

The Fund's Strategy

by

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It is a privilege and an honor to participate in this very important retreat to discuss the Fund's strategic direction. Management and directors of all institutions, private as well as public, have no more important duty than to decide periodically on answers to three questions. Where are we? Where are we trying to go? How can we get there from here? As a sometimes critic of international financial institutions, I am pleased to be asked to participate in trying to answer these questions, especially questions one and three. I accepted this invitation in the hope that we can conduct a dialogue about possible answers and their consequences including how we can get better arrangements that reduce risk, and if we can agree on what those arrangements are.

Where Are We?

Let's begin with the first question, where are we? The Fund's most important activity is to increase the stability of financial markets or, if crises cannot be prevented, to localize problems or crises and keep them from spreading to countries or markets that would otherwise be unaffected. This is a main duty of what I have called the service of a quasi lender-of-last-resort.

The word "quasi" is extremely important. Unlike domestic central banks or governments that serve as lender-of-last-resort, the Fund's resources are limited. Problems, or financial crises, become visible when a country's creditors conclude that a debtor country is, or with significant probability soon will be, unable to discharge its obligations denominated in convertible foreign currency. In the past, the size of the obligations was limited, and the Fund's resources were larger relative to the likely demands on those resources. The Fund could lend enough to manage the problem and prevent it from spreading to other countries.

By doing so, it provided a global public good, reducing risk and preventing the spread of crises. Unfortunately, that happy outcome is not the end of the story. Reduced risk encouraged more lending. IMF and other crisis assistance permitted private lenders to withdraw their funds to avoid losses. Lack of adequate information on the amount of indebtedness and the riskiness of debtor portfolios may also have encouraged lending. Growth in the size of private loans was followed by a large increase in Fund commitments in the 1990s. According to one report, Mexico in 1995 drew nearly 700 percent of its quota followed in 1997-8 by Korea at nearly 2000 percent and later by Argentina and Turkey. (James, 2004) These large loans raised issues about the viability of the system and the willingness of the principal member countries to provide resources of these magnitudes. That issue, about the size of Fund resources, remains.

A related consequence of the 1990s is that the debtor countries were left with large debts to the Fund, at concessional rates, while many private creditors escaped losses. I believe that a system in which private lenders charge substantial risk premia but do not bear the risk cannot, and should not, survive. In the recent past, the Fund has taken steps to change that system, for example in Argentina, and we are now in transition. The question is: Where are we headed? How do we reconcile large debtor liabilities and the Fund's limited resources? Will countries default on Fund loans? Will the Fund impair its credit rating by reducing the quality of its portfolio? Will private borrowers accept the Fund's preferred creditor status, if it does not bail out private lenders? (Lerrick, 2005)

Conditionality played a large part in the old system. To get loans, countries committed to major structural changes, and many others, at a time of crisis. Correspondence between commitments and actions has been the subject of considerable research. Some countries lived up to their commitments. Others did not. Sometimes the facts changed, and the commitments adjusted. Suffice it to say that evidence that commitments led to improved performance is not easy to establish for growth, inflation, unemployment, and other variables of interest. Of course the trade balance improved after the economy went into recession and foreign lending slowed or stopped.

When considering Fund conditionality as part of the *Report of the International Financial Institution Advisory Commission*, we came across a letter to your then Managing Director from Boris Feodorov, the Russian Finance Minister and Deputy Prime Minister. The letter asked the

Fund to stop sending money under the loan agreements because the money was being misused and commitments were not met. The Fund continued to lend.

This is one, extreme example. It raises a general question for the conduct of lending operations. Has the Fund been more eager to lend than the borrower is to borrow? Did borrowers expect that when the Fund imposed sanctions, for example stopped lending, it would soon after resume lending? How can debtor promises and commitments be enforced more fully? How can the Fund increase borrowers' incentives to honor commitments and reform? Without a system that supports stronger incentives for borrowers to reform, promises and conditionality will remain difficult to enforce.

The Fund was originally conceived as a supplier of foreign exchange to meet temporary current account deficits. With the passage of time, and changes in the international financial system, the Fund acquired new responsibilities. By the end of the last century, it had become for some countries a permanent or long-term supplier of capital. Four countries had been in debt to the Fund for more than 40 years, and 20 additional countries had been in debt for at least 30 years.

