Reform of the International Architecture

Realistic and Romantic Reforms of the International Financial System

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Efforts to strengthen the international financial architecture have been underway now for nearly three years.[1] It is a game that any number can play. I like to divide the players into the realists and the romantics. The romantics have idealized – that is to say, romantic – views of how the international financial institutions should be reformed. Martin Feldstein is a romantic. He would like to see the International Monetary Fund downsized and refocused on its core competence, namely, giving advice on monetary, fiscal and exchange-rate policies.[2] The Fund, in his view, has a mandate to pursue macroeconomic and currency stabilization and should concentrate on providing macroeconomic policy advice. It is not and should not be in the business of fighting corruption, alleviating poverty, reforming political institutions, remaking financial markets along Anglo-Saxon lines, or changing the way countries govern their corporations. To the extent that institution building and poverty reduction are goals to which the international financial institutions can in fact contribute, they are properly the province of the World Bank, not the IMF.

It would be nice were it possible for the IMF to limit its attention to monetary, fiscal and exchange rate policies and to disregard poverty, distribution and politics. But the only policies that work are policies that stick. If recommendations are not embraced by the governments to whom they are offered, they will not restore confidence. If they impose unfair burdens on a part of the population, they will incite a political backlash. If they have socially unacceptable distributional consequences, they will end up undermining both public support for the government and the social consensus for reform.

It follows that the IMF must worry about the political sustainability of the policies it recommends. This in turn implies that it has to be sensitive to the consequences for poverty, for the distribution of income, and for political stability. Admittedly, even those of us who accept this position are more than a bit uncomfortable with its implications. We appreciate that IMF staff and management are expert in economic theory and policy, not political science. But economic advice which ignores political realities is bad advice. Among the most important respects in which the world today differs from the world of the 1960s, 1970s and 1980s is that it is more democratic. Country after country has moved away from authoritarian politics toward more democratic political systems, and admirably so. But we must recognize that this makes the goals of the IMF that much more difficult to achieve. The money doctor's medicine can no longer be forced down the throat of a reluctant patient. And acknowledgment of this fact is subversive to the idea that concern with poverty, distribution, and politics is incidental to the IMF's mandate.

One romantic view: The IMF should only give macroeconomic policy advice

Moreover, it is essential to acknowledge that an institution that was established to assume responsibility for the stabilization of exchange rates has inevitably acquired a very different set of responsibilities. In 1944, when the IMF was founded, international financial markets were demoralized, controlled, and suppressed. International economic stability was synonymous with exchange rate stability, reflecting memories of exchange-rate turmoil in the 1930s and the infinitely more destructive conflicts that followed. Today's IMF is a different animal, not just because the Bretton Woods System of pegged-but-adjustable exchange rates that provided its original mandate is no more but

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[1] If one dates it from then U.S. Treasury Secretary Rubin's speech at Georgetown University in February 1998 that popularized the phrase.
[2] See Feldstein (1998).

because of the exponential growth of international financial flows. In the wake of World War II, a period of pervasive controls on international capital movements and tight domestic financial regulation, international economic stability was synonymous with macroeconomic stability and, more specifically, with exchange rate stability. Now, when they invoke the concept of international economic stability, most observers appropriately mean financial stability. Financial transactions, international financial transactions in particular, are back. The principal threat to the stability of national economies and to the world as a whole is financial crises, not simple changes in exchange rates. The IMF has consequently become the point man in the global effort to prevent and contain financial crises, for reasons whose logic is too compelling to deny.

Once one acknowledges this fact, it becomes impossible to accept the idea, however appealing it may be to the instincts of those skeptical of the motives and efficiency of large bureaucracies, that IMF surveillance and conditionality should be limited to monetary, fiscal and exchange rate policies. Because it is in the business of ensuring financial stability, and because the structure and regulation of financial markets are key determinants of financial stability, the Fund has no choice but to worry about auditing and accounting, financial disclosure, connected lending, prudential supervision and regulation, insurance market regulation, bankruptcy and insolvency procedures, shareholder rights and corporate governance. The single most important lesson of the Asian crisis is that international financial stability requires domestic financial stability. Given the speed with which financial problems spill across borders, international financial stability can be jeopardized by weak policies and institutions in a single country in the same way that the stability of a national financial system can be jeopardized by problems in a single bank (if the latter is big enough). And domestic financial stability requires upgrading national practice in all the aforementioned areas. Hence, the IMF, which has a mandate to promote international financial stability, cannot and should not avoid concerning itself with the domestic financial arrangements of its member countries. It is inevitable, then, that the institution should be led into surveillance of these areas and that it should attach conditions relating to them to its loans.

