

58. International Financial Crises and the IMF

Congress should

- reject additional funding requests for the International Monetary Fund;
- close down the Exchange Stabilization Fund at the U.S. Department of the Treasury;
- avoid giving the IMF new missions, including that of economic surveillance; and
- withdraw the United States from the IMF.

Since the \$30 billion bailout of Mexico in 1995, national-currency and financial crises in developing countries have increased, as has the incidence of IMF-led bailout packages (Figure 58.1). Since 1997 those packages have totaled about \$140 billion for Asia and Russia alone. Those bailouts and the continuing turmoil in international financial markets resulted in urgent requests for a massive increase in the IMF's resources. For the United States, the added contribution was \$18 billion, which U.S. Treasury officials disingenuously claimed did not cost U.S. taxpayers a dime even as those officials pleaded for more money. Cato Institute chairman William Niskanen, former head of President Reagan's Council of Economic Advisers, puts the U.S. relationship with the IMF more accurately: "U.S. government membership in the IMF is like being a limited partner in a financial firm that makes high-risk loans, pays dividends at a rate lower than that on Treasury bills, and makes large periodic cash calls for additional funds."

But the monetary costs of supporting the IMF were not the most important reasons to have opposed more funding. The costs to the global economy are high, and 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

Figure 58.1
Total IMF Credit Outstanding



a liberal global economy, then, at the very least, rich countries should deny further funding for the IMF.

Free-market economists have long been critical of the IMF. Mexico-style crises may have brought much attention to the fund in recent years, but the lending agency's record over the past 50 years has been dismal, as numerous books and studies have documented. The IMF does not appear to have helped countries either to achieve self-sustaining growth or to implement market reforms.

Despite its poor performance, the IMF has proven to be a remarkably resilient institution. When the system of fixed exchange rates ended in the early 1970s, so did the agency's original mission of maintaining exchange-rate stability by lending to countries experiencing balance-of-payments problems. Instead of closing down, however, the fund has created new missions for itself with each new crisis, each time expanding its economic influence or resources, or both. Those episodes included the oil

crises of the 1970s, the Third World debt crisis of the 1980s, the collapse of communism, and now, Mexico-style crises.

Although the IMF in theory makes short-term loans in exchange for policy changes in recipient countries, it has not helped countries move to the free market. Instead, the fund has created loan addicts. Through 1998, 19 nations had been relying on IMF aid for at least 30 years; 31 countries had been borrowers for between 20 and 29 years; and 36 countries had been using IMF credit for between 10 and 19 years. That is not evidence of either the success of the fund's so-called conditionality or the temporary nature of the fund's short-term loans.

Increased funding for the IMF will be used to finance a new fund, known as the New Arrangements to Borrow, which will function as a special bailout fund for countries in crisis, and to generally increase resources, which of course will also be used for bailouts. Using the IMF to bail out a country experiencing a currency or debt crisis is a bad idea for three reasons.

Moral Hazard

The first reason is that it creates moral hazard. That is, the more the IMF bails out countries, the more we can expect countries to slip into crises in the future because governments and investors will engage in risky behavior in the expectation that, if anything goes wrong, the IMF will come to their rescue. That is a major point recognized by both supporters of increased funding, such as U.S. Treasury secretary Robert Rubin and Bundesbank president Hans Tietmeyer, and those who have been opposed to additional money.

Moral hazard at the international level is not new. With every election cycle in the past 20 years, for example, Mexico has experienced a currency crisis caused by irresponsible monetary and fiscal policy. Each episode has been accompanied by U.S. Treasury and IMF bailouts, each time in increasing amounts. In Mexico, everybody has come to expect a financial rescue at the end of each presidential term. And although IMF and U.S. officials have proclaimed the 1995 Mexican bailout a success, its legacy has been the Asian crisis of today—at least in its severity. Indeed, the bailout of Mexico was a signal to the world that, if anything went wrong in emerging economies, the IMF would come to investors' rescue. Moral hazard helps explain the near doubling of capital flows to East Asia in 1995 alone.

Governments in Asia were not discouraged from maintaining flawed policies as long as lenders kept the capital flowing. Lenders, for their part, 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 if a crisis erupted, but it led to the mispricing of risk and a change in the investment calculations of lenders. Thailand, Indonesia, and South Korea, after all, shared some common factors that should have led to more investor caution but did not. 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. As Michael Prowse of the *Financial Times* commented after the Mexican bailout, "Rubin and Co. wanted to make global capitalism safe for the mutual fund investor. They actually made it far riskier."