I believe the Fund has taken steps to reduce continuous borrowing. But it has also expanded longer-term programs like the PRGF (Poverty Reduction and Growth Facility). To an outsider, the PRGF overlaps programs run by the development banks. If the development banks were more effective, the PRGF would be unnecessary. The general question is an old one: What is the proper division of labor between the development banks and the Fund? Is the best solution a unified structure as has sometimes been proposed? Or, at the opposite extreme can responsibilities be separated so that there is little overlap and clear division of responsibilities?

At the Fund's inception, member countries committed to a fixed exchange rate. Countries could maintain limited but active, independent monetary policy by restricting capital flows. Restrictions on capital movements resolved the famous trilemma for a time. Since 1971, international arrangements for the leading industrial countries have evolved to a permanent system of floating exchange rates, independent monetary policies, and large capital flows. A few countries have rigidly fixed exchange rates. A central issue for the Fund is to define its role in developing and maintaining the exchange rate system. A related issue is the extent to which it should encourage revaluation of undervalued currencies.

A perennial issue is the Fund's role in the choice between country responsibility for policy choices, often called ownership, and conditionality. Often the Fund's staff specifies conditions under which it will lend, leaving the borrowing country, after negotiation, with a choice of accepting the conditions or declining to borrow. In crisis periods, negotiations often take months to complete. During lengthy negotiations, the countries problems often worsen, and the crisis deepens.

Closely related is "governance." Governance has two meanings. One is the governing structure of the Fund. The other is the role of the Fund in relation to the political process in member countries.

The original Fund insisted that it did not try to change a country's political arrangements. In practice this meant that if the Fund recommended deficit reduction, it left to the member government to decide whether to reduce spending or increase tax revenue and which spending to cut or which tax rates to raise. Valid concerns about corruption, leading to efforts to reduce it, often require changes in long-standing internal arrangements and policies that are political decisions.

Developments in research and practice have shown the importance of institutions for reform or recovery and for the success of Fund programs. This is especially true if the Fund continues its poverty programs, but it applies also to crisis management. Efforts to explain why people in some countries are rich while in other countries most remain poor, or why some economies grow and others stagnate, have brought much more attention to the role of institutions. Can the Fund and other institutions effectively carry out their missions without becoming increasingly involved in the choice of institutions? How can it recommend institutional reform without making political judgments?

In 1944-45, Keynes warned that locating the Fund in Washington would make it subject to capture or influence by local political groups. The policy agendas of the Bank and the Fund have certainly been influenced by NGOs and other groups. The U.S. Congress has passed numerous resolutions instructing its executive director to insist upon environmental concerns, labor rights, control of abortion, and many other issues. Some of these concerns find their way into Fund programs. To the extent that programs are affected, the Fund is involved in local policy choices.

Early in the last century, political scientists (including Woodrow Wilson) discussed whether it is possible to separate policy and program administration. As I read that literature, they decided that generally it is not possible. The same, I believe, is true of policy and politics. It is not an accident that both words have the same Greek root. An issue for the future IMF is how it can reshape institutions without becoming an intrusive influence in countries' political choices.

Recent developments in markets for emerging market debt raise issues about the future of that market. Argentina's creditors have suffered the largest default followed by the largest proposed write-off ever. If Argentina succeeds in eliminating more than two-thirds of its external debt, will political pressures within debtor countries encourage others to follow Argentina instead of adopting austerity programs to pay their creditors? Will the IMF go back to lending money to pay off the creditors and bailout the debtor? Or, will recognition of increased risk curtail the size of the debt market? If so, what will take its place? Recent work shows that an active international debt market reduces agency problems for local firms. (Stulz, 2005)

Since the 1997-98 series of Asian crises, several of the Asian countries have greatly increased the size of their foreign exchange reserves and added an inter-Asian lending facility. These countries are, therefore, less dependent on the Fund in a crisis and less subject to Fund conditionality. Is this a further step toward the development of regional blocs? How should the Fund respond to these changes?