However, today financial crises are the principal threat to national macroeconomic stability

This agenda is not unproblematic. Most obviously, the IMF lacks the resources to monitor every aspect of economic structure and regulation relevant to the stability of financial markets. It thus needs to attach priority to monitoring those policies and arrangements that are most intimately connected to financial stability – and to figure out how to give operational content to this unobjectionable platitude. The reform of bankruptcy and insolvency procedures, for example, holds out more promise for strengthening creditor rights, market discipline and financial stability than breaking up Indonesia's clove monopoly. Similarly, however admirable are poverty eradication and an equitable distribution of income as social goals, conditioning IMF assistance on measures to address poverty and income distribution is justified only if the case is made that such measures are essential to the political sustainability of reforms required for the restoration of financial stability.

Second, there is the problem of limited competence, since the Fund lacks staff possessing the specialized skills of accountants, bank supervisors, and securities market regulators. Some of these it can find in its sister institution across the street and in other public agencies. Others it can beg, borrow and steal from the private sector. A successful experiment along these lines is the IMF and World Bank's newly-created Financial Sector Assessment Programs, in which Fund and Bank staff, together with experts from national central banks, supervisory agencies and private-sector organizations on secondment, undertake systematic assessments of the implications for stability of the organization and regulation of national financial systems. This is the approach being taken to gathering and analyzing the information needed for the Reports on the Observance of Standards and Codes (ROSCs) that the IMF now proposes to issue for its members.

Third, there is the danger that the Fund will give one-size-fits-all advice, destroying the biodiversity of the „genetic pool" of diverse national practice. International bureaucrats situated in Washington, D.C. inevitably know less about the distinctive circumstances of 182 national economies than locals who encounter those circumstances every day. Hence, advice regarding institutional design, if it comes down from above, may fail to take advantage of "local knowledge."[3] This raises the danger

[3] A point emphasized by Rodrik (1999).

that the Fund will recommend institutional arrangements ill suited to local circumstances.

The solution is to rely on international standards for national practice in areas related to the organization and regulation of financial markets, which define minimally acceptable practice while allowing countries to meet those standards in ways that accommodate the diversity of national economic, political and historical circumstances. Governments that believe in the existence of a distinctive Asian model of high debt gearing and bank-centered lending, for example, should be given the leeway to develop and regulate their financial markets in a manner consistent with that model. The only consideration relevant to the IMF should be whether those national practices are consistent with financial stability. In the context of the Asian model this means strengthening market discipline by limiting explicit and implicit guarantees for financial institutions and mandating the prompt public disclosure of financial information by banks and corporations.

The implication is that the IMF's new focus on standards and codes is not a departure from its core competence or a manifestation of mission creep. Rather, it is central to the mandate of the institution in the 21st century.

The obstacles to be surmounted should not be underestimated. The Fund and the multilaterals generally lack the expertise and resources to devise financial standards in all the relevant areas. They must rely, as they have begun to do, on specialized bodies like the International Accounting Standards Committee, the International Federation of Accountants, and the International Association of Insurance Supervisors, and serve as ex officio members of their standard-setting committees. They must encourage these bodies to expand the representation of emerging markets, who are prominent among the countries to which the resulting standards will be applied. Rather than objecting to the entire standard-setting agenda, as the Group of 24 developing countries did in a communique issued during the recent Bank-Fund meetings, emerging markets will then have an incentive to take "ownership" of the resulting guidelines.

In addition, there is a reluctance to issue blunt assessments of the adequacy of national practice. The ROSCs issued to date by the Fund mince too many words to be effective. If the markets are to going to key the price of credit to IMF assessments of whether or not national practice in these areas meets the international norm, then the Fund's evaluations will have to be less opaque.

The consistency and effectiveness of market discipline being uncertain, there is still the need for the official sector to provide its own incentives for governments and countries to meet the standards it sets. Unfortunately, it is unclear what incentives the official community is prepared to offer. There is a recognition of the desirability of keying the capital weights applied by regulators to international bank lending to whether the borrowing country meets the relevant standards and codes but no concrete agreement on reforming the Basle Capital Accord. There is general agreement on the desirability of conditioning access to certain IMF facilities on countries' conformance to those standards but again no concrete agreement on how to proceed.

