CHAPTER 13:
THE IMF AND CAPITAL ACCOUNT CRISES:
THE CASE FOR SEPARATE LENDER OF LAST RESORT AND CONDITIONALITY FUNCTIONS[*]

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1. Introduction

What has happened to the push for reform of the international financial architecture that had such momentum during the rash of international financial crises in the 1990s?[1] While not the stuff of dramatic news headlines, a great deal of progress has been made, especially in the areas of increased transparency at the IMF and the growing acknowledgement of the danger of trying to run a stickily pegged exchange rate regime in a world of substantial international capital mobility. Less progress has been made, however, in dealing with another implication of high capital mobility – the need for the IMF (or some other international agent) to have more effective capability to act as a quasi international lender of last resort (ILOLR).[2]

As Barry Eichengreen (2002a) has put it, "On prevention, a number of useful steps have been taken. In terms of how to manage and resolve crisis, in contrast, disappointingly little has been achieved…disagreement and confusion continue to rein" p. 52.

In a similar vein, Park and Wang (2002) argue that "the G-7 and international financial institutions appear to have lost the zeal to garner the support they need for reform. The ongoing debate on the future direction of international financial reform suggests that most of the problems are likely to remain unchanged. This pessimistic outlook arouses a deep concern in developing countries…" p. 124-5. They go on to argue that much of the interest in regional monetary institutions in Asia has come from frustration at the limited scope of the reforms at the global level.

To be sure, the international community through the International Monetary Fund has not been idle. Two new financing mechanisms have been created within the IMF for crisis prevention and management. In the judgment of many experts, however, these reforms are far from sufficient. One, the Supplemental Reserve Facility (SRF), has been quite useful but does not go far enough in the view of those who think we need a functional ILOLR. The more radical Contingent Credit Line (CCL) has serious design problems and hasn't yet been used.[3]

While debate continues among researchers, public attention largely moved on to the proposal by Anne Krueger, Deputy Managing Director of the IMF, to create some type of debt restructuring facility. The Krueger proposal addressed an important issue but has met with strong political opposition. While current official interest in both ILOLR and debt restructuring mechanisms seems highly muted at the present time, we shouldn't infer from this that our current institutional framework for dealing with international monetary and financial issues is in satisfactory shape.

There have been sharp disagreements in the recent discussions of these issues and this has undoubtedly contributed to the lack of progress. Some of the reasons for

disagreement can be clarified by emphasizing the differences in political assumptions made by the disputants. As the reader will see, I share the view of those who argue that there are times where imperfectly functioning markets do present a case for ILOLR type lending by the IMF (or some other international organization). Furthermore, the growth of international capital mobility and the limited catalytic role played by recent IMF programs in bolstering confidence imply that very large programs will sometimes be called for. Thus there is a strong case for a well-functioning ILOLR type facility at the IMF.

To the contrary, however, many economists have called for smaller IMF programs. The reason is that in practice, actual IMF programs have often been far from first-best. Some economists and politicians, mostly on the right, have even argued that past IMF programs have worked so badly that it would be best to shut down the institution all together.

Most middle of the road experts argue that this is too extreme a response, but recognize that the poor-track-record IMF programs presents a serious problem. The recent discussion by Barry Eichengreen (2002a) is typical of such views. He notes that because there are strong political pressures on the IMF to lend "the IMF rarely if ever says no the first time; it says no only after being pushed into a corner by the failure of a long series of loans…where the short-run prospects of the country are so clearly hopeless that it would be absurd for the IMF to continue lending" p. 55. "The problem is not just that politicians or IMF management like to lend; it is that they fear the uncertain consequences of doing otherwise" p. 7.

Waste of IMF reserves is not the only consequence of excessive lending. These programs have "…permitted governments to cling longer…to unsustainable policies, allowing economic and financial vulnerabilities to build up and creating the potential for very severe political and social dislocations when support is ultimately withdrawn…" p.7.

Furthermore, such lax lending policies have substantially undermined the value of the IMF's seal of approval, thus requiring large loans to calm current crises. A vicious circle is at work.

In recent years the IMF has shown greater recognition of this problem – and there have been efforts to be tougher under the new management team of Horst Kohler and Anne Krueger. It is still too soon to tell, however, how major a change in IMF policies is at hand, and the guesses of independent experts vary widely. Thus we see that the sources of dispute about a new ILOLR-type facility for the IMF rest as much on judgments about the extent of bureaucratic and political failure as on the extent of market failure.

This suggests that instead of just imposing conditionality on others, it may be necessary for others to impose conditionality on the IMF. Only if the IMF and its political stakeholders demonstrate sufficient reforms in their lending practices is the international community likely to provide the IMF with the increase in resources necessary to operate an effective ILOLR-type facility.

We may interpret in this light the proposals of the majority report of the recent U.S Congressional Commission (commonly called the Meltzer Report). This report called for abolishing all traditional IMF programs and replacing them with a new ILOLR type facility that could make large loans, but only for short time periods and under strict

conditions. Many experts and officials dismissed this proposal as being too extreme. From the standpoint of political acceptance this is certainly true. This paper will argue, however, that while it is unsatisfactory as a comprehensive blueprint, the Meltzer Report and the debate it has stimulated makes an important contribution.

Ironically, while one of the major criticisms of the IMF has been its excessive leniency in lending, another has been the excessive breath and stringency of the conditions that it imposes. Of course some of the seemingly contradictory nature of these criticisms is that some come from the right and some from the left, but another important cause is the Fund's spotty record of enforcement. The Meltzer Majority Report recommended abandoning ex post policy conditionality all together and placing exclusive emphasis on meeting pre-conditions, i.e., ex-ante conditionality. While there have been a number of criticisms of the specific pre-conditions recommended by the Meltzer Report, it has helped spark a valuable debate about ex ante versus ex post conditionality.

This paper argues that there is a useful role for some of the types of traditional IMF conditionality programs rejected by the Meltzer Report and that we should not yet give up entirely on the ability of the IMF and its political stakeholders to do a better job of running such policies. It has been increasingly widely recognized, however, that the conditions under which such programs can be effective are limited. In particular, considerable national ownership of programs is required.

The development of such ownership generally takes considerable time, however, but in the midst of currency crises rapid action is needed. This paper proposes that this inherent conflict can be reduced by separating IMF programs into two major categories. An ILOLR type facility would provide short term financing to countries facing liquidity

crises who meet a set of pre-conditions or ex ante conditionality. In a pure liquidity crisis this is all that will be needed, as the Meltzer Report assumed. Frequently, however, crises are a combination of liquidity crisis and genuine problems that aren't hopeless, but require reforms over several years. The latter is where traditional IMF conditionality programs can be useful if they are based on sufficient ownership. By providing a separate facility for dealing with the short run aspects of crises, the ILOLR type facility would allow more time to negotiate conditionality programs that had a greater chance of success. If it has become politically taboo to talk of lender-of-last-resort-type facilities, we could instead label this a facility for bridge loans while traditional export conditionality programs are being negotiated.

