Reforming the IMF

by

Charles W. Calomiris

and

Allan H. Meltzer[*]

Before agreeing to provide more money for the International Monetary Fund (IMF) as part of the 1998 budget agreement, Congress insisted on greater transparency in decision-making and higher interest rates on IMF loans. These changes are first steps toward reform of international lending institutions. More fundamental reforms are needed to reduce the risks of destabilizing crises that have become more frequent and more costly than ever before. Even the losses to bank depositors during the Great Depression pale by comparison.

The IMF and the World Bank were created in 1944 on the presumption that: (1) countries would maintain fixed exchange rates tied to gold and the dollar and (2) international capital flows would be modest at best. Both presumptions proved to be wrong. The fixed exchange rate system ended in 1971, when President Nixon devalued the dollar and closed the gold window. All major currencies -- the dollar, yen and D-mark -- and many others began a managed float. Instead of a dearth of private lending, large-scale lending to developing countries has contributed to all of the major financial crises of the past twenty years.

If all foreign lending took the form of equity investment in foreign countries, lending risks would be borne by the lenders and investors. Under current arrangements, bankers in the developing countries borrow from banks and financial institutions abroad. The loans are denominated in dollars, marks or yen, so the borrower bears the risk of devaluation. Adding to the problem, many of the banking

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[*] Charles W. Calomiris is the Paul Montrone Professor of Finance and Economics at the Columbia Business School and a Visiting Scholar at the American Enterprise Institute. Allan H. Meltzer is the Allan H. Meltzer Professor of Political Economy at Carnegie Mellon University and a Visiting Scholar at the American Enterprise Institute.

systems are poorly capitalized. They often act as agents of their government's development plans. Or, they finance the conglomerates that control banks that lend to favored enterprises without careful screening for credit-worthiness. They do not diversify loans over borrowers in many different industries.

When problems arise in developing countries or the world economy, foreign banks fear that slow growth, recession or deep depression will be followed by bankruptcies and loan defaults. As these banks repatriate their funds, the currency and the weak domestic banking systems collapse. A currency crisis heightens the burden of the financial crisis.

The IMF has taken on the role of lending to the governments of the developing countries to prevent default on foreign bank loans. In recent experience, the money has often been used to pay off foreign banks and domestic financial institutions, adding to the debt burden that local taxpayers must repay. The countries are often left in deep depression. Mexico in 1995, Thailand and Korea in 1998 are the clearest examples.

Five factors go a long way toward explaining why there have been so many large financial and foreign exchange crises in developing countries during a long period of sustained growth and development in the world economy: weak banks, government interference and direction of lending (part of crony capitalism), a large volume of misdirected bank lending, domestic government and IMF bailouts to protect foreign lenders and domestic oligarchs, and fixed exchange rates.

The challenge is to reduce the costs of the present system while retaining the benefits for economic development of international lending and capital movements. Restricting capital outflows, as Malaysia recently did, penalizes economic development. Lenders don't invest in countries that take that road.

Economists recognized long ago that fixed exchange rates, free capital movements, and domestic monetary policy are an unstable combination. One solution would let exchange rates between currencies float freely. Lenders would then either bear more risk or pay the cost of shifting it to others. Well-run central banks could sustain domestic stability by offsetting the effects of capital inflows and outflows on domestic prices and output.

Freely floating exchange rates are an entirely feasible, and some would say desirable, solution. But with floating exchange rates, prices of imported and exported goods and services change frequently, both up and down. Many producers, importers and exporters do not want to be exposed to frequent price changes, so governments often prefer managed floating and fixed, but adjustable, exchange rates to fluctuating rates. Further, countries seeking to end inflationary monetary policies often fix their exchange rate to signal the change in regime. Economists' exhortations, based on long-term benefits for financial stability, which favor either permanently fixed or freely floating rates, have little impact. We expect the mixed system of "dirty" floating and fixed but adjustable rates to continue.

Banking Safety

In a world of that kind, there will continue to be two types of countries--those with relatively sound well-managed financial systems and those without. The role of the restructured international lender that replaces the current IMF should be (1) to serve as lender of last resort to countries with sound financial systems while (2) providing incentives for strengthening financial systems elsewhere. Rather than continue to participate in financial bailouts, the new IMF should maintain incentives that avoid banking crises and the accompanying severe losses to borrowing countries and their citizens.

