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THE INTERNATIONAL MONETARY FUND: ITS PRESENT ROLE IN HISTORICAL PERSPECTIVE

Michael D. Bordo
Harold James

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ABSTRACT

In this paper we describe what the IMF is and what it does. We consider its origins as the guardian of the Bretton Woods adjustable peg exchange rate system and financier of temporary current account deficits for advanced countries, to its present primary roles as development financier and crisis manager for the emerging world. We consider the externalities or market failures that the IMF is believed by many to correct and the public goods that the IMF provides. Critics of the IMF downplay the extent of market failure and the scope of public goods provided. They attach greater importance to market solutions. We consider their views as well. We conclude with a discussion of the case for reform in the light of historical experience.

Michael D. Bordo
Department of Economics
Rutgers University
New Brunswick, NJ 08404
and NBER
bordo@fas-econ.rutgers.edu

Harold James
Department of History
Princeton University
Princeton, NJ 08544
hjames@princeton.edu

Table of Contents

1. Introduction

2. What does the IMF do?

3. Origins and Original Aims

4. The IMF's Role in the Post Bretton Woods Era: Externalities and Public Goods?

5. The IMF in Search of a Mission

6. International Politics and the IMF

7. Conclusion: The Case for Reform in the Light of Past Experience

References

Tables

1. Average Time Spent in IMF Programs by Class of Borrowers

2. Arrears in the IMF

Figures

1. IMF Quotas as a Share of World Imports

2. IMF Charges and Commercial Interest Rates

3. Total Fund Credit Outstanding to Members

4. Low Interest IMF Lending

5. Transactions of the International Monetary Fund, 1955 – 1997

• 1. Introduction

After 55 years of existence there are strongly conflicting views on the importance and role of the IMF for today's international economy, and on its effectiveness. On the one hand there are those who see the Fund as having adapted well to the changing world environment with perhaps the need for some reforms to the International Architecture.[1] On the other hand are those who believe that its useful time has passed in the environment of exchange rate flexibility and open capital markets.[2] These radically conflicting views require the need for a balanced perspective on the role and performance of the IMF within the context of its historical evolution.

In this paper we describe what the IMF is and what it does. We consider its origins as the guardian of the Bretton Woods adjustable peg exchange rate system and financier of temporary current account deficits for advanced countries, to its present primary roles as development financier and crisis manager for the emerging world. We consider the externalities or market failures that the IMF is believed by many to correct and the public goods that the IMF provides. Critics of the IMF downplay the extent of market failure and the scope of public goods provided. They attach greater importance to market solutions. We consider their views as well.

The reincarnation of the Fund occurred against the backdrop of a series of major economic and political shocks: the oil price shocks of the 1970's, the debt crisis of the 80's, the collapse of the Soviet empire in the late 1980's, and the recent emerging market crises in Mexico and East Asia. These events served as a template for the creation of new Fund responsibilities, facilities and enhanced resources. As we document, the expansion of the Fund served different constituencies: the United States, the other advanced countries, the emerging countries and the very poor LDC's. Most importantly, the evolution of the IMF has reflected the geopolitics of the international economy, which we discuss in Section 6. We conclude by considering the directions that reform might take in

[1] See e.g. De Gregorio and others (1999).
[2] See e.g. Schwartz (1998).

the light of historical developments. A greater role for market discipline supplemented by a more limited range of IMF policies and advice is a foreseeable outcome.

2. What does the IMF do?

Most people think of the IMF as an institution that provides emergency credits to countries that have found themselves in difficulties, either as a consequence of poor economic policies or through external circumstances, such as a sudden drop in commodity prices, or a financial crisis in a neighboring country. In return the country is obliged to impose painful austerity policies, usually involving reductions of budget deficits, through spending cuts or increased revenue (taxation), a rise in interest rates to reduce inflation, and an alteration of the exchange rate (a devaluation).

This view, while not inaccurate, gives only a partial picture of the reality of the Fund's operations, or of what it is supposed to do. Its mandate, as laid down in the first Article of Agreement in 1944 in Bretton Woods, NH, is very general: to promote international monetary cooperation, facilitate the growth of world trade, promote exchange rate stability, and to help to create a multilateral system of payments. In order to achieve these objectives, the Fund was supposed to provide short term balance of payments support to countries in need of additional international reserves.

It is now an almost universal financial institution, having grown from the 44 states represented at the 1944 Bretton Woods conference to 182 countries today. Now it includes almost every economy of the world. (There are only a few exceptions: Cuba, North Korea, Taiwan.)

Who runs it? The IMF is owned by the governments of its member countries, represented through a Board of Governors. The Governor for each member country is usually the Minister of Finance or sometimes the Central Bank Governor (in the case of the United States, the Secretary of the Treasury). Voting is in accordance with the size of a country's share-holding in the Fund (or "quota"), and many important decisions require special majorities (85% of the vote). There is no attempt to give an equal voice to every

country, as there is in the United Nations. Periodically, quotas are recalculated to reflect changing economic size.