At present these two different types of functions are conflated in IMF facilities – with the partial exception of the Contingent Credit Line. The result is to the detriment of both functions. Such a technical improvement in the division of labor of Fund activities will achieve its potential only in connection with major changes in how the Fund does business. With such a change in attitudes and incentive structures at the Fund and in the willingness of its major shareholders to allow it to operate with less politically motivated interference, however, the separation of LOLR and traditional conditionality programs holds some prospect for helping the Fund operate in a more prudent and effective manner. Thus while Calomiris and the Meltzer Commission majority would "replace ex post negotiations over conditions for IMF lending with ex ante standards for access to IMF lines of credit…" (Calomiris, 2003, p. 260), I argue that there is a strong case for seeing these two approaches as complements rather than substitutes.

We begin with a review of a number of important areas of consensus that have developed about reforms of the international financial systems. It is argued that these developments are a necessary precondition for serious consideration of expanding the IMF's capacity to operate as an ILOLR. We then turn to the Meltzer Commission's report and the controversies it has generated. This is followed by more in-depth discussion of several key issues involved in the ILOLR debate: ex ante versus ex post conditionality moral hazard issues, the role of standstills and private sector involvement (PSI), and catalytic effects and the size of Fund programs. We then turn to the case for creating a separate ILOLR function at the IMF, but as a complement to rather than a substitute for IMF conditionality programs.

2. Areas of Consensus About International Financial Reform

Despite the high degree of controversy about reform of the international financial architecture, a good deal more consensus has developed than would meet the eye of the casual observer. This is especially true with respect to policies of crisis prevention. This is crucial became without this development the case for expanding the IMF's capacity for crisis lending would be much weaker.

One of the most important causes of the IMF's tendency toward excessive leniency in its lending policies, was the pressure to help countries defend regimes of pegged exchange rates. We can imagine circumstances in which such defenses are desirable but they are a small subset of the actual defenses that have occurred over the

last several decades. IMF's track record in aiding such defenses has been abysmal. Just think of the recent cases in Argentina, Russia, and Turkey.[4]

Today, the political pressures on the IMF to help countries defend pegged regimes have fallen sharply. For one thing, there are now many fewer pegged regimes.

Secondly, there is now considerable agreement that pegged exchange rates have been a major (albeit not the only) cause of international currency crisis and that the IMF should not provide financing to countries that follow domestic policies inconsistent with their exchange rate regimes. This view is reflected in both the Meltzer and Council on Foreign Relation Reports, and statements of the U.S. Treasury and the IMF. There is some evidence of a move back toward heavier exchange rate management by some countries, and some old fashioned pegs remain in countries such as China and Malaysia. Thus it would be an overstatement to argue that this source of pressure for ill-advised IMF lending has been totally eliminated, but it has surely been sharply reduced.

There is also widespread agreement that the IMF's policies of conditionality must be substantially revamped. The basic idea of conditionality is a good one. IMF lending with no strings attached could help countries postpone necessary but painful adjustments. By making funding contingent on good domestic policies, IMF programs provide both a carrot and a stick to help ease the costs of adjustment for recipient countries while increasing the incentives for them to undertake such policies. A few scholars have criticized the basic theory underlying conditionality[5], but most criticisms concern its application.

The IMF has done both too much and too little. Over the past decade it greatly expanded the range of its policy conditionality. While often put to good causes, policy

conditions became far too intrusive and played insufficient attention to the appropriate balance between international influence and national responsibility. At the same time, however, the IMF's track record for effectively enforcing its policy conditions was in many cases quite poor.[6]

Political and bureaucratic incentives made it difficult for the IMF to enforce sufficient implementation. The Fund has frequently pulled programs for non-compliance but then started them up again soon after with little or no penalty for previous behavior. A strong consensus has emerged that the IMF should refocus on its core competencies of macro, financial and exchange-rate economics. Under the new Managing Director, Horst Kohler, the Fund has at last begun to pay attention to these criticisms, and streamlining conditionality and developing national ownership of programs are now the watchwords.[7] It is too soon to tell just how effective this shift will be, but it is certainly in the right direction.

Another area of consensus among most outside experts is that the major powers should stop using the IMF as a backdoor way of funding countries for geopolitical purposes such as the ill-fated Russian loan in the late 1990's. The attractions of using the IMF as a political slush fund by national leaders with short time horizons are quite understandable; but if continued, such manipulation will undercut the IMF's ability to carry out its prime mandate of promoting international financial stability with long run costs to all. The combination of the problems just noted has seriously eroded the credibility of IMF programs and reduced the effectiveness of its seal of approval as a signal to private financial markets.[8] More than its billions of cash, its credibility is the Fund's most valuable asset, and this has been dangerously eroded.

Despite the frequent charges that the IMF is an unresponsive and unaccountable international bureaucracy, many of the problems that experts have identified with the operation of the IMF have been due primarily not to the staff of the Fund, but to its management of the Fund and its shareholders (the governments of the member countries) who elect the management.[9] There is, of course, some bureaucratic slippage, but it is much less than in most international organizations. Particular groups of countries may feel that they have little to say in Fund policies, but there is not much the Fund does against the wishes of the major industrial countries.

It is not clear, however, whether the major powers have accepted the argument that continued use of the IMF for political purposes is substantially undercutting its effectiveness. The Bush Administration was sharply critical of excessive IMF lending but then became the leading advocate for big IMF loans to Turkey and Argentina. Geopolitical considerations may be the biggest obstacle faced by advocates of IMF reform. Another important area of consensus is that IMF procedures developed to deal with the early post-war period of low capital mobility need substantial revision in a world of high capital mobility.

The IMF was established in an era where capital controls were widespread and balance of payments difficulties tended to emerge fairly slowly over time and were typically of relatively small size. Indeed, IMF financing was initially intended only to cover current account deficits. The key tasks for IMF programs were to see that countries were initiating appropriate adjustment policies and providing interim financing as these policies began to turn around the balance of payments. IMF funds were paid out in installments. This process helped keep IMF leverage over national policies after a

program was agreed. If a country deviated too much on its policy promises, than disbursements could be held up or terminated. While in practice it has proven difficult for the IMF to manage this process with sufficient toughness, the basic strategy of installment payments linked to policy conditionality was well conceived.

