

The Financial Economists Roundtable Statement

on

The Future of the International Monetary Fund

October 23, 2000

The International Monetary and Financial Conference at Bretton Woods, N.H. in the summer of 1944 set the institutional ground-rules for international economic and financial relationships in the post-World War II world, and established two complementary institutions, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank). The World Bank was to focus on longer-term development finance, notably specific projects that could bring to bear the institution's technical expertise, while the IMF was to focus on the restoration of foreign exchange convertibility, the maintenance of a fixed but adjustable exchange rate regime, and the provision of short-term lending facilities to countries in temporary balance of payments difficulties. Together with the General Agreement on Tariffs and Trade, the Bretton Woods design for a postwar economic order that would speed economic recovery and promote sustained development of the global economy undoubtedly represents one of the great achievements of international economic policy in the 20th Century.

Much has changed with respect to the IMF's mission. Restoration of full currency convertibility among industrial countries was achieved by the beginning of the 1980s, and has been progressively attained by most of the major developing countries as well. The fixed but adjustable exchange rate system ended in 1973. With it, the need declined for massive short-term balance of payments financing for countries moving to floating exchange rates ? thus focusing central bank intervention on the maintenance of orderly conditions in currency markets. Consequently, the IMF's activities shifted increasingly to providing financial assistance and advice to developing countries, often under crisis conditions in which an existing fixed exchange rate regime became unsustainable in the light of domestic or international economic and financial developments. The IMF's role in the global lending crises of the 1980s, the Mexican crisis of 1994-95 and the Asian, Russian and Brazilian crises of 1997-98 was notable and in some cases highly controversial. By July 2000 some 69 developing countries had IMF programs in place and many had drawn on IMF facilities for decades, effectively extending the Fund's mandate from short-term stabilization lending into long-term finance. The Fund's recent, long-term Poverty Reduction and Growth Facility exemplifies this expansion of scope. IMF advice, inevitably controversial, became increasingly intrusive to many client countries and susceptible to political manipulation by major creditor countries. Meanwhile, the size of available IMF facilities, even after successive increases, has steadily dwindled in relation to cross-border financial flows involving developing countries.

Pressure for Change

Almost six decades after the founding of the IMF there is a consensus, reflected in the reports of numerous task forces, study groups and conferences, that it is now time to reassess the role of the IMF ? even as there is little agreement on key elements of reform. The basic issues are: (1) The appropriate scope for Fund activities; (2) The role of the IMF as a quasi lender of last resort; and (3) The terms on which IMF assistance should be made available to member countries.

The Financial Economists Roundtable (FER), meeting at Bretton Woods in July 2000, examined these issues against the background of the intense debate that has characterized the past several years, and has come to the following conclusions:

1. We are concerned that mission creep has compromised the effectiveness of the IMF over the past three decades. As the IMF has responded to demands from many of its member countries to finance structural transformations and alleviate poverty, its role in preventing and managing international financial crises has been undermined. Although these are all worthy activities, structural transformation and poverty alleviation are central to the mission of the World Bank and the regional development banks and do not fit comfortably with the shorter-term, macroeconomic focus of the IMF. FER believes that the IMF should constrain the scope of its activities to the prevention of international financial crises and the provision of limited liquidity-assistance to countries in temporary financial distress in order to help them resolve their difficulties in internationally responsible ways. We urge that the IMF cede responsibility for financing structural change and poverty alleviation to the World Bank and the regional development banks.
2. The IMF cannot and should not be an international lender of last resort. Unlike a national central bank, the IMF is severely resource-constrained and therefore lacks credibility as a lender of last resort. This has become evident in major recent support actions such as that in Mexico, in which IMF resources had to be supplemented with bilateral and other multilateral support in order to restore confidence. But even if it were possible to vastly increase the resources of the Fund so that it could meet the liquidity needs of any of its member countries, we believe that it would be undesirable to do so. The provision of unlimited liquidity would surely encourage imprudent borrowing and lending, ultimately increasing the number and severity of international financial crises, an outcome that is counterproductive to the IMF's central purpose. Since our recommendations imply a restriction on official resources, some of the shortfall will necessarily be borne by private creditors.
3. Financial crises may involve widespread costs that are not necessarily recognized by private sector market participants in their lending and pricing decisions. Consequently, the IMF might usefully provide assistance on a temporary basis when a country in financial distress loses access to the capital markets.