Issues have been raised repeatedly about the governance of the Fund, representation of debtor and creditor countries, procedures for choosing the Managing Director, and many related issues. These are mainly political issues or issues of organizational structure. Although I believe they will help to shape the future of the Fund, I will leave them to people with more knowledge of and expertise on organizational issues.

I have not tried to present a catalogue of all issues and open questions. My list is long and I hope comprehensive. Before turning to some possible changes, I will summarize some main topics about where we are and what has changed.

First, we have seen substantial growth of private lending in the past twenty years. It has grown relative to lending by public and international institutions and relative to Fund resources. Given the recent large Argentine default and prospective write down, we can not be certain whether lending on this scale will continue, whether the form of financial transfer will change,

and how the Fund can respond to one or more large crises. How can the Fund continue to serve as a credible quasi lender-of-last-resort if the size of private outstanding debt continues to increase?

Second, tension in the relation of Fund conditionality and country ownership has increased. Also, increasingly, conditional loans are criticized by organized groups for many reasons. Can the Fund continue its role as crisis manager or quasi lender-of-last-resort despite these organized protests and possible loss of public support?

Third, the fixed exchange rate system has been gone for thirty years. Can the Fund help to restore a more stable exchange rate system that increases economic well-being and reduces the risk of crises?

Fourth, what should be the dividing line between the responsibilities of the Fund and the development banks?

Reshaping the Fund for the Future

Institutions and institutional change must be at the center of your discussions. The lessons of experience with economic development, successful crisis management, and crisis avoidance suggest the importance of two factors. One is a country's institutions, including the rule of law, protection of property rights, the exchange rate system, openness to trade, and solvent financial institutions. Second is the presence of a local leader able to develop a team that wants to reform the system to promote development or reduce the risk of crisis.

Institutions are important because they structure incentives. For example, where the rule of law is established, property rights are less subject to arbitrary authority; contracts are more secure; and long-term investment in productivity enhancing strategies is more likely. Where trade is open, world markets direct resource use, and competition encourages use of the most productive technologies. Recent research suggests that development in the tropics is mainly affected by incentives—the choice of institutional arrangements. Other factors often cited as critical such as location and disease appear to affect growth through the choice of institutions. (Easterly and Levine, 2002).

The main challenge to the Fund is to reduce risk to the minimum inherent in nature and institutional arrangements. This requires local leaders willing not just to promise reforms to get finance but to be committed to making and keeping them—institutionalizing reform.

The Fund should take the lead in encouraging an international exchange rate system that reduces risks. Floating exchange rates reduce the risk of financial crises by allowing the exchange rate to adjust. But floating exchange rates and open capital markets do not anchor inflation. No country acting alone can expect to achieve both relatively stable exchange rates and either low inflation or stable prices.

The three major currencies—the dollar, the euro, and the yen—have now achieved low inflation with floating exchange rates. If these countries commit to a common goal, for example inflation of zero to two percent, they will supply a public benefit to themselves and to others that choose to fix their exchange rate to one or more of the major currencies. By fixing its exchange rate, the smaller country benefits from the stability of a fixed exchange rate and imports low inflation. The major countries also benefit from the low inflation that they provide and from the stability of the exchange rate that other countries provide. In economic jargon, this arrangement provides a public good that countries cannot achieve on their own.

Nominal exchange rates between the major countries would remain relatively stable, given anticipations of a common inflation rate. But real and nominal exchange rates would remain free to adjust to changes in relative productivity and opportunities. These changes in the real exchange rate contribute to the adjustment of the global economy to new conditions. The three major currencies are now close to a common low inflation rate. What is required is a clear policy statement from each of them committing to zero inflation or inflation below (say) 2 percent.

All other countries, as now, would remain free to choose their exchange rate system. The proposal provides an opportunity and a public good. Countries that fix their exchange rate would give up independent monetary policy. Countries that prefer to conduct their own monetary policy would give up the opportunity to have low inflation, a fixed exchange rate, and relatively free capital movements.

Experience shows that excessive fiscal and monetary expansion, undercapitalized banking systems, and adjustable pegged exchange rates are leading causes of financial crises. The Fund of the future must depend more on incentives and country decision-making and much less on conditionality and promises. One way for the Fund to encourage stabilizing incentives is to deny assistance to countries and governments that do not maintain stabilizing policies and sound banking practices.

