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Restructuring IMF Facilities to Separate Lender of Last Resort and Conditionality Programs: The Meltzer Commission Recommendations as Complements rather than Substitutes

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What happened to the push for reform of the international financial architecture that had such momentum during the rash of international financial crisis in the 1990s?. 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 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 a more effective capability to act as an international quasi lender of last resort (LOLR). In response to the recent crisis, the international community has created two new financing mechanisms within the IMF. One, the Supplemental Reserve Facility (SRF), has been quite useful but does not go far enough in the direction of a LOLR. The more radical Contingent Credit Line (CCL) has serious design problems and hasn't yet been used.

* Email: Thomas.Willett@cgu.edu This paper has benefited greatly from comments by and discussions with George Anayiotos, Arthur Denzau, Andrew Berg, Richard Burdekin, Peter Clark, Susan Collins, Michele Fratianni, Charles Goodhart, Olivier Jeanne, Joseph Joyce, Ken Kletzer, Paul Masson, Allan Meltzer, and Zeromin Zettlemeyer.

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.[1] Ex post conditionality would be entirely eliminated and replaced with ex ante criteria for gaining access to LOLR 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.[2] 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. This dissent stood in stark contrast to the unanimity on most of the recommendations concerning the IMF. It was strongly criticized by the Clinton administration's Treasury and many international monetary experts both for the

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[1] 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.

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.

As a consequence of such criticisms there has been a tendency to consider these aspects of the Meltzer Majority recommendations as Dead on Arrival. This is certainly a correct diagnosis as a predictor of the chances of their prospects of being adopted in pure form, but in section 3, it is argued that the tendency of some commentators to dismiss these recommendations out of hand is unfortunate. If taken as signaling desirable directions for change rather than an all or nothing blueprint for reform, the Meltzer Commission Report has much to commend it.

This paper agrees with the specifics of many of the criticisms of the Meltzer Majority's proposal to convert the IMF into purely an international LOLR, but argues that IMF lending facilities do need to be radically restructured to deal both with problems of high capital mobility and the poor track record of IMF conditionality. While new procedures for lending during currency crisis in a world of high capital mobility are definitely needed, IMF conditionality programs need to be streamlined and more rigorously enforced rather than eliminated. The creation of a seperate LOLR type facility in the Fund could make it easier to negotiate and enforce its conditionality programs. Section 4 turns to issues of implementation and addresses a range of questions including moral hazard, time inconsistency problems, and the roles of ex ante versus ex post conditionality. The importance of adopting a political economy perspective to analyze these issues is stressed. Section 5 offers brief concluding comments.

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

II. Areas of Consensus About International Financial Reform

It is not uncommon to hear arguments that despite all the initial discussions of the need for a new international financial architecture in the wake of the international currency crises of the 1990s, little of substance has actually been done. With respect to formal reforms such arguments have some weight, but with respect to greater appreciation of the types of policies that need to be avoided if crises are to be kept at bay there has been an important change. This is perhaps most evident with respect to exchange rate regimes. While there are still a few dissenters, there is today widespread agreement that pegged exchange rates are a major (albeit not only) cause of international currency crisis and that the IMF should provide not financing to countries who follow domestic policies inconsistent with their exchange rate regimes. This view is reflected in both the Meltzer and Council on Foreign Relation Reports. Furthermore, in many countries the IMF has strayed from its original mandate. In too many cases short term financing for balance of payments and macroeconomics stabilization purposes has been converted into long-term financing essentially for development outcomes through rolling over program after program. There is a good deal of disagreement about what should be done with respect to financial programs for these countries, but a substantial number of international monetary experts believe that the IMF should not continue with business as usual in this area.

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[3], 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 in 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.[4] Political and bureaucratic incentives made it difficult for the IMF to enforce sufficient implementation. The Fund would frequently pull programs for non-compliance but then start them up again soon after with little or any penalty for previous behavior. A strong consensus is emerging that the IMF must refocus on its core competencies of macro, financial and exchange-rate economics and recent actions by the Fund demonstrate that it at last has begun to pay attention to these criticisms.[5]

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

[4] 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 (2000) 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), 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 how much policies changed from what they would otherwise have been as well or what the effects of the policies were, which 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.

[5] The new Managing Director, Herst Kohler, has lead a push to streamline conditionality, and the Fund has placed many of his working documents for this process on its website for public comment.

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 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. 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.[6] More than its billions of cash, its credibility is the Fund's most valuable asset and its value has been dangerously eroded.

Despite the frequent charges that the IMF is an unresponsive and unaccountable international bureaucracy, most 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.[7] 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 say in Fund policies, but there is not much the Fund does against the wishes of the major industrial countries. Reaching agreement on Fund policies obviously requires a degree of compromise and the Meltzer Commission recommendations on eliminate all current Fund programs are much too far from the middle of the present spectrum of shareholder views to gain acceptance in their original

[6] See Willett (2000a) Recent work by Bird and Rowlands (   ) 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.

[7] See Willett (forthcoming)

form. They do point the way, however, to a productive compromise that might be able to secure considerable support.