The situation changes drastically, however, in a world of high capital mobility. Payments positions can turn from surplus to deficit quite quickly and the magnitude of the swings can be enormous. This was illustrated in both the Mexican crises in 1994-95 and the Asian crisis in 1997-98. Furthermore, with high capital mobility, crises can spread much more easily from one country to another. In my judgment there were no entirely innocent victims in the wake of the financial contagion stimulated by the recent currency crises—i.e. no countries with strong fundamentals in all dimensions were hit by large, unjustified speculative attacks—but modern international monetary theory stresses that fundamentals do not come in just two flavors—strong and weak.[10] There can be a sizable gray area in between and it is countries in this intermediate zone of vulnerability who are the "victims" of contagion from international currency crisis today.

Traditional Fund programs were ill-suited to deal with such situations. The international financial community recognized this and has responded with innovations in Fund programs such as the SRF that allow larger financial packages with greater front loading of funding and higher interest charges. These changes have been in the right direction, but they have not gone far enough. The recent CCL facility was a hastily designed political response to the recent currency crises and many international monetary experts believe that it was sufficiently flawed that it would be better to scrap it and start over again, rather than to continue to tinker with it as the official community has done so

far. The IMF understands that the substantial increase in international capital flows generally challenges old ways of doing business and indeed has recently published a study on "IMF-Supported Programs in Capital Account Crises" (Ghosh et al (2002)). This study is full of cogent analysis and clearly recognizes that the prospect of financial capital running for the exit plays havoc with the traditional IMF policy of doling out money for its programs in tranches over several years. Thus the Fund has moved toward front-loading its loans.

While the IMF study discusses the large overshooting of exchange rates that followed the outbreak of the Asian crisis, it gives little attention to the possibility that greater exchange market intervention financed by the IMF could have substantially reduced this overshooting and hence moderated the effects of the crisis. Because of the large unhedged foreign borrowings by firms in the crisis countries the economy wide effects of these large depreciations was quite substantial.

The IMF study is not used as a platform to support a request for additional resources to deal with such situations. Rather it emphasizes (quite appropriately) the risk that "…the financing gap itself become endogenous, with greater outflows of private capital enabled by more official money" (p. 20). This has indeed been a major problem in cases such as Russia where the IMF lent to help a country try to maintain a misaligned pegged rate. Such loans helped capital to rush to the exits at still favorable exchange rates. Thus it is heartening to see this danger emphasized. But once a country has gone to a more flexible exchange rate, as was the case with all of the Fund's programs during the Asian crisis, this consideration would seem less relevant.

Efforts at blame deflection may help explain the IMF study's conclusion that "above all, this discussion suggests that there are rather narrow limits to what the available financing tools can do to address an ongoing crisis" (p. 21). This statement, however, begs the question of whether large financing would have been a good idea or whether it just wasn't feasible given the Fund's policies and the size of its resources. For forward-looking policy analysis we need to separate the question of whether the Fund should be faulted for not having done more in the Asian crisis given the constraints it faced from whether these constraints should be changed for the future. The Fund study indicates "It is difficult to contemplate official financing packages several times the size of recent ones…" (p. 61), but from the standpoint of good future oriented policy analysis that is exactly what we should do. The answer could well be that it's a bad idea, but that's what we need to analyze.

In a similar vein, an influential report from the Council on Foreign Relations (1999) argues that "…private capital flows…are now just too big to expect Fund-led rescue packages to cover fully all financing gaps faced by emerging economies" (p. 67). In the full report (1999) the task force argues that "We are not persuaded that smaller rescue packages would necessarily make it more difficult to regain the 'confidence' of investors, as experience suggests that this owes more to the speed and determination with which underlying economic problems are addressed" p. 12.

Both statements are phrased in highly self-serving ways. Arguing that private capital flows "are just too big" seems to put an end to the issue. While this statement is certainly true given the current level of Fund resources, this limit is a political not a technical one. Likewise, it is certainly true that pouring more money at the wrong

countries would do little to help, but experience suggests that it usually takes time to restore market confidence even when countries are adopting appropriate policies. In such cases it seems unlikely that the quantity of funding available would have no effect. The key may be to get the IMF to be tougher in deciding to fund programs, rather than starving it of cash in general. Indeed, the Institute of International Finance has estimated that in the Asian and Russian crisis, international investors lost over $300 billion. (Cited in Council on Foreign Relations, 1999).

3. The Controversy Over the Meltzer Commission Report

As we have noted, part of the hesitancy for greatly expanding the IMF's capacity to act as a short-term emerging lender reflects growing recognition that the traditional IMF programs of conditional lending have had a less than stellar track record and that this is endangering the credibility of the IMF's seal of approval. There are also widespread concerns that IMF lending has generated moral hazard problems, and some even argue that the IMF has contributed more to the generation than the amelioration of crises.

Such concerns led to the majority of the recent commission established by the U.S Congress to study the international financial institutions to make the radical recommendations that all current IMF lending programs be terminated and a new LOLR be created in their place.[11] Ex post conditionality would be entirely eliminated and replaced with ex ante criteria for gaining access to ILOLR lending. While the conditions of access to IMF lending would be much tougher under the Meltzer Majority proposal,

and the cost of borrowing higher, the size of permissible Fund loans would be much larger. This is in line with the classic rule for a LOLR proposed by Walter Bagehot: lend freely but at a high rate and only to those with good collateral.[12] In the Meltzer Majority proposal the ex ante conditions play the role for countries that Bagehot's good collateral played for lending to the private sector.

This recommendation drew strong dissents from a minority of the commission members. Such dissent stood in stark contrast to the unanimity on most of the recommendations concerning the IMF. The Meltzer Majority was strongly criticized by the Clinton Administration's Treasury and many international monetary experts for the stringency of its ex ante conditions, for abolishing ex post conditionality, and for requiring very rapid repayment. Some have also criticized it for increasing the potential size of IMF programs rather than reducing them as proposed by the Report of the Task Force for the Council of Foreign Relations (1999a and b).

Kumar, Masson, and Miller (2000) emphasize that countries that do not prequalify for the CCL or ILOLR are likely to face a shorter maturity structure of their debt. As a number of recent papers stress (see also, Jeanne (2000b) and Fratianni and Patterson (2001)), shorter-term debt provides more discipline but also increases the risk of currency runs. What is unclear is whether the creation of prequalification conditions meet by some countries would as a consequence further shorten the debt maturity of the non qualifiers. If so, this might be considered a negative externality. If this increased penalty for poor policies induced substantial increases in good policy effort by the non qualifiers this "tax" could have net positive effects. Unfortunately there is little evidence

to date to give us reason to hope that this type of discipline effect will be large (See Willett (2000b)).