The Fund can enhance incentives by specifying a short list of verifiable policies that a country must adopt to be eligible for automatic assistance in a crisis. The policies should include: (1) responsible fiscal and monetary policies, (2) a sound and solvent banking and financial system, (3) freedom of entry and operations of foreign financial institutions (as many countries have accepted by adopting the relevant WTO protocol), (4) timely release of accurate information on financial position including the maturity structure of sovereign and guaranteed debt and off balance sheet liabilities, and (5) avoidance of pegged exchange rates (neither permanently fixed nor floating.)

After a reasonable period of time the new system would become the standard. Countries that adopted the reforms would have fewer crises, but they would have automatic assistance in a crisis. Countries that did not adopt reforms would not be helped. They would not get Fund loans. To prevent problems from spreading to third countries, the Fund would act as quasi lender-of-last-resort to these countries. The loan to Uruguay a few years ago is an example.

This program offers strong incentives to improve policies. The Fund would list the countries that it would help. These countries would be less risky, so the private sector would willingly lend larger amounts at lower rates. Countries that were not certified would get less private capital and pay higher interest rates to compensate for increased risk. Instead of relying on Fund exhortation to reform and promises that are not fully implemented, reform would be encouraged by local officials who wanted more loans at lower interest rates. Instead of going to their parliaments with demands for policy changes because the Fund demanded them in a crisis, governments would seek reforms because they would aid development. Governments that would not choose to reform would send a message about their policies. Lenders who willingly accepted the risk of lending to these countries would know that they should not expect a Fund bailout in a crisis.

I see two big problems with this proposal. First, it is subject to time inconsistency. Either the Fund would not help a country that it certified or much more likely, it would assist a country that it did not certify. This would reduce the incentive for reform. Second, the Fund would have to regularly monitor a country's position, as it does under Article 4. It must be willing to remove a country's certification if its policies deteriorated. The Fund's announcement that a country was subject to decertification would raise the risk premium it pays, increasing its incentive to improve its policies.

Many will recognize a similarity to parts of the Contingent Credit Lines or CCL proposed several years ago. Major differences are the strong incentives for local ownership of reform and the changed role of the Fund. Instead of managing the policy reform process country by country, the Fund would decide on a small set of pre-conditions that a country could choose to accept. The Fund would monitor compliance. Unlike the CCL, it could not refuse to assist a country in crisis if it remained certified.

Under current procedures, there is often a delay of several months between recognition of a country's need for assistance and the first disbursement of loans. Often the crisis worsens during this interval as private lenders withdraw, the exchange rate collapses, and banks fail. The proposed policy shortens the time period because crisis support is assured for certified borrowers. Also avoidance of pegged exchange rates, a condition of certification, slows the withdrawal of loans.

The list of five pre-conditions for assistance may require amendment or addition. The five I have listed are both observable and have been important in the past. It is not necessary in this audience to discuss the reasons for including prudent fiscal and monetary policies, the need to avoid pegged exchange rates, or the dissemination of timely and accurate information about the country's financial position.

Similarly, bank runs exacerbate crises if banks are illiquid or insolvent or if the public expects that they will be. To prevent a panic in these circumstances, Walter Bagehot warned the directors of the Bank of England almost 150 years ago that it was not enough for the lender-of-last-resort to lend freely. The lender must pre-announce its policy and conduct the policy that it pre-announced.

Portfolio diversification is one important way that financial institutions reduce risk. In many countries, domestic loans do not provide a base for the optimal degree of diversification. Even banks in a country as large as Korea may not achieve adequate diversification to minimize risk.

The presence of foreign banks that operate in many countries increases diversification. In the early stages of a crisis, depositors often run from local banks to international banks because they are more fully diversified. This reduces risk.

The World Trade Organization introduced its protocol 5 to encourage competition. Many countries have adopted the protocol and implemented it by permitting foreign banks to enter and compete. Their action also increases safety and reduces risk.

The Fund should avoid pressures to take a position on issues such as worker rights, core labor standards, and environmental policy that are far removed from its core competences and, I believe, should be left to local political processes.

