

Why We Should Say No to the IMF

On February 12 the Cato Institute held a Policy Forum, “Why We Should Say No to the IMF.” The speakers were Sen. Lauch Faircloth (R-N.C.); Allan H. Meltzer of Carnegie Mellon University; and Ian Vásquez, director of the Cato Institute’s Project on Global Economic Liberty. Excerpts from their remarks follow.

Lauch Faircloth: Before I begin, I would like to thank the Cato Institute for the great work it has done in exposing the problems with the International Monetary Fund.

I’m sure all of you are familiar with the bailouts of South Korea, Indonesia, and Thailand. But I don’t know if you realize that those bailouts are possibly the beginning of something much larger. In my opinion, we are witnesses to the dawning of a new era of international bailouts. Today we have South Korea, Indonesia, and Thailand. But what about tomorrow? Will we bail out Russia, Brazil, or China? Although things are getting better in those countries, all three are in quite bad shape. If the IMF is going to send money to South Korea, why not send it to Russia as well?

In the West we praise the free market, but we no longer have a free market in international finances. The legacy of the Clinton administration is what I like to call the “Rubin Doctrine.” Simply put, the Rubin Doctrine says that in developing countries we ought to privatize profits and socialize losses. That is a recipe for disaster, and it is unjust.

The Rubin Doctrine was implemented during the Mexico peso crisis of 1995. The price of that supposed one-time rescue has been very great, because it set a very expensive precedent. By bailing out Mexico, we essentially told people in developing countries that they need not worry about engaging in risky financial practices. If businesses fail or loans are unpaid, taxpayers in developed countries will clean up the mess and pick up the bill. In short, I would argue that our actions toward Mexico encouraged unsound business decisions in Asia and, in many respects, laid the foundation for the Asian crisis.

Unfortunately—and please excuse me for a slight digression—we see the same thing



Sen. Lauch Faircloth: The Mexican bailout led to the Asian crisis

happening at the micro level in the United States. We have had a 300 percent increase in bankruptcies in this country since 1980. People are not required to work out their problems with creditors. Instead, you can simply declare bankruptcy. What bankruptcy now amounts to is saying, “Excuse me” and then starting over. What we did in Mexico—and what we are doing in South Korea, Indonesia, and Thailand—is essentially the same. The governments of those countries are shouting “bankruptcy,” and we are going to rush in with funds before any attempt is made to work out the problems with creditors.

In the wake of the Mexican crisis, Robert Rubin and the IMF conceived of the idea—an all-time bad one—of establishing a new fund that would be used exclusively for bailouts of failing economies. The problem with that “solution” is that it does nothing to prevent future problems from occurring. It only creates a pot of money that is available for future bailouts. And when you have a pot of money at the ready, you encourage people to use it, either directly or as an insurance fund.

I am convinced that the IMF is more interested in perpetuating itself and creating a constant need for its existence than in truly aiding developing countries. The IMF has no interest in seeing any developing country become debt free, or developed for that matter.

So where do we go from here? The Clinton administration is asking Congress to

appropriate \$18 billion for the IMF. Does the IMF need more money? Absolutely not. Congress has a choice. It can link arms with the Treasury Department and continue down the bailout road, or it can correct the course. Congress can set its own policy and avoid future bailouts. I do not believe, and I speak as just one senator, that Congress will appropriate the full \$18 billion that the IMF is requesting. More fundamentally, Congress should demand that the IMF reform itself immediately.

Let me suggest some much-needed changes that should be made. First, the IMF should be required to develop a plan to reduce or eliminate all of its loans over a 5- or 10-year period. Second, the IMF should be charged with obtaining the following from each country: full fiscal transparency, open markets, and an end to crony capitalism. Third, the G-7 nations should develop an international bankruptcy code. Fourth and finally, we should think about new leadership at the IMF.

I would like to see the IMF eliminated. But, at the minimum, Congress should demand serious structural reforms that would bring an end to the IMF’s failed bailout policies.

Allan H. Meltzer: Let me begin by stating a fundamental truth: capitalism without failure is like religion without sin. It doesn’t work. Bankruptcies and losses, even the threat of bankruptcy, concentrate the mind on prudent behavior. Prudence was the missing element in the Mexican crisis of 1995, as it is in the Asian crisis of today. In its absence, bankers and other lenders take excessive risks. They have no incentive to learn about the number of outstanding loans, how much borrowers have borrowed short to lend long, or how much currency risk has been assumed. The lenders don’t care much, because they collect no matter what happens.