We propose that the restructured IMF would limit membership to countries that meet certain standards of conduct. The decision to adopt the standards would be left to each country but, of course, countries that wish to join the system would have an incentive to adopt the standards.

The standards would be simple and easily verifiable. First, all domestic commercial banks would have to keep part of their liabilities in uninsured debt. The owners of the debt would bear the risk of bank default, so they must be non-government entities--preferably foreign banks and institutional investors. Their function would be to monitor the bank's decisions and share the risk of failure with owners of the bank's equity. Hence, they would have incentives to demand prudent policies.

Second, depositors would continue to be insured, as in fact they are in almost all countries. Deposit insurance raises some problems, but its absence raises the much larger problem of bank runs and destruction of the payments system. Further, explicit deposit insurance has several advantages including the opportunity to charge for the service and strengthen prudential regulation.

Third, countries would be required to open their financial markets to competition from abroad. Foreign banks domiciled in the country would provide competition, improve standards of performance, and train local personnel. In the event of a problem or crisis, they would be protected by their parents, so they would contribute stability and enhance safety. Further, their domestic loans would be a small part of a diversified portfolio of loans to many countries. Diversification is an effective means of reducing risk.

The three elements of this system are not novel. Some variant of each of them is accepted practice in several countries now. Chile and Argentina have in place requirements for uninsured debt finance. A broad consensus, including the Bankers Roundtable, several Presidents of Federal Reserve Banks, and some members of Congress advocate a similar requirement for the United States.

Many Latin American countries have opened their markets to foreign banks. Approximately half of Argentine deposits are now held by such banks, and foreign banks operate successfully in Mexico, Brazil and elsewhere. Moreover, the World Trade Organization's financial protocol requires free trade in financial services, achieved over the next decade. Our proposals would strengthen countries' incentives to open their financial markets sooner.

Many other rules could be added in the interest of solvency. Our aim is to have few, transparent, and verifiable conditions for membership in the new IMF. We rely on incentives and competition to lead bankers toward more prudent behavior. Market discipline provides incentives for banks and their debt holders to improve transparency, adopt effective bankruptcy codes and develop rules for contract enforcement.

Governments can accelerate the process of improvement by adopting accounting standards that increase transparency and provide uniform measures of profit and loss. But accounting rules and legal restrictions are of little use if no one has an incentive to use them or enforce them. Market competition is a lever that raises standards because prudent lenders are more secure and better able to service their customers without interruption.

Historically, when banks faced market discipline, they were far more resilient in the face of shocks. Banks responded to losses by reducing asset risk or raising capital. By increasing their cash holdings and cutting dividends to stockholders, they tried to reassure depositors that the bank's losses would not result in depositors' losses. When discipline is absent, however, banks have opposite incentives. Initial losses are followed by increases in bank risk taking. Failing U.S. savings and loans in the 1980s increased risk, gambling to achieve high profits but instead taking large losses. Losses on risky investments were shifted to taxpayers via the deposit insurance system. In Japan, Korea and elsewhere, risks were increased both to continue supplying credit to borrowers favored by bankers or the government and to increase profits. Failures were borne by the taxpayers, as in the United States.

The taxation of ordinary citizens to pay for bank bailouts can wipe out the savings of a generation. Losses in excess of 20% of GDP are not uncommon in Asia today or in Latin America earlier. Japanese banks will cost taxpayers 20 to 30% of GDP.

Our proposal seeks to eliminate or reduce the size of bank bailouts. Banking reform is one step. Reform of international lending is the other.

Rules for International Institutions

Banking system insolvencies and improper government policies, not unwarranted speculative attacks on exchange rates, are among the principal reasons behind currency instability and financial failure. The IMF adds to the problem by lending directly and arranging loans to foreign banks. The ultimate cost is borne by local taxpayers.

Prior to 1987, the IMF would not lend until borrowers worked out agreements with private foreign creditors. This forced debtors to negotiate in good faith with their creditors. Since 1987, the IMF has often been a lender of first resort, offering loans before debtors and creditors reach agreement. One consequence is that its programs are now much larger than before.