The United States, the largest member of the IMF, currently has 17.78% of the vote, and thus can veto any major decision of the Fund it feels is unacceptable. Under the terms of its Articles of Agreement, the IMF's headquarters are located in the largest member country: they have always been in Washington D.C..

Meetings of the full Board of Governors are a rather cumbersome annual event; a smaller and more manageable body is the so-called "Interim Committee", of 24 Governors, which meets twice a year and is charged with reporting to the Governors (and in practice making recommendations which stand a good chance of success) on "the management and functioning of the international monetary system and on proposals to amend the Articles of Agreement".

Day to day decisions are made by an Executive Board. Countries are grouped into constituencies to elect 24 Executive Directors as members of the Board, with the exception that the five largest members of the IMF (the United States, Germany, Japan, France and the United Kingdom) have their own Executive Directors. The Executive Board also appoints a Managing Director. The staff of the IMF (currently 2,660) is recruited internationally, but without any quotas as to nationality (as is the practice in the United Nations).

How big is it? Fund quotas for member countries are initially determined by a calculation based on the size of the national economy (GDP, current account transactions in the balance of payments). They are periodically increased, in response to perceived needs for the IMF's operations. The Articles of Agreement provide for a general review of the quotas every five years. There have been a total of 12 such quota reviews, in 4 of which it was decided that no increase was needed. In the other 8, there was a general increase, and some redistribution of quotas to reflect changing positions in the world economy. In the most recent round of increases, the total quota was raised by 45%, from SDR 146 bn. to 212 bn. (approx. $291 - on September 3, 1999, SDR= $1.37494), with the U.S. share being set at SDR 37,149.3. The size of the IMF, measured by the total of

IMF quotas, measured as a proportion of world trade fell sharply between 1946 and the mid-1970s; since then this ratio has been stable, and even shown a slight increase.

Figure 1: IMF Quotas as a Share of World Imports

Since borrowing from the Fund (or "drawing" of quotas in IMF parlance) is related to the size of a country's initial deposit or quota, the IMF is often seen as analogous to a credit union rather than a bank, in which there is no such association between lending and deposits.[3]

What does it do? The IMF has evolved into a major influence on the development of the world economy. Its functions today include the following, many of which correspond directly with the mandate, and others have been added, with the intent of realizing the original mandate:

1. The IMF still sees its primary purpose in promoting world trade, and in securing the general well-being of the world economy, through analysis and advice. This advice is aimed at avoiding inconsistencies between the policies of its different member states, and policy mistakes by individual members. The IMF tries to influence the policies of its members, in the belief that poor policies have an adverse effect that extends beyond national frontiers. Its Articles of Agreement (Article I, 1) refer to the establishment of a "machinery for consultation and collaboration on international monetary problems". The term used by the IMF for this function is "surveillance".

Surveillance takes two principal forms: the first is multilateral, based on a general overview of the inter-connections and inter-actions between national economic policies and performance, and of forecasts based on a variety of scenarios. The most important practical expression of these calculations is an exercise conducted by the IMF's staff, and then discussed by the Board and presented as a publication, the World Economic Outlook. World Economic Outlook material is also used in G-7/G-8 economic summits and in the meetings of the G-7 Finance Ministers, where the views of the IMF are presented by the Managing Director and by the Director of the Research Department.

[3] See Kenen (1986).

The IMF staff also prepare published assessments of world capital markets, the International Capital Markets Reports. These focus on market developments, not only in advanced economies, but also in emerging markets (which are dealt with much more fully than in the analogous BIS reports). WEO and capital markets reports material is generally highly regarded, and the econometric model used is state of the art, although analysis of errors in past forecasting in the WEO shows a tendency toward optimism.[4] Recently, the IMF has also conducted research on early warning signals that might show the imminence of currency or banking crises: but such research - in common with similar academic research - tends to show the difficulties in finding reliable prior indicators of crisis .[5]

Secondly, there is a bilateral surveillance, based on regular consultations with member countries (known as Article IV consultations). As a result of a feeling in the 1990's that some of the problems in the international economy were a consequence of inadequate surveillance, the IMF reverted to a pattern of annual consultations (after a period in which they were less frequent). Sometimes IMF staff reports on member countries are thought to be insufficiently critical (because of the development of a sort of "clientism", in which good relations with officials and ministers develop).

The economic basis of staff papers in preparation for these consultations have been published for some years (under the title "Recent Economic Developments"). In April 1999, the IMF launched an experimental program for the release of staff reports subsequent to consultations. The results of the consultations are expressed in a paper, which is now published by the IMF, given the consent of the member country concerned, as a "Public Information Notice" (previously, the outcome of such discussions was regarded as confidential). In 1999, the IMF began to release full staff reports.

Within the general field of surveillance, the IMF has a special mandate with regard to exchange rate policy. This was the original rationale for the IMF's existence (see Section 3), and exchange rate policy remains at the center of advice to member

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[4] See Artis (1996), and James (1996), Figure 13-2. Such problems arise in part because of the unpredictability of economic shocks, but also in part because of the method of building up forecasts "from the bottom up", by the use of area department material to generate assessments of the international economy as a whole.