The facts that governments would never choose to lead their countries into crises and that national leaders have been replaced after such crises are often cited as evidence that moral hazard is not a problem. In fact, moral hazard operates in a different way, as economist Allan Meltzer explains. "A country may find it necessary to choose between offering guarantees to foreign lenders and facing large withdrawals of foreign loans. . . . When the government offers the guarantee, it believes the default risk is manageable or bearable. . . . It is not necessary for the government to plan a debacle; the debacle is one possibility. . . . A finance minister faced with this choice will almost always prefer to avoid the crisis now, at the risk of a future larger crisis." The moral hazard arises when there is "the opportunity to take a (possibly small) risk of a later crisis instead of a certain, smaller, current crisis."

Moral hazard also exists at the national level, where governments explicitly or implicitly guarantee that they will rescue domestic banks, thus encouraging risky bank behavior. The proliferation of government-subsidized risk since 1982 has led to 90 severe banking crises in the developing world, and the bailout costs in 20 of those cases have ranged between 10 and 25 percent of GDP. In a world of increasingly liberal capital flows, IMF bailouts only encourage governments to maintain flawed arrangements and foreign lenders to keep lending to those governments. Thus, even in countries whose monetary and fiscal policies appear conservative, crises

can break out as malinvestment and the need to pay for bailouts become evident. The claim that markets react irrationally in countries whose macroeconomic fundamentals are sound ignores the liabilities governments face under those conditions—a factor markets take into account.

Still, advocates of the IMF argue that it must lend to prevent a “contagion effect” in other countries. The fund has thus provided bailouts to countries after economic crises have occurred (e.g., Mexico and Thailand) and before potential crises (e.g., Indonesia and Russia). Neither timing has successfully prevented future financial turmoil. Countries that have succumbed to financial crises have done so because of poor domestic policies; countries that do not maintain poor policies have not suffered from so-called contagion. The real contagion effect is not what IMF proponents typically have in mind, but rather that of future crises encouraged by the bailouts themselves.

An Expensive, Unjust Solution

IMF bailouts of Asian countries are expensive, bureaucratic, and fundamentally unjust solutions to currency crises. In the first place, the financial aid cuts investors’ losses rather than allowing them to bear the full responsibility for their decisions. Just as profits should not be socialized when times are good, neither should losses be socialized during difficult times. “The \$57 billion committed to Korea,” Harvard economist Jeffrey Sachs observes, “didn’t help anybody but the banks.” Unfortunately, ordinary Asian citizens who had nothing to do with creating the crisis will be forced to pay the added debt burden imposed by IMF loans.

IMF bailouts pose another burden on ordinary citizens because the bailouts don’t work very well. The fund’s money goes to the governments that have created the crises 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 governments to change their policies. Suspension of loans will tend to concentrate the minds of policymakers in the various troubled countries. The reason, after all, that there is any talk today of market reform is not that the IMF has shown up and suggested that it is a good and necessary thing. Economic reality is forcing the long-needed change. To the extent that the IMF steps in and provides money, reform will not be as forthcoming. Thus, the citizens of recipient Asian nations suffer the added burden of IMF intervention.

Not only do they have to pay a greater debt, they also have to suffer prolonged economic agony that is produced by the fund's bailouts.

But what about the fund's "strong conditionality"? Don't the strict conditions of IMF lending ensure that important policy changes will be made? Again, the record of long-term dependence of countries shows that conditionality has not worked well in the past. But besides the fund's poor record, there is good reason why IMF conditions have little credibility. As we have seen with Russia over the past several years, a country—especially a highly visible one—that does not stick to IMF conditions risks having its loans suspended. When loans are cut off, recipient governments tend to become more serious about reform. Note that the IMF encourages misbehaving governments to introduce reforms by cutting loans off; it is the *cutoff* of credit that induces policy change.

Unfortunately, when policy changes are forthcoming, the IMF resumes lending. Indeed, the IMF has a bureaucratic incentive to lend. It simply cannot afford to watch countries reform on their own because that would risk making the IMF appear irrelevant. The resumption of financial aid starts the process over again and prolongs the period of reform. The fund's pressure to lend money in order to keep borrowers current on previous loans and to be 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, which makes the fund's conditionality that much less credible. It is telling that the conditions of the IMF's \$11.2 billion loan to Russia, approved in July 1998, were virtually identical to those of previous loan packages totaling more than \$20 billion in 1992, 1993, 1994, 1995, and 1996.