Since foreign banks did not suffer losses in Mexico, they did not believe they were taking big risks in Asia and Russia. Bankers reasoned that if Mexico was important enough to the U.S. Treasury and the IMF that the banks had to be spared, Korea and Russia were at least as important. Many lenders believed that the 50% or 100% rate of interest on loans to Russia was close to a free ride because the U.S. and the IMF would not let Russia default.

We now know these judgments were wrong in the case of Russia. International lending has declined, as lenders have lost money and become much more cautious.

Our aim is to restore international lending while avoiding excessive risk taking leading to financial bailouts and severe depressions, as in Mexico, Thailand, Indonesia, Korea, and Russia. The new IMF would avoid both the problem of excessive risk taking, followed by collapse, and the risk of a protracted reduction in capital flows to developing countries.

More than a century ago, a British economic journalist, Walter Bagehot, set out the classical principles for a central bank acting as lender of last resort: lend freely in a crisis at a penalty rate against collateral. Adapted to international lending, Bagehot's rule is the proper rule for a restructured, more effective, IMF.

There are two major differences from current IMF programs. First, until this year, the IMF lent at below market rates of interest, in effect subsidizing borrowers and encouraging delayed repayment. We propose that lending be done at a penalty rate, a rate above the market rate on the borrower's collateral. A penalty rate encourages the borrower to negotiate with private creditors, at (lower) market rates. The IMF would lend mainly when there is a liquidity crisis, that is when private lenders are unwilling to lend. That is precisely the responsibility that a lender of last resort should fulfil.

Second, currently the IMF does not require collateral to guarantee repayment. Collateralized lending separates insolvent from illiquid borrowers. Requiring collateral for loans encourages countries to maintain liquid assets to be used in a crisis, thereby reducing the chance that a banking crisis will occur.

IMF lending would be restricted to member countries that adopt prescribed banking standards and present collateral. A large part of the collateral would consist of negotiable foreign bonds. The balance would consist of other items. For example, to guarantee its loan from the U.S. Treasury in 1995, the Mexican government pledged its receipts from oil sales. These receipts were deposited at the New York Federal Reserve Bank until the debt was repaid. Collateral could also include other dollar-denominated assets owned by the borrowing country's central bank.

If it followed this rule, the IMF would not bail out insolvent banks or banking systems in the guise of protecting the liquidity of member governments faced with a run on their currency. Unlike the present system, the IMF would not impose conditions on the borrowing country, other than membership rules and collateral requirements. Countries would be free to adopt the economic policies of their choice. Private lenders, knowing that they would not be bailed out without loss, would have an incentive to scrutinize more carefully the policies of countries to which they lend.

Collateralized lending has other substantial benefits. As we have noted, debtor countries would strengthen their financial position by holding collateral in case of a crisis. Since borrowing arrangements would be fixed in advance, countries would avoid the weeks or months of negotiation during which the Mexican, Indonesian, and Korean crises became more severe and more costly to local populations.

To finance its lending, member governments would contribute marketable bonds to the IMF. These bonds could be sold in the market or to central banks in hard currency countries to obtain the balances lent to countries facing a liquidity crisis. The IMF would be allowed to borrow, against collateral, from central banks in countries with internationally accepted monies. The central banks would lend risklessly at a market rate against collateral. They would be free to offset the effect of the borrowing on their own interest rates and economic activity.

All currency crises are not banking crises. Indeed, our plan separates the two by requiring countries to develop and maintain prudential standards. As the number of IMF member countries increases, banking crises would become less frequent. Currency crises may continue but they would be less costly because banking systems would be much more stable.

Other Foreign Assistance

Two other changes would be a necessary accompaniment of our program. Congress should abolish the Exchange Stabilization Fund, a remnant of the 1930s. The World Bank should be restructured to concentrate on long-run assistance to spur economic development. It should not participate in, or compete with, the IMF as a source of emergency lending.

Originally intended to support the dollar exchange rate after the 1934 dollar devaluation, the Exchange Stabilization Fund has become an off-budget slush fund that the Treasury uses to make foreign loans. The appeal of the Stabilization Fund to the Treasury and the administration is that they avoid the Congressional appropriation process. They obtain funding, in part, by a complex arrangement called "warehousing", under which the Treasury borrows from the Federal Reserve.