The most important changes, however, remain the increased role of country ownership and the heightened role of incentives on governments to improve policy and enhance stability. Note also that the proposal requires the Fund to concentrate its efforts on the provision of two public goods. One is the increased stability of the international economy. Second is the improvement in the quantity and quality of information. If international transfer of capital remains a major source of development funds, improved information lowers costs and reduces market risks. Fund management and directors have made very helpful improvements in the quantity and quality of information in recent years. As you know, more remains to be done.

With improved policies and increased use of floating rates, future crises should be smaller and less frequent. Nevertheless, the size of the Fund's resources remains relevant.

Some Remaining Issues

The directors of the Fund and the Bank should settle on a division of responsibilities. I believe the proper division would leave the Fund responsible for providing two public goods—preventing the spread of financial crises and improvement in the quality and quantity of information about country policies. The development banks would be responsible for poverty reduction and institutional reforms to promote growth and development.

If the PRGF remains a Fund program, the directors will have to decide how to avoid overlap with development banks. The program should recognize that growth is the most effective poverty program as we learned again from China and India. Development lending and anti-poverty programs have the best chance of success when there is a local leader committed to implementation and the country's policy develops institutions that sustain development.

The institutions that a country must support include the rule of law, reduction in corruption, protection of human and property rights, and openness to trade. Support for the new institutions must be long-term in many cases, and it must be monitored to show steady progress.

The Meltzer Commission developed one such scheme. Considerable attention should be given to developing effective methods for facilitating and monitoring these institutional developments. Once again, the Fund must be willing to terminate programs that do not work. And it should substantially increase non-lending programs to give advice and technical assistance.

Countries such as Mexico, Korea, Turkey and perhaps some others have geopolitical or other ties to the United States. Both Germany and the United States had special concerns about Russia after 1989. These large members have insisted on aid to specific countries outside the Fund's limits. This problem requires more open discussion. Fortunately, many of the client countries have adopted reforms in the recent past.

The large Argentine default, the lengthy negotiations that followed, and the large discount that bondholders were asked to take raise questions about the viability of the bond market as a source of long-term capital for developing countries and the role of the IMF. Emerging market debt rose dramatically following Fund policy of assisting countries in crisis. Lenders could withdraw capital without experiencing large losses. If that support is no longer present, it raises two types of questions.

What form will long-term capital transfer take? Should the Fund encourage more transfer as foreign direct investment or equity holdings?

If the Fund substantially reduces support that permits private lenders to flee, will the lenders refuse to support the Fund's preferred creditor status?

I suggest that increased reliance on foreign direct investment and equity ownership would be desirable. It would reduce the risk of crises and assign risks to those who invest. The main criticism is that it would reduce the amount of capital transfer both because countries would resist foreign ownership and overseas investors would have to accept greater risk. Again, Argentina's action raises a cautionary signal.

Recent discussions of prospective Fund policies suggest a greatly increased role for Fund advice without lending. Improved rules governing equity finance is one place where technical assistance without lending can be helpful.

Finally, the Fund and other lenders should complete the HIPC initiative to forgive debt of impoverished countries. Debt forgiveness should not be so easy to obtain that many other debtor countries will insist on forgiveness of their debts. Debt reductions should not occur without prior

legislated reforms by the debtor country that institutionalize progress toward the rule of law, openness to trade, protection of property rights, and reductions in corruption.

The principal and perhaps only financial reason for debt forgiveness is that the borrowers are unable to pay now or in the future. Debt forgiveness should not be the first step in a cycle of lending, forgiving obligations, then lending again.

The Meltzer Commission recommended monitored grants instead of loans to the poorest countries. That recommendation was accepted partially. It is critical that, where countries fail to make the institutional changes essential for sustained development, monitored grants become the means of providing potable water, sanitation, inoculation against preventable diseases, and other minimum standards of 21st century life.

The term monitored grants should convey that payment of the grant to the provider should be made after performance is complete and the outcome is monitored. In many poor countries where governments do not elect to develop growth-enhancing institutions, aid should be limited to monitored grants.

I have emphasized the role of incentives and the importance of institutions that encourage and sustain incentives for development. Let me close by reminding us all that opening the economy to trade requires action by the developed countries to remove barriers to exports from the less developed countries. After many years, there is progress on textiles and apparel. Agriculture must be next, and soon.

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