Failure of the Fund
Rethinking the IMF Response

The world is just emerging from the Asian financial crisis, perhaps the most cataclysmic event to affect global capitalism since the Great Depression. While the United States emerged from this event unscathed—some might argue that it even benefited from the crisis as plummeting commodity prices reduced domestic inflationary pressures—many developing nations were not so lucky. Whereas the Great Depression induced a great deal of soul searching about capitalism's basic principles, the seemingly quick global recovery from the financial crisis and its limited effect on industrial countries have brought a more mixed response—self-congratulation on the part of some, renewed criticism of the impacts of globalization by others. In both instances, however, the global economic arrangements were clearly inadequate. The international financial institutions and arrangements established at the end of World War II to guard against another global economic depression are widely viewed as incapable of managing the modern global economy. The International Monetary Fund (IMF), in particular, has failed to perform the tasks for which it was designed. Today, the institution requires serious reform to ensure a more stable global economic environment.

Beggar Thy Self
The IMF's philosophy has moved far away from its roots. In this past financial crisis, the IMF provided funds under the explicit condition that countries engage in more contractionary fiscal and monetary policies than they might desire. The money went not to finance more expansionary fiscal policies but, instead, to bail out creditors from the more industrialized countries. The beggar-thy-neighbor policies that were so widely condemned gave way to even worse "beggar-thy-self" policies, with disastrous effects both for the home country and for its neighbors. The downward spiral in the region accelerated as declines in domestic GDP led to cutbacks in imports, thereby reducing regional exports. The beggar-thy-neighbor policy at least had the intention of making the nation's own citizens better off. No such benefits resulted from the IMF's beggar-thy-self policies. A country was told to build up its foreign-currency reserves and improve its current-account balance; this meant that it either had to increase exports or decrease imports. But exports could not rise overnight—in fact, as the country's neighbors' incomes plummeted, the prospects for increasing exports were even bleaker. Thus imports had to be reduced without imposing tariffs and without further devaluation. There was only one way that imports could be reduced in these circumstances: by reducing the consumption and investments that relied on imports. The immiseration of those at home was thus inevitable.

There is a further irony in the policies that the IMF pursued: while the IMF was created to promote global economic stability, some of its policies actually contributed to instability. There is now overwhelming support for the hypothesis that premature capital and financial market liberalization throughout the developing world, a central part of IMF reforms over the past two decades, was a central factor not only behind the most recent set of crises but also behind the instability that has characterized the global market over the past quarter century.

The Indictments
There is now widespread agreement that the IMF response

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to the Asian crisis was a failure. Although exchange rates stabilized, interest rates dropped, and the world eventually emerged intact from the crisis, none of this turnaround can be attributed to the IMF when we judge the success of its policies by whether the downturn was unnecessarily long or imposed unnecessarily high costs on workers. Of the four crisis countries in Asia, Indonesia remains in deep depression. The political turmoil there has proven a nearly insurmountable obstacle, but there is little doubt that the magnitude of the economic downturn contributed to the severity of the social and political unrest, that the turmoil was anticipated, and that IMF policies contributed to the magnitude of the economic downturn. Thailand has been the IMF’s most faithful student, carefully following its dictates for several years; yet it has still to regain its pre-crisis output level. With almost 40 percent of bank loans non-performing, the country’s future prospects are far from rosy. The two success cases are Malaysia, which avoided an IMF program, and South Korea, whose recovery can be attributed, rean coffers, greatly aiding the country’s recovery. Had it followed the advice of outsiders, Korea would be in a far worse position today. Similarly, South Korea was urged to shut down or sell off two of its major banks; instead, it effectively nationalized them.

While there is some disagreement about the appropriateness of the policies pursued in East Asia, there is general consensus that the IMF pursued excessively contractionary fiscal policies, and that the manner in which it handled financial-sector restructuring, at least in Indonesia, was a dismal failure. Beyond this specific crisis, widespread evidence exists of other failures, such as the inability of the rescue packages in East Asia, Brazil, and Russia to sustain the exchange-rate cost of billions of US dollars. This money will come not from taxpayers in the United States or Europe, but largely from the pockets of those in the developing world, especially unskilled labor.

Intellectual Incoherence
There was a certain coherence in John Maynard Keynes’s post-World War II conception of the large, work poorly. One might suppose that an inherent tension exists here: the IMF, after all, is itself a governmental body, and many of the arguments concerning governmental inefficiency and incompetence hold with equal or stronger force at the international level than they do at the national level. From this perspective, the IMF’s economists would expect an international governmental body such as itself to be marked by failures.