As discussed earlier, there can be little question that the IMF needs to change its way of doing business with the countries that stay on IMF funding for one program after another. There is a good deal of disagreement about what if anything should replace these current Fund programs (for example, should they be shifted to the World Bank or simply terminated) but surely the IMF cannot continue with business as usual. Conditionality must be made tougher, but narrower and less intrusive, and much greater use should be made of preconditions. Even more effort should be made to develop home country ownership of IMF programs[8] and, where sufficient ownership cannot be developed, the IMF must be willing to say no. This will not be easy, but it is essential.

It is understandable that it is very hard for the IMF to say no and be held responsible for subsequent crises. It may prove impossible for the IMF's incentive structures to be reformed sufficiently for it to reform adequately in this area, but there's a chance, and the IMF should be given the opportunity to make a try. The recent emphasis on transparency and the creation of the Fund's new independent evaluation office are steps in the right direction. 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.

III. The Controversy

[8] The need for developing strong ownership, i.e. host government commitment to programs, has been stressed in recent IMF documents.

The Meltzer Commission Majority was right that with the growth in international financial integration the IMF needs to develop a better capacity to operate as a quasi LOLR.[9] The IMF has indeed created new programs in recent years that move in this direction. They are the Supplemental Reserve Facility (SRF) and the Contingent Credit Line (CCL). It will be argued below that they do not go for enough, however, and the CCL has not yet been used.

To gain a perspective on these issues, it is useful to briefly discuss the evolution of IMF programs in the light of the changing degree of international capital mobility. The IMF began in an era of relatively low capital mobility 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 the balance of payments around. IMF funds were paid out in installments. This process helped keep IMF leverage over national policies after a program was agreed. If a country backslides 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 is well conceived.

[9] There has been a great deal of recent literature on both whether the IMF should and whether realistically it could play the role of an international lender of last resort. As Jeanne and Wyploz [ ]emphasize there is still considerable ambiguity associated with the notion of international LOLR. Since as presently constituted, it cannot create its own currency, the IMF cannot be a true LOLR. It could, however, be a lender of large, albeit not unlimited funds. Thus the Meltzer Commission refers to the role of a quasi LOLR. For examples of the recent literature on these issues, see Capie [1998], Eichengreen [1999], Fischer [1999], Goodhart [1999], Goldstein [2001], Jeanne and Wyploz [2001] and Rogoff [1999].

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, crisis can spread much more easily from one country to another. 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 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. 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 of course 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 were in the right direction but did not go far enough, however. Such recognition helped lead to the recent CCL facility, but this 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. This is where the Meltzer Commission Report comes in. We should pay attention to the logic rather than the details of the Commission's Majority Recommendations and create a new IMF facility that plays a quasi lender of last function in an effective manner.

As in the Meltzer Majority Recommendations access to the facility should be made conditional on ex ante rather than ex post conditions. The specific recommendations of the Meltzer Majority for preconditions were both too narrow and too stringent to enjoy wide spread 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 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 is 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.[10]

The dissenting statement by C. Fred Bergsten and others argues 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

[10] For example, it is not at all clear that such a requirement would meet Feldstein's [1998] suggested criteria for appropriate IMF conditionality. 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.

recommended requirement that loans be prohibited to countries with substantially overvalued pegged exchange rates. A majority of the Commission is critical of pegged rates and recommends that “countries should choose firmly-fixed rates or fluctuating rates” (p 49) but these are not included as a precondition for IMF lending.[11]

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, but it is likely to prove difficult in practice to develop a good enough set of objective rules. While the attempt to do this should receive priority attention from the official community and academic researchers as well, 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 of whether they would be judged eligible or not. This would avoid a serious problem involved with the CCL’s formal prequalificatoin. The problem is how to deal with a prequalified country that slips. With clear ex-ante conditions the country 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 world this would not be a major problem, but in the real world of

[11] 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

bureaucratic incentives and political pressures, decertification of a country that had slipped backwards in its policies would be extremely difficult.[12] Again at a time when its credibility has come into question, this is not a burden that should be placed on the IMF.

It is true that the provision of a LOLR 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.[13] Indeed many international monetary experts believe that such measures are likely to be a part of any efficient reform of the international financial architecture. I agree with this analysis, but would emphasize that such measures are likely to be only a complement not a full substitute for a LOLR. Developments on PSI should of course 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. Against this, however, we must consider both the logic of Bagehot's rule, and recognition that at present the catalytic effect of Fund programs on private sector capital flows is rather limited. Indeed in the Asian crisis by its own admission, the Fund's programs badly underestimated the size of the flows of private capital from the crisis countries.[14]

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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.

[12] 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.

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

[14] See Lane et al (1999)

Indeed one can argue that in the Asian crisis the size of the Fund's programs were both too large and too small. In terms of helping to restore confidence and finance intermediate short run balance of payments deficits, the amount of immediately usable funding was likely too small. As former IMF Director of Research Michael Mussa put it, the effective size of these programs was much less than meet the eye. On the other hand, from the standpoint of long run policy reform and adjustment, the size of the packages may well have been too large.

