates and fiscal expansions, is dangerous as well as naive in the face of financial maelstrom.

Capital Control Freaks

Although currency crises and financial bailouts dominate media coverage of the IMF, much of the agency's routine work entails ongoing dialogue with the fund's 184 member countries. As part of the fund's surveillance efforts, IMF staffers regularly visit member states and meet with policymakers to discuss how best to achieve sustained economic growth and stable inflation rates. So, rather than judge the fund solely on how it copes with financial crises, critics should consider its ongoing advice in trying to help countries stay out of trouble. In this area, perhaps the most controversial issue is the fund's advice on liberalizing international capital movements—that is, on how fast emerging markets should pry open their often highly protected domestic financial markets.

Critics such as Columbia University economist Jagdish Bhagwati have suggested that the IMF's zeal in promoting free capital flows around the world inadvertently planted the seeds of the Asian financial crisis. In principle, had banks and companies in Asia's emerging markets not been allowed to borrow freely in foreign currency, they would not have built up huge foreign currency debts, and international creditors could not have demanded repayment just as liquidity was drying up and foreign currency was becoming very expensive. Although I was not at the IMF during the Asian crisis, my sense from reading archives and speaking with fund old-timers is that although this charge has some currency, the fund was more eclectic in its advice on this matter than most critics acknowledge. For example, in the months leading to Thailand's currency collapse in 1997, IMF reports on the Thai economy portrayed in stark terms the risks of liberalizing capital flows while keeping the domestic currency (the baht) at a fixed level against the U.S. dollar. As Blustein vividly portrays in *The Chastening*, Thai authorities didn't listen, still hoping instead that Bangkok would become a financial center like Singapore. Ultimately, the Thai baht succumbed to a massive speculative attack. Of course, in some cases—most famously South Korea and Mexico—the fund didn't warn countries forcefully enough about the dangers of opening up to international capital markets before domestic financial markets and regulators were prepared to handle the resulting volatility.

However one apportions blame for the financial crises of the past two decades, misconceptions regarding the merits and drawbacks of capital-market liberalization abound. First, it is simply wrong to conclude that countries with closed capital markets are better equipped to weather stormy financial markets. Yes, the relatively closed Chinese and Indian economies did not catch the Asian flu, or at least not a particularly bad case. But neither did Australia nor New Zealand, two countries that boast extremely open capital markets. Why? Because the latter countries' highly developed domestic financial markets were extremely well regulated. The biggest danger lurks in the middle, namely for those economies—many of which are in East Asia and Latin America—that combine weak and underdeveloped financial markets with poor regulation.

Moreover, a country needs export earnings to support foreign debt payments, and export industries do not spring up overnight. That's why the risks of running into external financing problems are higher for countries that fully liberalize their capital markets before significantly opening up to trade flows. Indeed, economies with small trading sectors can run into problems even with seemingly modest debt levels. This problem has repeatedly plagued countries in Latin America, where trade is relatively restricted by a combination of inward-looking policies and remote location.

Perhaps the best evidence in favor of open capital markets is that, despite the international financial turmoil of the last decade, most developing countries still aim to liberalize their capital markets as a long-term goal. Surprisingly few nations have turned back the clock on financial and capital-account liberalization. As domestic economies grow increasingly sophisticated, particularly regarding the depth and breadth of their financial instruments, policymakers are relentlessly seeking ways to live with open capital markets. The lessons from Europe's failed, heavy-handed attempts to regulate international capital flows in the 1970s and 1980s seem to have been increasingly absorbed in the developing world today.

Even China, long the high-growth poster child for capital-control enthusiasts, now views increased openness to capital markets as a central long-term goal. Its economic leaders understand that it's one thing to become a $1,000 per capita economy, as China is today. But to continue such stellar growth performance—and one day to reach the $20,000 to $40,000 per capita incomes of the industrialized countries—China will eventually require a world-class capital market.

Even though a continued move toward greater capital mobility is emerging as a global norm, absolute unfettered global capital mobility is not necessarily the best long-term outcome. Temporary controls on capital outflows may be important in dealing with some modern-day financial crises, while various kinds of light-handed taxes on capital inflows may be useful for countries faced with sudden surges of inflows. Chile is the classic example of a country that appears to have successfully used market-friendly taxes on capital inflows, though a debate continues to rage over their effectiveness. One way or another, the international community must find ways to temper debt flows and at the same time encourage equity investment and foreign direct investment, such as physical investment in plants and equipment. In industrialized countries, the pain of a 20 percent stock market fall is shared automatically and fairly broadly throughout the economy. But in nations that rely on foreign debt, a sudden change in investor sentiment can breed disaster.

Nevertheless, financial authorities in developing economies should remain wary of capital controls as an easy solution. "Temporary" controls can easily become ensconced, as political forces and budget pressures make them hard to remove. Invite capital controls for lunch, and they will try to stay for dinner.

Striking a Global Bargain

Should the international community just give up on global capital mobility and encourage countries to shut their doors? Looking further ahead in the 21st century, does the world really want to adopt greater financial isolationism?

Perhaps the greatest challenge facing industrialized countries in this century is how to deal with the aging bulge in their populations. With that in mind, wouldn't it be more helpful if rich countries could find effective ways to invest in much younger developing nations, and later use the proceeds to support their own increasing number of retirees? And let's face it, the world's developing countries need funds for investment and education now, so such a trade would prove mutually beneficial—a win-win. Yes, recurring debt crises in the developing world have been sobering, but the potential benefits to financial integration are enormous. Full-scale retreat is hardly the answer.

Can the IMF help? Certainly. The fund provides a key forum for exchange of ideas and best practices. Yes, one could go ahead and eliminate the IMF, as some of the more extreme detractors wish, but that is not going to solve any fundamental problems. This increasingly globalized world will still need a global economic forum. Even today, the IMF is providing such a forum for discussion and debate over a new international bankruptcy procedure that could lessen the chaos that results when debtor countries become insolvent.

And there are many other issues where the IMF, or some similar multilateral organization, seems essential to any solution. For example, the current patchwork system of exchange rates seems too unstable to survive into the 22nd century. How will the world make the transition toward a more stable, coherent system? That is a global problem, and dealing with it requires a global perspective the IMF can help provide.

And what of poverty? Here, the IMF's sister organization, the World Bank, with its microeconomic and social focus and commensurately much larger staff, is appropriately charged with the lead role. But poor countries in the developing world still face important macroeconomic challenges. For example, if enhanced aid flows ever materialize, policymakers in emerging markets will still need to find ways to ensure that domestic production grows and thrives. Perhaps poor nations won't need the IMF's specific macroeconomic expertise—but they will need something awfully similar.