Developing a coherent policy for an international agency such as the IMF thus requires identifying important instances in which markets might not work and analyzing how particular policies might address these failures. The IMF has, to date, failed to articulate a coherent theory of market failure that would justify its own existence and provide a rationale for its interventions in the market.

One of the IMF’s arguments in defense of its intervention is that an ongoing crisis in one country will spill over to its neighbors. This concept of contagion is a devastating criticism to market fundamentalism because it implies an inherent market failure. If it is desirable to take

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at least in part, to its deviation from the IMF prescription in important ways. For instance, South Korea was told to restructure by dispensing excess capacity in industries such as computer chips. But the excess capacity was purely cyclical, and the passing of the downturn put billions of dollars into South Ko-IMF and its role. Keynes believed that a market failure occurred when the actions of one country had spillover effects on others. Today, however, the dominant view inside the IMF is sometimes characterized as market fundamentalism, a strong belief that markets, by and large, work well, and governments, by and international collective action to address the consequences of a crisis, it is equally desirable to take international collective actions to reduce the likelihood that crises will occur. If an increase in the ratio of foreign short-term indebtedness to reserves (in excess of some critical threshold level) substantially increases the

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likelihood of a crisis, then there should be international pressure to limit short-term indebtedness; yet the IMF has pushed for capital-market liberalization, the effect of which is precisely the opposite.

Other examples of intellectual incoherence were displayed throughout the management of the Asian financial crisis. While the IMF

**The IMF Evolution**

Since the creation of the IMF, there has been a subtle change in mandate, a change that, were it made explicit, perhaps would not have been widely accepted. The conflict between the effective mandate and the original mandate created a tension that manifested itself in numerous ways, including intellectual incoherence.

The IMF's original mandate was to provide liquidity in a world of imperfect capital markets, so as to enable countries to maintain output as close as possible to full employment. Assistance was conditioned on the recipient nation's engaging in appropriate expansionary policies. Today, the mandate often appears to be that of a bill collector for lending nations: its objective is to make sure that the debtor country has as large a war chest as possible to repay outstanding loans and to ensure the maintenance of overvalued exchange rates in order to easily acquire foreign currency. These objectives require achieving a massive trade surplus as quickly as possible, regardless of the costs to the country or its neighbors. Capital-market liberalization also reflects the interests of the financial community in advanced industrialized nations. In part, the IMF is opening up lesser-developed markets to an industry in which the advanced nations have a comparative advantage.

The IMF focuses on the repayment of loans far more than on the rotation of the social contract under which these countries had so successfully operated for a third of a century, and that such an abrogation—and the public bailouts that follow—is the action that truly undermines capitalism and the long-term stability of society. The problem is that the IMF cannot openly announce its new mandate, and so it formulates an amalgam of policies that were both ineffective and lacking in intellectual coherence.

Other aspects of the IMF, such as its organizational structure and rules of conduct, also contribute to its policy blunders. The institution has a hierarchical structure, not uncommon among organizations that are designed to deal with crises; one cannot have intellectual debates on the best way to fight a fire in the midst of a fire. But whatever its merits in dealing with crises, such a structure often leads to organizations that do not adapt quickly. In addition, the IMF conducts much of its business behind closed doors, without transparency. The normal checks on institutional behavior, the pressures to alter its models,
and the criticism of peers that is a normal part of intellectual and democratic processes simply do not exist. The IMF makes assertions and predictions concerning its policies that are consistently proven wrong, yet its leaders are seldom held accountable. With each failure, the IMF has looked to others to explain away its mistakes. Its effectiveness and credibility as an advisor are undermined by its refusal to lay out clearly the consequences of its actions and by the fact that it has lost touch with basic economics. Its success as a market psychologist is undermined by its recurring inability not only to predict but, increasingly, to affect market reactions. And its effectiveness as a political actor is weakened not only by the first two failures but also by the growing perception that its policies are dominated by the political interests of the US Treasury.

A Mandate for Reform
The simplest and most straightforward reform—one advocated by many economists on both the left and the right—is the abolition of the IMF. Some of the “public good” functions, such as data collection, could be transferred to other bodies, such as the UN Statistics Division. Monitoring could be performed by private agencies, and if considered insufficient, by existing or newly created peer-review groups like the Organization for Economic Cooperation and Development. Its development and transition programs could be assumed by the World Bank, but its core crisis-management functions would be abolished. With flexible exchange rates, the IMF simply interferes with the functioning of the exchange market, and its recent performance has reinforced the widespread view that even if markets do not work perfectly, bureaucrats are unlikely to improve matters. Without abolition, there cannot be a credible commitment not to engage in bailouts, and without such a credible commitment, lenders will have an incentive not to engage in sufficient due diligence. Excessive lending without due diligence contributes to economic instability.