As we will discuss below, some of the specific criticisms of the Meltzer Commission Majority have considerable merit, but surely the report is right that with the growth in international financial integration the IMF needs to develop a better capacity to operate as a quasi ILOLR.[13] The question is how can this best be done? This is not to say that for most currency crises ILOLR type lending would be desirable. As Eichengreen (2002a) points out "most observers are of the view that the majority of crises reflect problems with fundamentals, not investor panic" (2001, xv). Even without panic, however, risk averse behavior can generate sudden reversals in capital flows. While seldom unjustified, such behavior can take on a self-fulfilling character and make the punishment much worse than the crime.

Where the IMF is convinced that the market is overreacting, there is a case for ILOLR type lending. But in a world of substantial capital mobility, the size of the loan may have to be quite substantial in order to calm markets. This is especially true since the credibility of IMF programs has been called into question. Politically it is easiest for the Fund to make limited loans to many countries. But we have massive evidence that this strategy has serious flaws. The Fund lends to many countries when it shouldn't, but sometimes doesn't lend enough in the cases where it should lend. The huge magnitude of over-shooting of exchange rates during the Asian crisis is one of the best examples. As capital mobility grows, this problem is heightened.

This is where the Meltzer Commission Report comes in. If we pay attention to the logic, rather than the details of the Commission's Majority recommendations, we can

see a strong case for creating a new IMF facility that plays a quasi lender of last function in an effective manner.

4. The Meltzer Ex Ante Conditions

The Meltzer Majority argues that access to the facility should be made conditional on ex ante rather than ex post conditions. While there is much to be said for this approach, the specific recommendations of the Meltzer Majority for preconditions were both too narrow (focusing primarily on financial considerations) and too stringent to enjoy widespread support. Even if one agreed that they were optimal on technical grounds, there is no way that the Fund could credibly commit to lending only under such circumstances. And what is badly needed is to increase IMF credibility, not to saddle it with rules that its major shareholders would never let it enforce.

The Meltzer Majority recommended that to be eligible to borrow from the IMF "a member should meet minimum prudential standards" (p 44). This principle is relatively uncontroversial, as are some of the specific recommendations for requirements such as that commercial banks be adequately capitalized, that the maturity structure of outstanding sovereign and guaranteed debt and off-balance-sheet liabilities be published in a timely manner, and that the IMF establish a fiscal requirement to assure that Fund resources are not used to finance "irresponsible budget policies." More controversial was the proposed requirement that countries must allow freedom of entry and operation for foreign financial institutions. Many who would agree with this as good policy advice, would also question whether it is so essential that such an invasion of traditional national

sovereignty is justified.[14]

The dissenting statement by C. Fred Bergsten and others argued that in addition to being unduly stringent in some areas the prequalification criteria are insufficient because they ignore the macroeconomic stance of a country. To this I would add the now widely recommended requirement that loans be prohibited to countries with substantially overvalued pegged exchange rates. A majority of the Commission was critical of pegged rates and recommended that "countries should choose firmly-fixed rates or fluctuating rates" (p 49) but these are not included as a precondition for IMF lending.[15] I would argue, however, that it should be one of the most important preconditions.

Conceptually, there is a case for lending to a pegged rate country that is subject to a pure liquidity crisis.[16] There is a substantial moral hazard problem, however, that national officials will argue that outflows due to more fundamental causes are instead due to unjustified speculation or liquidity fears. The track record of IMF lending to countries to help save their pegs is not good at all. Such programs often merely temporarily extend the life of the peg. Argentina, Brazil, Russia, and Turkey are all recent examples.

Ideally the Fund would develop a set of preconditions that would be clearly understood by all. It would be highly preferable to have good rules rather than discretion to determine access to Fund lending, as this would create a less uncertain environment and help protect the IMF from political pressures. It is likely to prove difficult in practice to develop a good enough set of objective rules, however. While the attempt to do this should receive priority attention from the official community and academic researchers it will likely prove impossible to avoid some degree of discretion. The same is likely true for the development of guidelines for private sector involvement in the burdensharing

associated with financial crisis. In both cases, however, the objective should be to make whatever ambiguities remain constructive rather than destructive.

Note that what is called for is to create stable expectations about access that would allow countries to have a pretty good idea of whether they would be judged eligible or not. This would avoid a serious problem involved with the CCL's formal prequalification. The problem is how to deal with a prequalified country that backslides. With clear ex-ante conditions the country would just fall out of eligibility. With pre-qualification, however, the country would have to be decertified of formal prequalification contained in the provisions for the as yet unused CCL. In a purely technocratic public interest world this would not be a major problem, but in the real world of bureaucratic incentives and political pressures, decertification of a country that had slipped backwards in its policies would be extremely difficult.[17] At a time when its credibility has come into question, this is not a burden that should be placed on the IMF.

A. MORAL HAZARD ISSUES

Jeanne (2000b) nicely puts one of the key dilemmas of the IMF, "The lender of last resort solves the coordination failure that makes debt runs possible because it is a large lender. Precisely because it is a large lender, however, the Fund[18] is also unable to discipline the government to implement the reform." (p. 20) Of course moving from Jeanne's model to a broader (albeit less rigorous) view of the world, the IMF's size doesn't make it impossible for it to discipline borrowers, only difficult. This difficulty will almost certainly be greater, the more important is the country in question (for economic or political reasons) and the more likely is a crisis in that country to spread to

others.

In part for the latter reason, the IMF is likely to have less effective leverage over the enforcement of policy conditionality in the middle of a crisis than during its aftermath. While a crisis situation increases the costs to both the government and the IMF of failing to reach an agreement on a lending program, it is harder for the IMF to say no to a country that promises policies that the IMF thinks are unlikely to be implemented, than it is for the country to make such promises. This suggests that it would be desirable for the IMF to partially tie its hands during crises by relying primarily on ex ante conditions for making crisis loans. In designing such conditions, however, attention needs to be given not just to what conditions are ideal on economic efficiency grounds under the assumption that the IMF was an optimal welfare manager completely insulated from political pressures, but also on what conditions the IMF might credibly be expected to be able to implement.[19]

This is a type of question on which it is hard to provide solid evidence, and hence the scope to base one's positive analysis on one's normative beliefs is enormous. Thus, it is quite understandable that economists do not like to pose the question in this way. Ignoring such political economy realities does not make them go away, however. Nor is just telling the IMF that it shouldn't give into political pressures a viable option. Rather a multi-pronged approach is required. Internal reforms hold at least some scope for reducing the bureaucratic incentives to be too soft. More difficult to implement will be measures to give the Fund greater insulation from short run political pressures. We can safely conclude that while such efforts are important, they are unlikely to be completely

successful. Thus, such issues need to be taken into account in the design of IMF programs.

