The IMF at 60
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Birthdays ending in zeros are not always happy events. I should know, since my wife and mother both celebrate such birthdays this year. This autumn the IMF similarly marks its 60th birthday, it having been that long since the conference that resulted in its conception. Management have decided to commemorate the event with a "virtual exhibition" on the official website and a paper for the Executive Board on the past and future of the organization. That they have not scheduled an elaborate birthday party for the annual meetings this week no doubt reflects worries that a public event would be marred by demonstrations.

For decades, protestors in developing countries have marched in the streets against the policies prescribed by the Fund. Demonstrations at the annual meetings are a more recent innovation; they date back less than a decade. This heightened attention to the affairs of the IMF among nongovernmental organizations in Europe and the United States is a corollary of the information and communications revolution – more people know what is going on in developing countries. It reflects the frequency of financial crises in the last ten years, from Mexico and Russia to Turkey and Argentina, and the severity of the economic fallout. Some of the criticism is unfair. For example, blaming the IMF for the policies of austerity adopted by governments when foreign investment dries up is a bit like blaming the paramedics for an auto accident.

Be that as it may, there is no question that the Fund's new managing director, Rodrigo de Rato, inherits a poisoned chalice. Moreover, in the three months since assuming office, he has done little to show that he knows what to do with it. A new manager may want to start with a quiet period when he meets his staff and gives their ideas a hearing. But Mr. de Rato's quiet period has gone on for long enough. It is time for him to make his positions known.

He inherits an organization that was reorganized by his predecessor Horst Koehler. Koehler sought to focus the Fund on the financial-crisis problem and created a Capital Markets Department to this end. He took big gambles on Brazil and Turkey that paid off and one on Argentina that failed disastrously. But Koehler neither solved the IMF's internal problems nor answered the big questions of how the Fund should respond to financial crises.

Internally, the IMF still lacks the expertise and organization needed to prevent, anticipate and respond to crises. The Capital Markets Department is bogged down writing for internal consumption daily summaries of events in financial markets, monthly summaries of its daily summaries, and quarterly summaries of its monthly summaries. The world has enough investment bank newsletters. It does not need the Capital Markets Department of the IMF producing another. What it needs is more forward-looking analysis of the risks to stability created by structural changes in financial markets. But this analytical work has been crowded out by management requests for one more report on what happened in East Asian currency markets last night.

Top management in the Capital Markets Department comes from an investment bank. But this is no excuse for attempting to replicate that industry's approach to market intelligence, which focuses on "the news just in." What the IMF needs from its capital-markets experts is intelligence of a different sort, focusing instead on how changes in financial-market structure are reshaping the challenges it faces.

Part of the problem is the mismatch between staff expertise and responsibilities. Staff continue to be dominated by macroeconomists hired from the economics departments of leading universities, like mine. Some criticisms of these individuals are off the mark, like that of Joe Stiglitz, who has called them "second-rate graduates of first-rate institutions." These people are first-rate macroeconomists. Unfortunately, sound macroeconomic policies are not the only thing needed for financial stability. The Asian crisis was not caused by macroeconomic problems; rather it resulted from incompetent financial regulation, weak corporate governance, inadequate auditing and accounting practices, and inefficient bankruptcy and insolvency procedures. The IMF still lacks bank supervisors, auditors, accountants and lawyers with experience in these areas. Changing the composition of staff is not easy when the incumbents have job security. But the time for doing so is long past.

These changes will make it easier for the Fund to anticipate and head off potential financial crises. But some crises will still happen. The volatility of financial markets makes them unavoidable. And this leads to the biggest unresolved question of all: what to do when crises erupt. Events in Argentina since 2001 have laid bare the fact that the IMF lacks a coherent strategy for dealing with such events.

That said, the critics lack a coherent strategy as well. Some, like Stanley Fischer, the Fund's former number 2 in command, argue that financial markets are intrinsically unstable and require a lender of last resort. The solution is to give the IMF more financial resources, especially now that the majority of its liquidity is tied up in Argentina, Brazil and Turkey. Others, like Ken Rogoff, the Fund's former economic counselor, argue that IMF loans only encourage investors to extend more finance to governments already in an untenable position, heightening the magnitude of the crisis when it finally comes. They only encourage governments to crawl out still further on their unsustainable financial limb. The solution is therefore to abolish IMF lending and for the institution to concentrate on giving policy advice.