The IMF’s programs contribute to the large wedge between the social risk—the risk borne by the troubled country—and the private risk borne by bankers. That is one source of moral hazard, and one reason we have a crisis-prone system. A common rebuttal to my claim is that Mexico repaid its loans to the U.S. government and the IMF. But that

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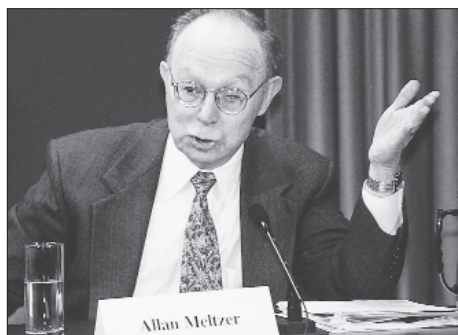
“Capitalism without failure is like religion without sin. Bankruptcies and losses concentrate the mind on prudent behavior.” —Allan H. Meltzer

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argument misses the point. If banks and financial institutions had taken losses in Mexico, they would have exercised elementary judgment about risks in Asia.

Some bankers and Treasury officials defend more money for the IMF by citing loans to Mexico as a success for U.S. Treasury-IMF intervention. That is an extraordinary claim. It looks only to the repayment of the loan, achieved mainly by borrowing abroad. It ignores the effect on the Mexican economy.

Consider the record. The U.S. Treasury



Allan H. Meltzer: IMF bailouts increase the risk of future crises

and the Federal Reserve have been “helping” Mexico since the 1930s. The IMF has been at it since the 1970s. Successive Mexican governments have learned that if they face a crisis, one or both of those institutions will lend them money to make the immediate crisis appear less onerous. Investors have learned that they get bailed out, so they continue to invest. I believe that goes a long way toward explaining why Mexican policy has been erratic and undisciplined at times. The Bank of Mexico and the government take excessive risks and incur large losses for Mexican taxpayers.

The results have been disastrous for the Mexican economy and people. Despite enormous growth in the world economy in the past 20 years, Mexican real income was the same in 1996 as in 1974. The Mexican people have been on a bumpy road to nowhere. In the same period Mexican debt in constant dollars increased from \$40 billion to \$160 billion. Much of that is the price Mexico paid for U.S. and IMF assistance. Without the IMF and the U.S. Treasury, Mexico would

have pursued better policies, would have accumulated less debt, and, I believe, would have made more progress.

It is frequently asserted that moral hazard is not a problem because no government chooses to subject its economy and its people to the type of losses Latin America experienced in the 1980s, Mexico witnessed in 1995, and Asia faces now. I believe that is true but irrelevant. The issue does not arise in that way.

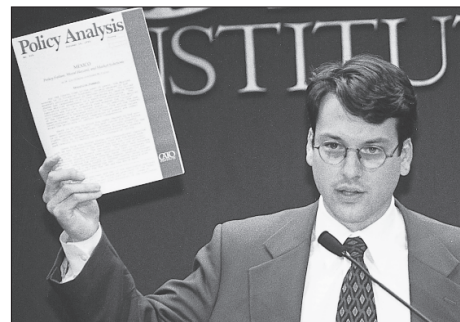
A country may find it necessary to choose between offering guarantees to foreign lenders and facing large withdrawals of foreign loans. Mexico, Korea, and other countries have faced precisely that choice. The government may choose to guarantee the loans by issuing dollar-denominated securities, such as the Mexican *tesobonos*, or by promising to accept responsibility for private debts denominated in dollars, as the Korean government did. When the government offers the guarantee, it believes the default risk is manageable, just as the U.S. government believed that the risk in the savings-and-loan system was manageable. It is not necessary for the government to plan a debacle; a debacle is always a possibility. A finance minister faced with such a choice will almost always prefer to avoid the crisis now, at the risk of a larger future crisis.

The opportunity to take the (possibly small) risk of a later crisis instead of a certain, smaller, current crisis is the second source of moral hazard. To reduce the risk of future crises, it is necessary to reduce the chances of a finance minister’s having to make the choice I described.

IMF and U.S. Treasury lending to Asian countries continues that dangerous process. It has increased the risk of large future crises. Too much of the world has become “too big and too indebted to fail.” Neither the IMF, nor the development banks, nor the U.S. and Japanese governments can pay for all the errors, mistakes, and imprudent actions they help to create.

“Too big to fail” was a flawed idea when applied to U.S. savings-and-loans and to Swedish, Japanese, Latin American, and other banks. It is no less flawed when applied to U.S., Japanese, and European banks and financial institutions that have lent in Asia.

Secretary Rubin was right when he said



Ian Vásquez: The IMF uses crises to expand its influence

in September 1997, “What we don’t want to have is a situation where people can do unwise things and not pay a price.” But that is the system that he and the IMF have created and sustained.

Ian Vásquez: The IMF has a dismal record of helping poor countries achieve self-sustaining growth or, for that matter, helping poor countries introduce market-oriented reforms. Despite its performance, the IMF has proven to be a remarkably resilient institution. For example, when the pegged exchange rate system ended in the 1970s, so did the original mission of the IMF. But the IMF has used successive world crises—such as the “oil crisis” of the 1970s, the Third World debt crises, the collapse of communism, and, most recently, Mexican-style crises—to expand its influence and resources.