We can improve the IMF's credibility by minimizing the extent to which it must make pressure prone decisions such as decertifying a wayward country under the CCL. Separating Fund programs into short run crisis and medium term conditionality types should allow the IMF to be much tougher in the enforcement of its traditional conditionality programs.

It is becoming more widely recognized that national government policies are the primary sources of investor and borrower moral hazard and that IMF programs contribute to moral hazard for the private sectors only indirectly through increasing the ability of national governments to make good on their explicit and implicit guarantees.

A second type of moral hazard can operate directly on government policies themselves. Seldom, if ever, would a government have incentives to directly generate a crisis in order to get cheap loans. Even with sizable bailouts, the economic and political costs of crisis are generally just too great. As Meltzer [1998] points out, however, the availability of international loans that reduce the costs of crisis could well induce governments to pursue policies that ran greater risks (albeit not a certainty) of crisis.

What makes this especially likely to be a problem are the time inconsistency problems associated with many types of economic policies combined with short time horizons of policymakers. Given certain political costs now of adopting crisis reducing policies versus the possibility of increased costs later, governments frequently decide to run the risks, especially if an election is approaching. As Kumar, Masson, and Miller (2000) point out, "in the case of sovereigns who borrow, the moral hazard lies not so

much in the incentive to gamble per se as in the failure to put in the necessary 'adjustment effort' after debt has been contracted" (p. 5). Such time inconsistencies provide one of the major rationales for IMF conditionality programs as a source of external discipline. However, where the enforcement of conditionality is weak then it is possible for the moral hazard aspects of Fund programs to dominate their discipline effects.

Kumar, Masson, and Miller (2000) suggest that the ILOLR use "conditionality as a substitute for the monitoring embodied in the short-term debt extended to the 'non-prequalified' economy" and argue that "the authorities can check moral hazard with measures to elicit effort…if the monitoring of countries via programs allows for conditioning directly on effort" (p. 13). This helps us see the dilemma quite nicely. Ideal conditionality is clearly superior to actual market discipline. On the other hand, ideal market discipline would be superior to IMF conditionality as it has worked in practice. With both imperfect markets and an imperfect IMF, the best course of action is much more difficult to determine and must rest explicitly on political economy as well as technical economic considerations. No wonder there is such a wide range of disagreement about policy. We cannot hope that such differences in view will quickly be resolved, but we can at least begin to make progress by stressing the need for commentators to make clear their political economy as well as their economic assumptions.

In the model developed by Jeanne and Zettlemeyer (2001) "whether international bailouts create excessive moral hazard, and which policy measures best deal with this problem crucially depends on the international allocation of their final costs" (p. 10).

They present striking evidence that the fiscal costs of past crises have fallen almost entirely on domestic taxpayers, not on the international taxpayers who finance the IMF. Since the default rate on IMF loans has been low, they argue that there has been little subsidy element in IMF loans and hence little generation of moral hazard at the expense of the global taxpayer.

This conclusion is an important corrective to some of the exaggerated views that have been presented on the moral hazard costs of the IMF – for example the argument that the Mexican bail out was the primary cause of the Asian crisis.[20] It has the possibility to mislead, however. While the concept of international subsidy they advance is certainly a valid one, it is not the only possible concept. Such a "non-subsidized" interest rate could still be well below market rates that rise to temporarily high levels during a crisis. Even with a substantial penalty tax included, IMF lending rates would still be well below market rates in the middle of a banking or currency run. Such LOLR lending would thus still have a type of subsidy element even if the premium was sufficient to remove any expected costs to international taxpayers. This in itself isn't bad. It is indeed implied by the efficiency enhancing potential of a LOLR. The fact remains that by lowering the costs of crisis, it can make them more likely.[21] Bagehot sensibility would have us deal with these problems in a domestic context by allowing access only to solvent entities who offer good collateral. As a number of writers have recently emphasized, the international equivalent of the solvency of sovereign countries is much more complicated.[22] It is in part to deal with the international analog of this problem that preconditions and/or ex post conditionality are called for.[23] But in this context ex post conditionality should not also be necessary to ensure repayment. The ex ante conditions

for ILOLR type lending should be set and implemented with sufficient strictness to keep this from being a problem.

Jeanne and Wyplosz (2001) make the important point that with foreign currency denominated debt a country or firm that is insolvent at one exchange rate may be solvent at another. Thus with a large depreciation that is widely believed to have overshot long run equilibrium, one could have many "temporary" insolvencies. Jeanne and Wyplosz argue, quite convincingly I believe, that evaluations of solvency should be made at normal rather than crisis prices.[24] Implementing this approach could have problems, however. There could be considerable uncertainty about what normal prices should be. Thus, authorities could have considerable discretion. As a consequence they might be subject to strong political pressures to make overly optimistic estimates.

Note that there may be a case for ILOLR lending even to governments that are insolvent. Even where debt restructuring which amounts to partial defaults is required, illiquidity can still magnify the short run costs of a crisis and these costs might be reduced through temporary loans. Such ILOLR lending would need to have seniority and have a high probability of repayment. It is not always understood that if seniority can be offered, then even an insolvent firm may have good collateral to offer. It is unclear whether solvency in some sense should be included as a pre-condition for access to an IMF ILOLR facility. This issue requires careful attention, as does the general degree of stringency of pre-conditions. The Meltzer Majority proposal makes them extremely stringent. The IMF's CCL facility, while not as tight, is clearly aimed at A-list countries. The problem is that most of the countries that have been hit by speculative attacks in recent groups have been at best B list countries, i.e. ones who are in the intermediate or

vulnerable zone. A contagion facility designed only to help completely innocent victims of major speculative attacks could well have no eligible customers.

Jeanne and Zettlemeyer (2001) note "where the fiscal cost of the bail-out is borne entirely by domestic taxpayer international bailouts could still generate excessive moral hazard but this requires a departure from the benevolent social planner paradigm" (p. 9). Most of those who worry about moral hazard would answer "precisely." It is the perceived existence of time inconsistency problems and other sources of political pressures to adopt suboptimal economic policies that provides the classic rationale for the IMF's role as a source of external discipline through its programs of policy conditionality. That the Fund has proven to be much less effective in this role than we might hope is no indication that such political biases do not exist. This suggests that we need to look well beyond concerns with repayment in assessing the design of IMF programs.