Closing the Exchange Stabilization Fund would require the administration to use the normal Congressional budget process. Foreign assistance, like foreign aid, could only be done with Congressional approval and oversight.

One of the IMF's most costly mistakes was to accept responsibility for lending to Russia. It had no previous experience and no special expertise in restructuring a non-market economy. It was unable to enforce the lending conditions it imposed. And, because it was committed to "successful transformation," it was reluctant to withhold its loans.

Transformation lending to Russia took the IMF, with the support and encouragement of the G-7 governments, far beyond its mandate and experience. The Russian default is a principal reason for recent financial turbulence and the large losses borne by banks and financial institutions in many countries.

A restructured IMF would have been prohibited by its charter, and the conditions of membership, from lending to Russia. This was foreign aid that should have required approval by the individual G-7 parliaments. The IMF and World Bank should not become the means of circumventing parliamentary oversight and appropriations.

Conclusions

The IMF has responded to recent financial crises and its past failures by proposing increased transparency, better, more timely release of information, and better surveillance and supervision.

These suggestions are useful but inadequate to correct the problems in international monetary arrangements. Government supervision and accounting standards do not prevent failures. Supervision did not alert the British government to the problems at BCCI or prevent the failure of U.S. savings and loans. Banking history provides many other examples.

The reason is clear. Unlike uninsured private market creditors, government supervisors lack both the incentives and the ability to enforce prudential standards. Supervisory failures of the U.S. savings and loan system and the banking systems of Mexico, Japan, Thailand, Korea, Indonesia and many other countries resulted from forbearance--the unwillingness to use available information in a timely way.

Our proposal anticipates greater future reliance on fluctuating exchange rates. In countries with fixed exchange rates, we rely on market processes, incentives, diversification, and competition to improve safety and soundness. Better information and supervision help these processes to work, but they are complements, not substitutes for market discipline.

By eliminating IMF discretion over the circumstances under which lending occurs, and the conditions and terms of that lending, we propose to end discretionary interventions by the IMF to distribute emergency foreign aid to insolvent governments and financial institutions as part of a bailout plan.

It is easy to construct examples of potentially beneficial emergency foreign aid using complicated economic models to show that, in some circumstances, the benefits exceed the costs. The IMF often justifies its actions as a means of preventing crises from spreading to other countries. This argument has some merit. A crisis in one country calls attention to unwise policies and weak financial systems elsewhere. Global lenders suffer losses, so they may restrict credit to solvent borrowers in other countries.

The solution does not lie in rescuing foreign lenders. That encourages continued imprudent behavior. A better solution is to give countries incentives to reform their financial structures and improve their policies to make them less vulnerable to contagion. Markets may err for a time, unable to promptly distinguish solvent from insolvent borrowers and more risky from more secure loans. These errors do not persist for long.

In our view, history teaches that misaligned incentives, not inherent financial fragility and unavoidable externalities, are the primary source of insolvency crises in the world today. Government safety nets and IMF bailouts are a major part of those incentive problems. We believe it is possible to correct these core incentive problems by constructing a world financial system subject to market discipline, with fewer and smaller liquidity crises, so we favor giving up the IMF's discretionary authority to channel foreign aid.

Although our proposal would prevent the IMF from ad hoc foreign assistance to the insolvent, other mechanisms would still exist as means to solve the problems of insolvent financial systems. Bankruptcy laws that delineate loss sharing rules are the answer to insolvency problems in financially developed economies. They would have evolved much faster in underdeveloped economies if IMF-orchestrated bailouts had been absent over the past twenty years.

At first glance, our proposal for a committed lender of last resort may appear similar to President Clinton's call for an IMF credit on which countries can draw before a crisis occurs. Differences are substantial. First, the President proposed an additional IMF function, not a substitute for current IMF programs. Second, the administration has not specified how access to the new credit line would be determined. Third, the administration has not recognized the need to restrict IMF lending so as to avoid financial bailouts. In contrast, we envision a new IMF that provides elastic and immediate liquidity to member countries that share a commitment to sound financial practices.

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