When two astute individuals with extensive experience in the IMF cannot even agree on the basics, is there any real hope for reform? The truth is that there is no magic formula, no single solution that applies at all times and places. Recommending that the IMF should simply stop lending is unrealistic. It ignores the intrinsic instability of financial markets. The first crisis following this "reform" will dwarf earlier disruptions in terms of both magnitude and social costs. Capital flows to emerging markets will dry up, and with them the prospects for faster economic development and higher living standards.

This is why tampering with the IMF's status as a priority creditor is a bad idea. The IMF is needed partly to lend to countries to which the markets refuse to lend. IMF intervention may be needed either because default would destabilize the international system or because the markets have exaggerated a country's problems. From time to time the IMF's effort to rescue a country will fail. To eliminate the Fund's priority creditor status, which allows it to be paid back first when the country begins to normalize its finances, would mean that it was no longer in a position to lend last and then to keep lending when the markets refuse to do so. It is understandable that Argentina's bondholders want the IMF to share the pain of that country's debt restructuring. This would leave for money for them. But forcing the IMF to take 25 cents on the dollar, like an Italian housewife or a Spanish investment bank, would prevent the Fund from being there next time when its emergency assistance was again needed.

The opposite recommendation, of allowing the Fund to lend unlimited amounts to crisis countries, is equally unrealistic. The IMF will never have sufficient resources to act as a true lender of last resort, that is, to restore confidence by replacing all the funds that private investors withdraw. Having moved a few steps down that path by extending large loans to Turkey and Brazil, it now finds itself dangerously short of liquidity for dealing with the next crisis. Nor are governments likely to augment its accounts anytime soon. The U.S. Congress is reluctant to turn over the hard-earned dollars of American "plumbers and carpenters," in then-Treasury Secretary Paul O'Neill's memorable phrase, to an international organization. Nor should it. Unlimited finance for bailouts could become a destabilizing engine for risk taking by investors and borrowing countries.

To avoid becoming an engine for "moral hazard," as this tendency toward induced risk taking is known, the IMF must be selective about to whom it lends. But it must lend enough to effectively restore confidence, if only to fundamentally solvent countries experiencing a temporary interruption of market access. This means that it should not attempt to reimpose strict numeral lending limits, as recommended by the UK Treasury, among others. From time to time, exceptional amounts of rescue lending will be required to restore confidence. Had normal lending limits been imposed on Brazil, for example, preventing the IMF from extending exceptional access, its loan would have been dismissed as a drop in the bucket. It would not have succeeded in restoring confidence.

Nor should the Fund attempt to decide in advance who qualifies for assistance. This was tried in 1999 with the creation of the Contingent Credit Line, a facility for which no country ever applied. While the CCL has now expired, I predict that the idea will soon be revived. Staff would be asked to undertake debt-sustainability analyses to determine which countries are insolvent and which are merely experiencing temporary liquidity problems. On this basis the second set of countries would then be prequalified for IMF assistance, while the first will be told “Sorry, you’re on your own.”

The idea that this approach could work is unrealistic. With new information about developments in financial markets, the IMF will have to revise its assessment of which countries merit assistance and which ones don’t. To pretend that this decision could be mechanized and taken in advance is a recipe for disaster.

What these bad ideas have in common is that they seek to remove the human element from IMF decision making. They seek to substitute a mechanical decision making process, whether in the form of hard-and-fast limits on lending or a prequalificiation requirement, for human agency. They reflect a lack of trust in the independence of the staff and the even-handedness of the Executive Board. Staff, the critics worry, give upper management the advice it wants, since dissent is incompatible with internal promotion. The decisions of the Executive Board reflect the political priorities of the organization’s principal shareholders, notably the U.S. government, and not efforts to enhance the welfare of the crisis country or the stability of the international system. The decision to extend a last loan to Argentina in August 2001, on U.S. insistence and over the strong objections of other countries, epitomizes the point.

If taking discretion out of the hands of the IMF is not a solution, then what is? A better response would be to force management and the board to take more decisions in the light of day. If the board had to release the minutes of its meetings, it would be harder for directors to cast and defend votes taken on purely political grounds. The U.S. would find it harder to take positions that advanced its narrow self interest at the expense of economic efficiency and financial stability. If staff were obliged to publish its advice to the board, it could better resist pressure to deliver management's preferred recommendations.

The IMF is much more open than it was ten years ago. But that openness has not gone far enough. The Fund should take a leaf from central banks like the Bank of England and become truly transparent, releasing board minutes and formerly confidential staff recommendations, perhaps with a lag of a few weeks. Transparency will strengthen checks and balances on the institution. Outsiders will have reason to believe in the equity and efficiency of its decisions. They will then be prepared to give it the resources and discretion needed to advance the cause of financial stability.

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