Despite their conclusion that there has been little, if any, subsidy element in IMF crises lending, Jeanne and Zettlemeyer do recognize the case for making future IMF loans contingent on the quality of domestic policies – with respect to moral hazard in the financial sector as well as for macroeconomic and exchange rate policies. They provide further support for the growing view that more emphasis needs to be put on ex ante conditionality and suggest that the amount of funds available as well as their interest cost be made contingent on a set of ex ante conditions.[25]

B. STANDSTILLS AND PRIVATE-SECTOR INVOLVEMENT

Of course the provision of an ILOLR is not the only way to deal with a liquidity crisis. Payments stand stills and other forms of private-sector involvement (PSI) are also possible.[26] Indeed many international monetary experts believe that such measures are likely to be a part of any efficient reform of the international financial architecture. Besides requiring less money for credible IMF programs, PSI would reduce investor moral hazard and to many would seem more equitable since careless or optimistic investment would not be fully bailed out.

Developments on PSI should clearly influence the size of loans from a LOLR. This is presumably a major part of the rationale for the call by the Council on Foreign Relations Task Force that IMF programs should be smaller. Progress on PSI has not been great, however.

This should not be surprising since the collective action problems involved are substantial and so is the political clout of many financial institutions that would just as soon not be involved. The recent IMF study on capital account crisis concludes "extensive work on private sector involvement suggests that, short of draconian measures that could jeopardize a country's market access for years to come, there is no simple way to stop the exit of capital once a crisis breaks" (Ghosh et al (2002) pp. 61-2. Likely the most promising approach is the idea of temporary standstills. This is an element of the Sovereign Debt Restructuring Mechanism (SDRM) proposed by Anne Krueger. It is not clear, however, how broad a coverage is envisioned. If it were limited to sovereign debt alone, its usefulness for dealing with liquidity crises would be quite limited.

While not yet attracting major attention for the official community, many independent experts have expressed support for the possibility of IMF-sanctioned

national standstills or for provisions for activating mandatory rollovers for short time periods at penalty rates such as have been proposed by Buiter and Siebert (1999).[27]

A trade off between reducing the costs of a current crisis and increasing the probability of future crises is inevitable, but we can search for better rather than worse tradeoffs.[28] In general it will not be optimal to place weight entirely on minimizing either current costs or the chance of future crisis. Having some degree of PSI in the sense of having major financial actors bear at least some costs from crises is an essential part of finding the efficiency frontier for this trade off. Limits on the extent to which national governments promise to bailout major financial actors should thus be one of the criteria on which eligibility to borrow from the IMF is based. This should be feasible. Obtaining support for broad standstill measures will not be easy, however. In the near term we cannot expect standstills to provide an adequate substitute for an ILOLR type facility.

C. CATALYTIC EFFECTS AND THE SIZE OF LOANS

Recognition that at present the catalytic effect of Fund programs on private sector capital flows is rather limited also has important implications for the size of IMF lending. The Fund is beginning to recognize that the conventional wisdom about the powerful catalytic effect of IMF programs needs revision, at least temporarily. This indirect route for "bailing in" the private sector has not worked well during recent crises. This is documented in the Fund's study of recent capital account crisis. In most of these programs Fund staff projected a positive catalytic effect but in a majority of cases reviewed net capital outflows were recorded and in some cases the differences between projections and outcomes were enormous.[29] This was especially true of the Asian crisis

where the forecast errors for Indonesia and Korea were greater than 9 percent of GDP and for Thailand exceeded 17 percent of the GDP. (It is a credit to the new transparency at the IMF that these figures have been made public.) For Brazil in 1999, net capital flows remained positive and the forecast error fell to 3.5 percent of GDP.

The IMF's tough bargaining with Argentina since its crisis is consistent with the view that the top officials at the IMF and industrial country finance ministries have finally recognized the importance of worrying about the credibility of IMF programs, but full credibility cannot be earned back overnight.

The IMF requires deep pocket backing to be an effective ILOLR. There is a dilemma here. There is considerable evidence that international financial markets do not always behave with perfect efficiency and that within zones of vulnerability there is scope for self-fulfilling bank or currency runs that present a case for an ILOLR.[30] On the other hand, the IMF's track record on enforcing conditionality leaves a great deal to be desired. Thus it is quite understandable that its shareholders are likely to limit the amount of resources that they are willing to provide to the IMF. In a second best world, institutional failure limits the optimal level of resources that should be provided to the IMF to offset market failures.

There is a danger in making loans too small, however. Jeanne and Wyplosz (2001) show that in the case of twin crises problems (i.e. both banking and currency crisis) with high international capital mobility international lending to finance-sterilized intervention in the foreign exchange market will be ineffective and huge amounts of lending could be required of the ILOLR. On the other hand, to the extent that the problem is disorderly markets due to temporarily high risk aversion such as is analyzed in

Willett (2000b), sterilized intervention can be effective and much less funding would be needed.

While small compared with the huge funding requirements in a Jeanne-Wyplosz world, the required funding in the Willett scenario in the absence of strong catalytic effects on private capital flows, could still be quite large compared with traditional IMF programs, much less with the recommendations of Goldstein (2001) and the Council on Foreign Relations Task Force (1999) that the size of Fund programs be reduced.

There are definite dangers to making the size of lending too small as well as of making it too large. One can construct models in which a partial bailout is even worse than no bailout at all. (See, for example, Zettelmeyer (1999).) It is certainly true that if a loan is too small to stem a crisis of confidence, than all it will do is help some agents get their money out at favorable rates. While this could be an important objective for a government presiding over a regime of crony capitalism, this would hardly be one for the IMF. Still one should not understate the potential helpfulness of limited loans if they are accompanied by stabilizing domestic policy actions. As Roubini (2000) concludes, "while middle solutions…may not work in theory they do appear to work in practice as recent episodes (Mexico, Korea, Brazil) seem to suggest" (p16).

5. Separating the LOLR and Conditionality Functions

Serious consideration should be given to separating IMF funding into two components – one to deal with the short run liquidity crisis and the other to deal with medium-term policy reforms and adjustment. It is widely agreed that Fund programs are

much more effective where there is considerable national ownership of its programs.[31] One of the biggest difficulties with developing such ownership is that it takes time to consult broadly, and this is not available in the midst of a crisis.

By creating an explicit ILOLR type facility in the IMF with only ex ante conditionality, i.e. preconditions, national governments and the Fund would be given more time to both design and develop political support for a medium term financing and adjustment package. This is likely to be especially important for issues of financial sector reform where concentrated interests make the political economy of reform even more difficult than in the macroeconomics and exchange rate areas. It seems likely that the existence of a short-run facility without ex post conditionality would thus increase the effectiveness of IMF conditionality for its other programs by reducing the need to reach agreement before sufficient domestic support is obtained.