Ultimately, the international community will have to reject the notion that the IMF can simply "get back to basics" and concentrate on giving monetary, fiscal and exchange-rate advice. The desire of the romantics for a "focused Fund" with a clear sense of priorities, that is cognizant of its own limited capacities and of the autonomy of its 182 members, is understandable, even admirable. But in a financially-integrated world, the focus needs to be on financial stability, not just monetary, fiscal and exchange rate policies. Ineluctably, the Fund will be led to confront the complex reality in which much more matters than simply its traditional concerns centering on macroeconomic policy. The inaugural speech at September's Prague meetings by the IMF's new managing director, Horst Koehler (Koehler 2000), betrayed this fact. While repeating his now familiar mantra of the need to "refocus ... to prioritize and concentrate on implementation," Koehler then enumerated a long list of essential measures necessary to make the world a safer financial place. The conclusion is unavoidable.

The IMF's new focus on standards and codes is central to its mandate in the 21st century

Another set of romantics are the members of the Meltzer Commission, which reported to the U.S. Congress and Treasury on reform of the international financial institutions.[4] The commission's

[4] See International Financial Institution Advisory Commission (2000).

report concludes that the IMF should lend only to countries with fundamentally strong policies experiencing financial difficulties for reasons not of their own making (investor panic, for example, or the spillover from crises in other countries). The Fund should identify eligible countries, if possible in advance. It should lend to them without attaching detailed policy conditions, at high interest rates, for limited periods. Because the country's policies are fundamentally sound, no reforms are required in any case. And if a country that does not qualify for assistance, because for example it had failed to adequately supervise and regulate its banking system, experiences a crisis, then the Fund should stand aside and let it meet its fate (which would typically take the form of having to suspend payments on external debts, devalue its currency, and undertake restructuring negotiations with its creditors).

Distinguishing countries with sound and unsound policies is not easy. But if IMF loans are extended at penalty rates, the Meltzer Report reasons, and if the Fund's claims are effectively senior to the borrower's other liabilities, then countries can be relied on to sort themselves. Those with fundamentally sound policies but a temporary liquidity problem would still want to borrow in order to ride out the storm, while countries with deep policy problems would recognize that doing so would only compound their difficulties (by superimposing additional debts bearing high interest rates on an already difficult fiscal position), temporarily put off the day of reckoning (because IMF loans would have to be paid back in short order), and antagonize existing investors (since their claims would be subordinated by the government's obligations to the IMF).

The Meltzer Commission represents another romantic view

The appeal of this approach is obvious. The extension of international financial assistance in times of crisis would be routinized. The discretion possessed by the IMF would be removed. It would not be necessary to attach onerous conditions to the institution's loans, since assistance would be provided only to countries where macroeconomic policy and prudential supervision were already strong. Moral hazard would be reduced, market discipline strengthened. Liquidity crises would disappear. It is not surprising that these arguments have struck a cord. Even before the Meltzer Report was written, the IMF's First Deputy Managing Director, Stanley Fischer, was asking whether the Fund should take on the mantle of an international lender of last resort. In response to the report, U.S. Treasury Secretary Summers advocated a reduction in the term of IMF loans and an increase in their cost, a recommendation adopted by the IMF Board, in modified form, last September.

However appealing these ideas are in principle, operationalizing them is easier said than done. Does a government have only liquidity problems or something more – policy problems that need to be fixed – when there is no technical obstacle to raising taxes or cutting public spending, thereby mobilizing the requisite resources for debt service, but there is political resistance to doing so? How bad do its policies have to be before it is placed in the category of cases that the IMF will not help? And which policies should be emphasized in this determination? Some countries experience crises because they have poorly regulated banking systems, as the Meltzer Commission emphasized when it honed in on the adequacy of prudential supervision as a key determinant of whether restoring stability required fundamental policy reform or the simple provision of liquidity. But other countries experience crises for other reasons, as the commission ultimately acknowledged: reckless monetary policies, inconsistent exchange rate policies, and unsustainable budget deficits are among the factors that spring to mind. This acknowledgment puts paid to the idea that detailed surveillance of policy can be superseded by simple lending rules.

