Zanny Minton-Beddoes, "Why the IMF Needs Reform" *Foreign Affairs* May/June (1995): 123-133

THESIS

The IMF's role should be in mitigating risks and failures of financial markets and integrating new players. The IMF should limit its role to promotion of timely information dissemination a la a public rating service and to adjudication of debt restructuring, rather than be a manager of the world's monetary system or a major lending institution.

SUMMARY

The complacency arising from the Washington Consensus is misplaced. A gulf between the rhetoric and the reality of the IMF's role exists. The Fund is impotent in industrialized countries and its role is "worrisomely unclear" in the developing world. In the poorest countries, the IMF has become a development institution with a narrow macroeconomic focus. "The IMF is floundering as it looks for a role." / The Bretton Woods System (BWS) broke down and technological and financial innovation have transformed global finance. Private financial flows, dominated by FDI and portfolio investment, to emerging countries increased from less than $42 billion in 1989 to $160 billion in 1993. / ER management among the major economies is almost impossible due to this influence of the private-sector finance. Countries' macroeconomic policies are necessarily constrained. Though the possibility of systemic breakdown precipitating from an isolated collapse is inherent in all financial systems, the increase in private investors—bond-, stockholders—makes markets more liable to panic. In addition, the "tequila effect" of the contagion effect exists: Sudden loss of confidence in one market results in collapse of other markets. To prevent this, some reformist countries may choose to become autarkic, but global integration needs to ensure that they stay on the liberalization path. Finally, some countries are excluded from the world of private finance. Many countries in Africa riddled with instability, war and bad economic policy do not receive private finance and even risk losing foreign aid from industrialized countries. / Even after the breakdown of the BWS, the IMF still has been aiming to monitor the world's monetary system and provide financial support to needy economies. But, the IMF is largely irrelevant to the industrialized economies (it only provides statistics and research findings; was not involved in the Plaza or the Louvre Agreements; was not involved in the creation of the ERM). The IMF's focus shifted to the developing world—it "became both a police officer of economic policy and a mediator between debtors and creditors." For the Mexican peso crisis, the IMF put together a $17.8 billion rescue plan to assert its relevance. The amount was far higher than allowed by the IMF rules, and this quest for relevance both undermined the rule-based nature of the IMF and revealed its increasing politicization. The weak conditions under which the Fund lent to the former communist countries is another example of politicization of the Fund. The IMF and the World Bank were used as the vehicles for Western assistance. Another gap between the IMF rhetoric and reality is in the poorest countries, where the IMF supports complex long-term structural adjustment, which does not fit with its original mandate of addressing short-term balance-of-payments problems. / Some reform suggestions: 1) The IMF and the World Bank can combine, but the relatively small IMF would get entangled in the bureaucratic sprawl of the Bank. 2) Reorient the IMF toward the central position in coordinating economic policies among major economies. The Bretton Woods Commission, an independent review panel, has suggested that the IMF return to its original mandates and the world return to a more formalized system of exchange rates. Minton-Beddoes disagrees. 1) The global prosperity that accompanied fixed ER system under the BWS is erroneously identified with the BWS institutions. The system was held up by America's underwriting; the IMF only acted as a facilitator. 2) It's difficult to see how (quasi-) fixed ER would work among the world's largest economies. The capital movement is pushing the system toward either free floating of a single unified currency. Political willingness among the countries is also lacking. 3) The IMF being a lender of last resort creates moral hazard problems. Also, the amount of money necessary to act as the lender of last resort ex ante (preventing crisis from precipitating) is unknown; the approach assumes that the IMF knows about the country with impending crisis more that the market. "The modern financial system cannot be 'managed' by an international institution." / The IMF should work to mitigate risks and failures in the financial markets and integrating new players. The IMF can reduce risk by better monitoring capital flows and economic policy through promotion of timely publishing of relevant statistics and publicity of its opinion on economic policy ➔ The IMF should become more like a public rating service. To prevent failures, the IMF should try to minimize market overreaction through helping a country announce rapid corrective policy measures. The IMF should also focus on finding ways to develop private market liquidity. In cases of insolvency rather than illiquidity, the IMF should play a central role in coordinating a debt restructuring (a la Sachs' recommendation). Promotion of prudent macroeconomic policy and bankruptcy adjudication would increase the IMF's role in integrating currently excluded players, such as former communist countries, African countries, etc. While focusing on short-term issues and approving on-going reform packages, the IMF should leave longer-term development projects to the World Bank. Fostering integration of new players and mitigating risk are the central roles that the IMF should play in the modern financial system.