Of course, it can be argued that by providing immediate short run financing the IMF will reduce its leverage over future national policy reforms. This concern can easily be overstated, however. The ILOLR funding should carry a substantial penalty rate and, more importantly, should be of short duration. This should keep plenty of pressure on national governments to reach agreement on a medium term program. The Meltzer Majority is emphasis on making the ILOLR funding short term is well taken.[32]

Of course, if the duration were made too short and roll overs were not allowed then the ability of the loan to calm the market could be compromised. There is a basic tradeoff. The shorter the duration and the greater the difficulty of a rollover, the greater is the pressure on the government to agree to a conditionality program but the greater also is the danger of not quelling the immediate liquidity crisis. Clearly this tradeoff needs to be

given careful analysis. Charles Goodhart has suggested that this tradeoff can be improved by imposing a schedule of sharply increasing interest rates as the time before repayment lengthens.[33] The SRF in fact embodies this principle, but in a relatively mild form with the interest surcharge increasing only annually and being capped at 350 basis points.

We have observed in recent crises in emerging market countries a tendency for financial markets to take some time to return to their normal functioning. As a consequence there was a tendency for currency depreciation to frequently initially overshoot.[34] The provision of temporary financing to reduce such overshooting provides another rationale for IMF programs. It is less clear, however, whether financing for this type of problem should be done through an ex-ante or an ex-post conditionality facility. Here again a policy of time escalating interest rates for the ex-ante facility could be helpful, with the rising interest costs giving governments an incentive to negotiate an ex-post conditionality program that would carry a lower interest cost. The continuation of this market conditions periods of six months or more as occurred during the Asian and Russian crises suggests a case for giving the ex-ante facility a maturity longer than would be needed to deal only with outright speculative attacks.

6. Concluding Remarks

Because of the combination of the growth of international financial integration and the poor track record of the IMF in enforcing its policy conditionality, the Meltzer Commission Majority were right that the traditional structure of IMF funding programs needs substantial reform. The analysis of potential reforms must go beyond technical

economic issues to take into account political economy considerations as well. The latter help explain why past IMF lending policies have been much too lenient and threaten to undermine its credibility.

A substantial reorientation of the behavior of the IMF and its principal shareholders is essential for the IMF to achieve its potential. This will require both changes in attitudes and in institutional mechanisms to better align incentive structures with efficiency considerations.[35]

It is important to recognize, however, that efforts to adopt too stringent a limitation on access to IMF funds will lack credibility and hence defeat their purpose. Much of the current debate about ex-ante versus ex-post conditionality has been drawn too sharply, with those on each side often implicitly assuming that one type will be effective and the other won't. Basic principles of political economy suggest that neither type is likely to be fully effective and that at least to some degree the two approaches should be viewed as complements rather substitutes.

A strong tilt towards greater emphasis on preconditions and the removal of ex-post conditionality for short-term crisis lending combined with a general increase in toughness would be desirable. By giving more time to develop conditionality programs, such short term ILOLR type lending could help facilitate the development of greater national ownership of IMF policy conditionality programs and give the IMF more cover to say no when insufficient domestic support for programs is forthcoming. This in turn should help the IMF to begin to regain much needed credibility for its programs and restore the traditional catalytic role of the IMF seal of approval.

It is understandable that it is hard for the IMF to say no and then be held responsible for subsequent crises. It may prove impossible for the IMF's incentive structures to be reformed sufficiently for it to perform adequately in this area, but there's a chance, and the IMF should be given the opportunity to make a try. Its recent toughness with Argentina is a hopeful sign, as is the recent emphasis on transparency and the creation of the Fund's new independent evaluation office. So is the Fund's current effort to streamline conditionality. In effect the Fund has itself become be the subject of policy conditionality from its shareholders. Notice has been clearly been served that if the IMF does not start to be more effective in its policy conditionality, support for increased funding over time will likely decline sharply.

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[*] This paper has benefited greatly from comments by and discussions with George Anayiotos, Andrew Berg, Graham Bird, Richard Burdekin, Peter Clark, Susan Collins, Arthur Denzau, Michele Fratianni, Charles Goodhart, Olivier Jeanne, Joseph Joyce, Ken Kletzer, Paul Masson, Allan Meltzer, and Zeromin Zettlemeyer, the students in my seminar on international money and finance and discussion at presentations at the annual meetings of the Western Economic Association, the London School of Economics Conference on Euroization, and at the Yale University Conference on the International Monetary Fund and the World Bank. An earlier version was titled, "Restructuring IMF Facilities to Separate Lender of Last Resort and Conditionality Programs: The Meltzer Commission Recommendations as Complements rather than Substitutes."

[1] For an excellent review of reform discussions, see Kenen (2001).

[2] The issues surrounding whether the IMF can be a true ILOLR will be discussed below.

[3] The SRF provides larger loans at higher interest rates and has become the facility of choice in recent crises. The CCL was developed in response to fears of contagion and

was designed to protect countries with top quality policies from unjustified contagion. In effect it was a pre approved credit line but with the preapproval not absolute. This and fears that an application would be viewed by the market as a signal of looming problems have helped contribute to the failure of any countries to formally apply. For more on the current IMF facilities see Bird (forthcoming) and Kenen (2001), (2002).

[4] There is some disagreement about the case of Brazil. While the defense ultimately failed, some argue that the delay generated substantially reduced contagion.

[5] See for example, Killick (1996).

[6] Summarizing the literature on the effectiveness of Fund conditionality Goldstein (2000) concludes "existing studies suggest that obtaining compliance with Fund conditionality has been a serious problem" and that "The compliance problem has been getting more serious over time" (p. 47). Based on the research to date, Bird (2002) suggests the evidence of the effectiveness of IMF conditionality is neither as low as the Meltzer Commission suggests nor as positive as the IMF implies. He points out that there is a basis for the IMF's rosy glasses if one looks only at effects on the balance of payments, but that the evidence suggests little, if any, systematic effect on other major variables. Such evidence absolves the IMF of the claims from the left that its programs typically harm those they are supposed to be helping; but this should be of only minor consolation. For additional reviews of the effects of IMF programs see Bird (1996), Bird (2002), Killick et al (1998), and Ul Haque and Khan (2000).

Note that the full evaluation of effectiveness includes consideration not only of the extent of compliance, but also how much policies changed from what they would otherwise have been as well as what the effects of the policies were. This is in turn a function both

of the degree of implementation and of the appropriateness of the policy actions agreed to in the IMF programs. Thus it is not surprising that there is a good deal of controversy about such evaluations.

[7] The need for developing strong ownership, i.e. host government commitment to programs, has been stressed in recent IMF documents. See IMF 2001a and 2001b and Khan and Sharma (2001). See also Bird (1998), Bird and Willett (forthcoming) and Drazen (2002). The concept of ownership is of course full of ambiguities since countries are not unitary actors. Frequently IMF programs are used by some domestic actors to try to gain more political leverage over other domestic actors. How broadly ownership needs to be spread for effective implementation is a crucial question which pure economists have little competency to address. Thus there is a tremendous need for the IMF to develop more capacity for political economy analysis. See Willett (2000c) and Bird and Willett (forthcoming). More systematic knowledge by IMF staff of the countries in question is another important aspect.