Despite such arguments, governments consistently react in the same way to crises: they want someone to seem to be in charge. If the IMF were dissolved, it would almost surely be re-created when the next crisis occurs. Thus, given that the IMF exists and will certainly continue to do so, how should it be reformed?

There is now a widespread consensus about one key aspect of this reform: the IMF should be restricted to crisis management in order to limit the damage that its mistaken
policies might impose. Its other functions should be given to other institutions. But limiting the IMF to crisis management clearly does not solve the problem. After all, problems in managing the recent global crisis were what precipitated the debate over reforming the international financial architecture. Thus reforms must focus on what the IMF does in response to a crisis. Three sets of reforms are crucial.

First, the IMF must become more transparent. This increased transparency would subject its policies to more critical scrutiny; it would hopefully make it more difficult for it to use outdated and inappropriate models. Part of this increased transparency would require the IMF to disclose the models it used and to predict the consequences of its policies. Outsiders could then independently ascertain the accuracy of these forecasts. In addition, if the IMF paid insufficient attention to the consequences of its programs on poverty, there would likely be a significant outcry before the damage was done.

Second, the IMF’s interventions need to be limited. Huge bailouts should be a thing of the past. In effect, the advanced industrial countries provide the funds for the developing countries to repay the developed countries’ banks, but the real burden is borne by taxpayers in the developing countries, since the IMF is almost always repaid. There should be a prima facie case that if a huge bailout is required, the exchange rate should not be at an equilibrium level.

Third, the conditions imposed by the IMF need to be reformed. Supporters of the IMF often point out that all lenders impose conditions to make sure that the funds are used as promised by borrowers. But the IMF’s conditions are different. They are not necessarily designed to enhance the likelihood that the loan will be repaid; in some cases the conditions actually have the opposite effect. In other cases, the conditions have little or nothing to do with the crisis. For example, South Korea’s crisis had nothing to do with loose monetary policy leading to excessive inflation, yet the IMF entered into the political sphere demanding reforms of Korea’s central bank to make it focus exclusively on reducing inflation and becoming more independent. Forcing Korea to move up the timing of some trade liberalization measures to which it had previously agreed had absolutely nothing to do with the crisis; it was simply a crude political power play.

Even when there are particular structural weaknesses that can be linked to a crisis, reforms must be carefully timed and paced. What would have happened had the United States gone to the IMF in the midst of its 1989 financial crisis? The IMF would have insisted on abolishing the special tax treatment of real estate and agricultural subsidies, which serve to inflate the price of land. Had it done so in the midst of the Savings and Loan debacle, the United States would have had a full-blown crisis.

The rapid abolition of tax preferences would have had a devastating effect on real-estate prices, and thereby on the entire banking system. Eventually the United States should eliminate the real estate preferences as they interfere with the productivity of the US economy, but adverse effects from the rapid elimination of these preferences would have more than outweighed any gains from improved efficiency. IMF conditions thus need to be greatly circumscribed, limited only to actions that are absolutely essential to ensure the repayment of the loan and/or to mitigate externalities, such as those associated with excessively contractionary policies.

Some reformers have argued that the IMF should be de-politicized. They observe that some of its worst lending practices, such as the loan to Russia in 1998, are based not on economic analyses (which showed that Russia had unsustainable debt dynamics and an overvalued exchange rate), but on political motivations. Such an argument, however, runs contrary to the idea that one of the key problems is the IMF’s lack of political accountability. It would be one thing if the IMF’s bureaucrats were engaged in totally technical operations. But as we have repeatedly seen, they are engaged in actions that are inherently political, whether it involves a decision to bail out international creditors at the expense of the domestic economy, or designing bankruptcy laws that are more creditor-friendly than debtor-friendly.

**Beyond the Rhetoric**

While markets are by and large the most effective way of increasing output and promoting growth, they often fail. Thus, within national economies, the government must often assume some role. But just at the time when the need for international economic institutions has increased, confidence in global institutions has eroded, and for good reason. Reforms must focus more on what the IMF does and how it does it. But we should also be aware that the IMF is a political organization that has survived and expanded over the past 50 years; while its adaptation may not have enabled it to better stabilize the world economy, it has enabled the IMF to survive—some say even to prosper. Thus, we should expect the rhetoric of the IMF to seriously consider such critiques. True reform needs to look beneath the surface, beneath the rhetorical veneer.