Elements of a New Approach

FER has considerable sympathy with the view that the traditional IMF approach of tranching lending subject to detailed, intrusive and complex policy conditions is not always well suited for dealing with countries in financial distress. Instead, we concur with the report of the recent International Financial Institution Advisory Commission that the IMF should establish preconditions which, if met, will entitle a member country to automatic access to a limited amount of credit (proportional to the country's quota in the Fund), for a limited term – e.g., no more than five years – at a penalty rate of interest above the market rate that existed shortly before the crisis. The penalty rate will ensure that the line of credit is used only in the event of financial distress, when the country cannot borrow on international capital markets. The preconditions are designed, in particular, to encourage countries to strengthen their financial systems so that they are less crisis-prone. Preconditions should include the following:

- (i) Openness to foreign financial institutions. Foreign-based financial institutions should be subject to no greater restrictions than domestic institutions with respect to entry and scope of activities. This will increase the likelihood that a country's financial institutions meet international standards for risk management and efficiency, and will help safeguard the local financial system. Local depositors will have the option of placing their funds with a wider range of banks, placing competitive pressure on local institutions. The presence of foreign banks can also serve as a constraint on the ability of governments to pursue unreasonable fiscal and monetary policies, since they are less likely to be pressured into allocating credit for governmental politically expedient but financially questionable purposes.
- (ii) Adherence by the local bank regulatory system to the Basel Core Principles for Effective Banking Supervision. These principles, designed to strengthen banking systems, to a considerable extent address the preconditions for effective banking supervision, licensing and structure, prudential regulations, capital adequacy requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking. The principles have been developed in consultation with banks and their national regulators in many countries, and today represent a broadly consistent and credible set of minimum banking industry benchmarks.
- (iii) Subscription to the Fund's Special Data Dissemination Standard (SDDS). The SDDS was designed to improve the availability of timely and comprehensive statistics. Compliance with the SDDS will enhance the transparency of a country's external financial position, including its international reserves and the maturity structure and currency composition of its external debt. This will enable financial markets to monitor and price sovereign risk more effectively.
- (iv) Commitment to a responsible fiscal policy. This precondition might be quantified analogously to the Maastricht Treaty fiscal requirement – i.e., a budget deficit no greater than a specified percent of GDP and a ratio of public sector debt to GDP no greater than a specified percent (or trending downward decisively and credibly?). The standard should be sufficiently stringent to prevent fiscal policy from being a cause of financial crisis.

Countries that meet these preconditions could also be permitted, if necessary, to borrow some additional amount beyond that which is automatically available during periods of temporary distress. Under such circumstances the IMF would impose only those conditions that reasonable bankers would require in order to ensure that their loans are likely to be repaid.

We do not wish to prohibit the IMF from making loans subject to conditions. Countries that do not meet the above preconditions would not necessarily be barred from receiving IMF assistance. But they would not have automatic access to funds and, relative to countries that have met the preconditions, the amount of support would be less, the interest rate would be substantially higher than the rate just prior to the crisis, and the required repayment period considerably shorter. Uncertainty about the availability of funds and the increased cost should give countries an incentive to meet the preconditions, while protecting the option for the IMF to intervene when necessary to minimize potential systemic costs. However, acceptance of IMF loans should be conditioned on meaningful action by the recipient country leading to compliance with the four preconditions specified above.

Structural Financing

In our view there have been a number of occasions where access to IMF funding has encouraged a country to implement needed reforms, many of which are consistent with the aforementioned preconditions. FER therefore supports a system in which the IMF is empowered to make tranching, medium-term loans not exceeding five years in duration at subsidized interest rates in return for specified reforms. Such loans should not be rolled over to provide long-term financing and the IMF should avoid overly detailed policy prescription. We also wish to see such structural lending clearly separated from short-term crisis lending. We suggest that consideration should be given to possible organizational changes that would help preserve the separation between short-term crisis support and long-term structural assistance, either by clear functional separation within the IMF or by delegating structural assistance to another institution.

The Way Forward

The approach to financial distress and the future role of the IMF suggested by the Financial Economists Roundtable emphasizes prevention of financial crises rather than post-distress stabilization and adjustment and, as such, seeks to promote global financial stability primarily through a rule-based rather than discretion-based approach. Like other rule-based approaches, such as the World Trade Organization, NAFTA, and the EU Maastricht Treaty, it seeks an optimum combination of clarity, transparency, automaticity, consistency, and compatibility with the incentives facing private-sector lenders and investors, as well as public policymakers. Within this framework, it is our view that the proposed recalibration of the IMF mission would alleviate many of the

institution's shortcomings and provide an efficient, equitable, and effective mandate for this important supranational institution.

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