[8] See Willett (2000a). Recent work by Bird and Rowlands (2001) fails to find evidence of the commonly assumed catalytic effect of IMF programs on private capital flows but Bussière and Mulder (1999), find that during the crisis of the second half of the 1990s countries with IMF programs were much less vulnerable to contagion, suggesting a positive credibility effect from Fund programs. Mody and Saravia (2003) also finds evidence of positive catalytic effects under certain circumstances. These results are consistent with the view that the IMF needs to become more selective with its proposals on IMF conditionality as a screening device. See Marchese and Thomas (1999).

[9] See Willett (2002a)

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[10] Often after the initiation of a crisis the financial markets become somewhat indiscriminately conservative for a short period of time resulting in upward pressures on interest rates and downward pressures on stock prices. Major speculative attacks have tended to be much more focused, however. A number of economists have suggested that the speculative attack on Indonesia in the wake of the Thai crisis was not justified by the fundamentals. This is definitely true with respect to traditional economic fundamentals. It becomes much less clear that the speculative outflows are unjustified when financial and political considerations are included in the fundamentals. See Willett (2002b).

[11] This report is widely known as the Meltzer Commission Report, after its Chairman, the distinguished economist Allen Meltzer. Its official name is the International Financial Institution Advisory Commission (2000). For reviews of this and other recent reports on international monetary reform see Bird (2000), Kenen (2001), (2002) Willett (2001b), and Williamson (2000a).

[12] For a review of what Bagehot (1873) actually said and the earlier analysis by Thornton see Goodhart (1999).

[13] There has been a great deal of recent literature on whether the IMF should and whether realistically it could play the role of an international lender of last resort. As Jeanne and Wyplosz (2001) emphasize, there is still considerable ambiguity associated with the notion of international LOLR. Some have argued that since it cannot create its own currency, the IMF cannot be a true LOLR. This ignores, however, the possibility of the IMF being given the authority to issue new Special Drawing Rights. And even without this the IMF could be made a lender of large, albeit not unlimited funds. Thus the Meltzer Commission refers to the role of a quasi LOLR. As is emphasized by

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Fischer(1999), the crisis manager role of a LOLR is also of considerable importance. For examples of the recent literature on these issues, see Calomaris (1998), Capie (1998), Capie and Wood (1999), Eichengreen (1999), (2002b), Fischer (1999), Giannini (1999), Goodhart (1999), (2000), Goodhart and Huang (2000), Goldstein (2001), Jeanne and Wyplosz (2001), Kenen (2001), Rogoff (1999), Sachs (1999), Srinivasan (1998), (2002), and the papers in Goodhart and Illing (2002).

[14] For example, it is not at all clear that such a requirement would meet Feldstein's [1998] suggested criteria for appropriate IMF conditionality that includes that conditions should be essential for the restoration of access to international financial markets. This recommendation is particularly interesting in light of the Commission's criticism of the infringements of national sovereignty implied by the broadening of IMF policy conditionality.

[15] This may have been due to hasty drafting under intense time pressure for completion of the report. Allan Meltzer has indicated that he does support the inclusion of such a requirement. While it is widely agreed that with substantial capital mobility a narrow band adjustable peg is a recipe for currency crisis, it is a more open question whether systems of limited flexibility such as crawling bands are still viable. They have worked well in some cases and not in others. On these issues see Leblang and Willett (2003) and Williamson (2000b).

[16] There is, of course, some question whether we ever have pure liquidity crises. Tirole (2002) argues that "There is never liquidity without at least some suspicion regarding insolvency" p. 111.

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[17] In part to cope with this problem the CCL does not formally provide automatic access to pre-qualified countries. They still require approval of the Executive Board to draw funds. This was probably one of the reasons why no countries have asked to be pre qualified. In recent revisions to the CCL, the Fund has attempted to make this last stage less of a potential hurdle.

[18] The reference here is to any ILOLR, not necessarily the IMF.

[19] This point is emphasized in Eichengreen (2000).

[20] For recent analysis of the extent of IMF induced moral hazard see Dell'Ariccia et al (2000) and Lane and Phillips (1999).

[21] This does not necessarily connote an inefficiency. Some degree of tradeoff in this area is inevitable. In this context inefficiency from refers to from the choice of policies that fail to give the most efficient tradeoffs.

[22]For example, Goldstein (2000) argues that "The distinction between illiquidity and insolvency is not regarded as particularly helpful in most crisis situations since the dividing line between the two often rests on the quality of crisis management." (p. 9)

[23] For contrasting views on whether the ILOLR should follow Bagehot and lend only on good collateral see Feldstein (1998), Goldstein (2000) and Meltzer (1999).

[24] This was also Bagehot's position implicitly

[25]A key issue (which lies beyond the scope of this paper) is whether access to an ILOLR facility should be all or nothing as recommended in the Meltzer Commission Report and adopted in the CCL or graduated as favored by the Council in Foreign Relations Task Force, which recommends three categories. Again in assessing this issue it will be

important to pay attention to political economy considerations, not just technical economic analysis.

[26]For recent discussions and references to other literature on private sector involvement and the restructuring of sovereign debt see Cooper (2002), Eichengreen (1999), (2000), Goldstein (2001), Kumar, Masson, and Miller (2000), Roubini (2000), Rogoff (1999), and Williamson (2000a).

An alternative approach to the ILOLR function has been suggested by Lerrick and Meltzer (2001). They propose, consistent with the spirit of Bagehot, that the IMF and other official lenders stand ready to buy distressed debt to the private sector "at a cash price will below its expected restructured value." Such a "constructive default framework" they argue would fight panic by capping the size of expected losses while avoiding problems of moral hazard. Whether there is in fact a floor price that would meet both objectives is an important question for study.

[27] See, for example, Williamson (2000a).

[28] Jeanne (2000a) shows that the comparative welfare effects of crisis management policies such as the use of an ILOLR, coordinating creditors, and taxation of short term capital flows are all highly dependent on the causes of short term foreign currency debt and the nature of shocks.

[29] See Lane et al (1999) and Ghosh et al (2002).

[30] See the analysis and references in Willett (2000b).

[31] See, for example, Drazen (2002), Khan and Sharma (2001) and the references cited there.

[32] I would, however, recommend allowing more rollovers than they propose.

[33] In private correspondence to the author.

[34] See Willett (2000b).

[35] For discussion of bureaucratic and other biases that may affect IMF lending see the analysis and references in Willett (2001a) and (2002a).