Undermining Better Solutions

Third, IMF bailouts undermine superior, less expensive market solutions. In the absence of an IMF, creditors and debtors would do what creditors and debtors always do in cases of illiquidity or insolvency: renegotiate debt or enter into bankruptcy procedures. In a world without the IMF, both parties would have an incentive to do so because the alternative, to do nothing, would mean a complete loss. Direct negotiations between private parties and bankruptcy procedures are essential if capitalism is to work. As James Glassman has stated, capitalism without bankruptcy is like Christianity without Hell. IMF bailouts, unfortunately, undermine one of the most important underpinnings of a free economy by overriding the market mechanism. There is simply no reason why interna-

tional creditors and borrowers should be treated any differently than are lenders and debtors in the domestic market.

Governments would also react differently if no IMF interventions were forthcoming. There would be little alternative to widespread and rapid reforms if policymakers were not shielded from economic reality. Lawrence Lindsey, a former governor of the U.S. Federal Reserve, who is opposed to bailouts, has noted, for example, “All of the ‘conditions’ supposedly negotiated by the IMF will be forced on South Korea by the market.” Of course, there is always the possibility that a government would be reluctant to change its ways under any circumstances; but that is a possibility that is larger, and indeed has become a reality, under IMF programs.

The IMF as a Lender of Last Resort and Surveillance Agency?

Many people who recognize the practical problems of IMF bailouts, including moral hazard, questionable policy advice, and the difficulty of enforcing conditions, still believe that the IMF is needed as an international lender of last resort. Yet the IMF does not perform that function now, nor can it. A true lender of last resort provides funds at a penalty rate to solvent banks that are temporarily threatened by panic, thereby containing financial turmoil. By contrast, the IMF provides subsidized funds that bail out insolvent financial institutions, thereby discouraging much-needed bankruptcy proceedings and corporate restructuring. The IMF cannot act quickly or create money as can true lenders of last resort. Countries that experience threats to their financial systems can rely on their own central banks as lenders of last resort. That includes the United States, where the Federal Reserve is charged with such a mission. The Fed’s failure to perform that mission earlier this century—not the absence of an international lender of last resort—led to the Great Depression. It is highly improbable that the Fed would repeat the same monumental policy mistakes today.

Others have recommended that the IMF strengthen its role as a watchdog agency that provides an “early warning” of potential financial troubles. Yet it is unclear how a warning mechanism would work. As economist Raymond Mikesell asks, “Who would be warned and when? As soon as the financial community receives a warning that a country is facing financial difficulty, a massive capital outflow is likely to occur, in which case crisis prevention would be out of the question.”

On the other hand, if the IMF perceives serious financial difficulties in a country and does not disclose that information, then it undermines its credibility as a credit-rating agency for countries. That appears to have been the case in Thailand, where the IMF now claims it issued warnings about the economy before the crisis erupted but kept those concerns confidential. The fund's credibility is further undercut by inherent conflicts of interest: in many cases, it would be evaluating countries in which it has its own money at stake; in all cases, it would be evaluating countries that, as member-owners of the IMF, have contributed to the fund's pool of resources. Only by ceasing to lend could the agency increase its integrity. At that point, however, its evaluations would merely replicate a service already available.

The Exchange Stabilization Fund

The executive branch has also used a little-known account, the Exchange Stabilization Fund, at the Treasury Department to circumvent Congress in providing foreign aid. Originally set up in 1934 to stabilize the value of the dollar, the ESF has since been used to prop up foreign currencies and economies. Most recently, it has been used as a bailout fund for countries in crisis. In 1995 the ESF made a \$12 billion loan, its largest, to Mexico; it has since made available billions of dollars more to South Korea, Thailand, Indonesia, and Brazil.

The ESF should be closed down because its bailout function suffers from the same defects that afflict the IMF: it creates moral hazard, delays reforms, and precludes superior market solutions to financial crises. Moreover, the ESF is an undemocratic institution since it is exempt from legislative oversight and its transactions, under the sole discretion of the executive branch, are secretive. Economist Anna Schwartz finds that the ESF failed even in its original mission, having “always been wasteful and ineffective at controlling the relative price of the U.S. dollar.”

Conclusion

Crises in Mexico, Asia, and elsewhere have occurred because of flawed domestic policies. Bailouts by the IMF or the U.S. Treasury only encourage further crises and aggravate current ones. At a time when the world is moving toward the market, the bureaucratic response to government-induced financial turmoil makes matters worse. The market is far more effective in enforcing conditions, promoting reform, and minimizing the

risk of a crisis spreading in the near term or far into the future. The United States and other major donors should reject further funding for the IMF and in that way vote for a more stable and free global economy. That would send a signal to the world that the fund's resources are not, in fact, unlimited. Beyond that, the United States should help the world's poor by withdrawing from the IMF.

Suggested Readings

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