What is needed in such situations is a clear separation of 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. 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 but 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. Here I think that the emphasis of the Meltzer Majority on making the LOLR funding short term is well taken.[15] Of course if the duration were made too short and roll over were not allowed then the ability of the loan to calm the marker 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 crises. 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 or the time before repayment lengthens.[16] The SRF in fact embodies this principle, but in a relatively mild form with the interest surcharge increasing only annually and are being capped at 350 basis points.

We have observed in recent crises a tendency for financial markets to take some time to return to their normal fluctuations in emerging market countries. As a consequence there was a tendency for currency depreciation to frequently initially overshoot.[17] 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 due through an ex-ante or ex-post conditionality facility would

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

[16] In private correspondence to the author.

[17] See Willett (2000b).

be more appropriate. 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 crisis suggests a case for giving the ex-ante facility a maturity longer than would be needed only to quell outright speculative attacks.

IV Issues of Design: Time Inconsistency, Moral Hazard and Ex Ante Versus Ex Post Conditionality

An important part of the lender of last resort function is crisis management, not just the provision of short-term liquidity.[18] Indeed, in some cases, such as the Long Term Capital Management crisis, this crisis manager function of helping to coordinate the actions of individual creditors was sufficient by itself. There is of course always the moral hazard danger that the provision of emergency help reduces the incentives for prudent risk management and hence while reducing the costs of the current crisis also increases the likelihood of future crisis. Used as part of a crisis manager role, however, there is scope for a strengthened ILOLR facility in the IMF to help with the coordination of bail ins from lenders rather than just being a source of bailouts.

Some have worried that IMF programs will increase not only moral hazard in the private sector but also for national governments. Even more serious in my judgment is the time inconsistency incentive that faces both the IMF and national governments to minimize the costs of a current crisis and not give enough weight to the effect that this will have on private sector behavior that will increase the risks of future crises.

[18] See, for example, Fischer (1999).

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. 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 would bailout major financial actors should thus be one of the criteria on which eligibility to borrow from the IMF is based.

Also of considerable importance is the development of better institutional mechanisms to limit the natural tendency of crisis managers to give too much weight to short run considerations.[19] Greater short run involvement of the major shareholders in monitoring IMF lending decisions is likely to offer only limited help on this score, since national financial officials will also be subject to such short run biases as well as to concerns that a country is too important to fail on geopolitical as well as systemic grounds.

Since the SDR is not really a currency, 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. 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

[19] For discussion of bureaucratic and other biases that may affect IMF lending see the analysis and references in Willett [2001a] and [forthcoming].

the IMF. In a second best world, institutional failure limits the optimal level for backing for the IMF to offset market failures.

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 (2000)).

Jeanne and Wyploz (2000) 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 overshoot long run equilibrium, one could have many "temporary" insolvencies. Jeanne and Wyploz argue, quite convincingly I believe, that evaluations of solvency should be made at normal rather than crisis prices. 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 of course 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 LOLR facility. This requires careful attention, as does the general degree of stringency of pre-conditions. The Meltzer Majority proposal makes them extremely stringent. The IMF-CCL facility, while not a 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, as opposed to milder financial market contagion, could well have no eligible customers.

Jeanne (2000a) makes the important point that the comparative welfare effects of crisis management policies such asthe 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. In a similar vein Jeanne and Wyploz (2000) 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 (2000), sterilized intervention can be effective and much less funding would be needed. While small compared with the funding requirements in a Jeanne-Wyploz world, in the absence of strong catalytic effects on private capital flows, the required funding in the Willett scenario could still be 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 theoretical models in which a partial bailout is 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).

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[20] 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 is 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. The argument here is that 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. This, of course, 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 are measures to give the Fund greater insulation from short run political pressures. We

[20] The reference here is to any LOLR, not necessarily the IMF.

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 IMF's credibility by minimizing the extent to which it must make pressure prone decisions such as decertifying a wayward country under the CCL. Likewise, 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.

Any analysis if IMF lending facilities should address the extent of moral hazard generated by IMF "bailouts". It is becoming more widely recognized that national government policies are the primary sources of 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 sovereign 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 than 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 crease 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 of the moral hazard costs of the IMF – for example the argument that the Mexican bail out was the primary cause of the Asian crisis.[21] 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.[22] 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

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

more complicated.[23] It is in part to deal with the international analog of this problem that preconditions and/or ex post conditionality are called for.[24]

As 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". As noted above, 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

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[22] 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.

[23] 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)

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

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]

V 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. While the Fund has been moving in the right direction in recent years, it still has a considerable way to go. There is a danger, however, of going too far as well as not far enough. This paper argues that efforts to adopt too stringent a limitation on access to IMF funds will lack credibility and hence defeat their purpose. However, a strong tilt towards greater emphasis on preconditions and the removal of ex-post conditionality for short-term crisis lending offers the prospect both of coping more effectively with crises and of helping the IMF restore the credibility of its seal of approval. It would 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 approach suggests that much of the current debate about ex-ante conditionality has been drawn too sharply, with those on each side often implicitly assuming that one type will be effective and the others 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.

[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 favored the Council in Foreign Relations Task Force, whcih recommends three categories. Again in assessing this issue it will be important to pay attention to political economy considerations, not just technical economic analysis.

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