In theory, the IMF makes short-term loans in exchange for policy changes. But that has not helped countries move to the free market. Instead, a review of IMF loans reveals that the IMF has created loan addicts. Cato has found that 11 nations have been relying on IMF aid for at least 30 years, 32 countries have been borrowing for between 20 and 29 years, and 41 countries have been using IMF credit for between 10 and 19 years. That record leads one to be highly skeptical of the “conditionality” or “temporary nature” of the IMF’s short-term loans.

In the case of Mexican-style bailouts, I have three objections to IMF intervention. The first one, which has been mentioned by the previous speakers, is the moral hazard problem. It is not a small detail. We’ve seen moral hazard in the past and we’re seeing it

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New staff in development, government affairs

William Niskanen, José Piñera Honored

Cato chairman William A. Niskanen has been selected as president of the Public Choice Society. Previous presidents have included Nobel laureate James Buchanan, Gordon Tullock, and Mancur Olson. Niskanen has published numerous works on public choice theory, including the acclaimed 1971 book *Bureaucracy and Representative Government*. Later this year Edward Elgar will publish *Policy Analysis and Public Choice: Selected Papers by William A. Niskanen*. The book will be divided into two sections. The first will detail Niskanen's contributions to public policy analysis and include essays on defense spending, trade policy, crime and drug policy, and welfare and the culture of poverty. The second section, addressing public choice and political economy, will feature essays on the liberal economic order, progressive taxation, and bureaucracy.

◆ José Piñera, co-chairman of the Cato Project on Social Security Privatization, received the Liberty Award for Opportunity from Americans for Hope, Growth and Opportunity at a dinner at the Waldorf-Astoria in New York on April 15. Piñera, the architect of Chile's privatized pension system, was honored for showing "the way to unleash opportunity for all citizens to build

up a real nest egg for their retirement and strengthen the economy at the same time." More than 900 people attended the event, which was emceed by Cato Mencken Fellow P. J. O'Rourke.

◆ Executive vice president David Boaz's books *Libertarianism: A Primer* and *The Libertarian Reader* have been issued in paperback by the Free Press. In addition, a Japanese edition of *Libertarianism* will soon be published by Yosensha, and Blackstone will release an audiocassette version of the book later this year.



M. Christine Klein

◆ M. Christine Klein has joined the Cato Institute as director of sponsor relations. She will be the primary contact at Cato for Sustaining, Patron, and Benefactor Sponsors. She has previously been an attorney with the Richmond firm of McGuire, Woods, and Battle. Nicole Gray, former director of sponsor services, has left Cato to join School Choice Scholarships, a private voucher program in New York.



Nicole Gray



Peggy Ellis

◆ Derrick Max has joined Cato as director of government relations, with primary responsibility for liaison with the House of Representatives and the governors. He has worked at the American Enterprise Institute and the House Committee on Education and the Workforce, and most recently for Sen. Tim Hutchinson (R-Ark.). He replaces Peggy Ellis, who left to become director of congressional and public affairs for the Republican National Committee. ■



Derrick Max

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today. Mexico has experienced currency crises during every election cycle of the last 20 years because of its poor monetary and fiscal policies. In each crisis, the U.S. Treasury and the IMF have come to the rescue, with bailouts of increasing amounts. Had the IMF not bailed out Mexico in 1995, the Asian crisis of today would be far less severe.

The second reason I oppose IMF bailouts is that they are expensive, bureaucratic, and fundamentally unjust solutions to currency and debt crises. Just as profits should not be socialized when times are good, losses should not be socialized during difficult times. It is not just that citizens bear the debt burden that is attached to IMF loans. IMF bailout money goes to governments that have created the problems to begin with and have proven unwilling or reluctant to introduce

necessary reforms. Giving money to such governments helps to sustain bad policies and delays necessary reforms.

But what about strong conditionality? Allan suggested that conditionality has little credibility. I agree. Conditionality has not worked well in the past, as the record of long-term dependence shows. But besides its poor record, there's a good reason why the IMF's attempts to impose conditions have little credibility. A country that does not stick to IMF conditions risks having its IMF loans suspended. When loans are cut off, governments tend to become more serious about introducing reform. Note that it is the elimination—not the provision—of credit that induces policy changes. Unfortunately, once policy changes are forthcoming, the IMF feels the need to resume 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 all over again and prolongs the period of stagnation.

The third reason that I oppose IMF bailouts is that they 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 insolvency or liquidity: renegotiate their debts or enter into bankruptcy proceedings. Both parties would have an incentive to act because the alternative would mean a complete loss. There is no reason why international creditors and borrowers should be treated any differently than domestic lenders and debtors.

Congress should vote for a freer and more stable global economy by denying the IMF the funds it has requested for future interventions. Then it should begin considering whether the IMF serves any purpose at all. ■