More generally, the notion of prequalifying countries for IMF assistance, which will then be disbursed without additional conditions, is problematic. The Contingent Credit Line (CCL) established by the Fund in the aftermath of the Asian crisis is an attempt to move in the direction of more prequalification and less ex post conditionality. In practice, the CCL has been less than a stunning success, given the reluctance of countries to apply. The reasons are not hard to see. If the Fund prequalifies a country because its policies are good, then it will have to un-prequalify it if those policies deteriorate. (Otherwise moral hazard returns with a vengeance.) Un-prequalifying a previously prequalified country runs the risk of precipitating a crisis. Knowing this, the Fund is forced to establish a high hurdle for prequalification or hold out the option of reconsidering whether the country still qualifies when it asks to draw. Moreover, countries will be reluctant to apply unless others have already done so for fear of signaling that they anticipate problems. The IMF, following the U.S. Treasury's lead, sought in September to make the CCL more attractive by eliminating the commitment fee and reducing the differential interest surcharge. It simplified the conditions that a previously prequalified country has to meet when it seeks to draw. The present perspective suggests that these limited changes are unlikely to make the CCL wildly attractive.

Most fundamentally, the notion that the IMF can simply stand aside if a country with deep domestic problems experiences a crisis flies in the face of common sense and historical experience. If a country's problems go beyond a temporary loss of investor confidence, the romantics argue, then it should be left to restructure its debts. Providing it with liquidity assistance, which it will then use to pay off its foreign creditors, will only delay the inevitable while letting investors off the hook and aggravating investor moral hazard.

But there are good reasons why restructuring is rare and bailouts are frequent. Bonds issued in the United States typically lack any provision for a bondholders assembly, a deed trustee to act as a communications center for the creditors, sharing clauses, and majority-voting clauses. Because each and every bondholder must agree to the terms of a restructuring, vulture investors can threaten litigation and hold up the process. Restructuring should not be too easy, of course, or debtors would be tempted to walk away from their debts, creating moral hazard for the borrower.[5] But the frequency of IMF rescues in the 1990s suggests that the balance of risks has shifted in the other direction, to ever more frequent IMF bailouts, extended in response to the difficulty of debt restructuring, and investor, not borrower, moral hazard.

If the problem is well known, then so is the solution: adding collective action clauses (which would specify who represents the bondholders, provide a communications center, and add majority voting and sharing rules) to bond covenants. The IMF could then credibly commit to stand aside if a country with deep policy problems experienced a crisis, requiring it to restructure its debts. Advocating that the Fund stand back without creating an alternative way of resolving financial crises is to assume a solution to the problem where none exists. For those who take seriously the moral hazard created by IMF rescues, this is an essential reform.

Here is where both governments and experts have dropped the ball. While the official community has mouthed the right words about the desirability of collective action clauses, it has done little to encourage their adoption. The U.S. Treasury, concerned to retain the good graces of the bond market, is reluctant to do anything that might unsettle investors. The IMF's great innovation has been to establish a Capital Markets Consultative Group for fostering regular dialogue with the private sector.[6] Another talk shop cannot hurt, but this is a far cry from an institutional mechanism to concert the creditors. While the Meltzer Commission recommended strict limits on IMF lending, it did not embrace the idea of collective action clauses.[7] But without specific recommendations in this area, the commission's other suggestions will go nowhere. The pressure for IMF rescues in the event of crises will diminish only when alternative mechanisms are developed for resolving the latter.

Needed: Adding Collective action clauses to bond covenants

From this point of view, it is no coincidence that the changes in lending terms and conditions agreed to by the IMF Board in September are less than meet the eye. Does anyone really believe that cutting the term of IMF standby loans by a year from the current term of 3¹/₄ to 5 years, and of extended fund facilities from 10 to seven years, will really alter behavior? Do we really think that modest increases in IMF interest charges will discourage borrowing by a government desperate to survive until the next election? The members of the Meltzer Commission will complain that officials lacked the guts to implement their more radical recommendations, like curtailing IMF loans to 120 days with a maximum of one renewal and raising interest rates even more sharply. But why more ambitious steps have not been taken is no mystery. IMF lending can be limited only if other ways are devised for responding to crises. And there has been a reluctance to address this issue head on.

[5] A point that is emphasized by Friedman (2000).

[6] Koehler (2000), p. 5.

[7] As one member put it, „We struggled with these questions, heard testimony, and debated at length what might be done. I think it is fair to say that it was not clear whether existing mechanisms, and the ongoing improvements to them that were reported at our hearings, could be improved by some sort of interventions or mandates on the part of the multilateral institutions. In the interest of 'doing no harm' the Commission did not make specific recommendations in this area." Calomiris (2000b), p. 4.

The official community deserves a passing grade, even a good one, for its efforts on the crisis-prevention front. By comparison, attempts to date to reform and improve the way we respond to crises must be judged a failure. This contrast is suggestive of where the efforts and attention of the international community should be focused going forward.

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IMF lending can be limited only if alternatives are devised for responding to crises

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