[5] See Kaminsky Lizondo and Reinhart (1998).

countries. The IMF groups and lists the exchange rate policies of its members, and a great deal of its research is concerned with theoretical as well as practical issues relating to exchange rate policy.

Currently, the surveillance function accounts for 42% of the IMF's budget, if overhead costs are included.

2. The IMF is primarily a financial institution, which provides credits to member countries, known in IMF terminology as "drawings on the Fund". Such credits are extended in relation to the size of the quota. Since the 1950's, credit has been provided in "tranches", units corresponding to 25% of a member's quota. The first tranche is available automatically, without any discussion of policy. The larger the credit is in relation to the quota, in other words, the higher the tranche, the higher is the extent of policy reform required (conditionality). These credits are at a rate of interest calculated by the IMF to correspond with market rates of principal member countries, and to cover the IMF's operating costs.

Figure 2: IMF Charges and Commercial Interest Rates

At the end of April 1999, the IMF had SDR 63.6 bn. credit outstanding (approx. $ 87 bn.). This might look as if it is only a relatively small share of the total of quota resources (it is less than half of the pre-quota increase total of SDR 146 bn.), but in practice not all of the quota IMF's resources can really be used in support operations (using the quotas paid in national currency by a small developing country, or even a larger emerging economy, even though such currencies may nominally be convertible, might provoke a problem for that country; in practice, the IMF is thus usually limited in lending out the quotas paid in by its richer members.) In reality, an assessment of what really constitutes the usable resources of the IMF requires very careful judgment of the current state of international currency markets. A critical measurement of the Fund's position is the "liquidity ratio", the proportion of uncommitted usable resources to liquid liabilities. The highest ratio recently was 170%, in January 1995. It fell sharply after the Asian crisis

to 45% (April 1998), but has risen to 89% (April 1999), after the most recent quota increase.

Figure 3: Total IMF Credit Outstanding to Members

As shown in Figure 3, IMF credit is given in different forms and on different conditions. The stand-by arrangements assure that a member can make borrowings over a specified period, usually between 1 and 2 years, but sometimes for a shorter period and sometimes for up to 3 years, with repayments scheduled between 3 ¼ and 5 years after the borrowing. The extended facility, introduced in the 1970's, is available for a longer period, of 4 ½ to 10 years. These facilities carry an interest rate based on an average of rates in the major industrial countries. Thus, inevitably, for each of the IMF's major net contributors of resources (the industrial countries), depending on the relative state of the business cycle, rates of remuneration on resources (the SDR interest rate) deposited with the IMF are sometimes higher and sometimes lower than prevailing interest rates in the national economy. Thus IMF rates were slightly higher than U.S. interest rates in the early 1990s, and are now slightly lower (see Figure 2).

During the Asian crisis, a new facility (the Supplemental Reserve Facility) was introduced, that resembled more closely the traditional notion of an emergency lender of last resort, as envisaged by Walter Bagehot in his classic work Lombard Street (1873). This facility is aimed at dealing with abrupt reversals of confidence. The amounts lent are higher, but charged at a penalty rate of 300 to 500 basis points above the IMF's regular rate of charge. In making such loans, the IMF inevitably has to consider its own liquidity position, and is obviously not capable of extending infinite credit in a manner analogous to the monetary authority in a national setting.[6]

There are further possibilities of lending in response to natural disasters, in post-conflict situations (such as Albania, Bosnia, Rwanda, Tajikistan), and special facilities: the Compensatory and Contingency Financing Facility, for unexpected and temporary falls in export prices, export volumes, or for increases in the cost of cereal supplies; and

[6] See Capie (1998).

the Systemic Transformation Facility, which was used between 1993 and 1995 to support economies in transition from plan to market.

In addition, there is also a possibility for the Fund to borrow resources outside its quotas. Since the 1960's the IMF has been able to borrow additional sums from 11 large industrial countries (under the so-called "General Arrangements to Borrow", or GAB), which may be lent "to forestall or cope with an impairment of the international monetary system" (it was intended to deal primarily with potential problems in the major reserve centers, the United Kingdom and the United States). This new potential source of IMF credit broke with the previous IMF principle of operating on the lines of a credit union, and turned the institution toward a role as a bank. After the end of the par value system, the GAB was rarely needed as a support for reserve currencies; and the provision had in fact been inactive for twenty years, until it was resuscitated in July 1998 to provide resources for Russia. It was last enlarged in 1983, to an amount of SDR 17 bn. There is also an additional amount available under a separate, but analogous, agreement with Saudi Arabia.

The GAB has recently (1997) also been supplemented by an as yet unused mechanism for borrowing SDR 34 bn. from a wider group of 25 members of the IMF (the "New Arrangements to Borrow"), as a response to the Asian crisis and in order to provide additional facilities in the event of systemic problems in emerging markets..

3. In some circumstances, the IMF is a provider of subsidized credit. Since the 1970's, the IMF has given low interest credits to poor countries, who at that time were especially vulnerable because of the increased cost of imported fuel. The interest subsidy was paid through a Trust Fund, financed in part in the 1970's by the sale of parts of the IMF's gold reserves. Currently, the IMF's facilities for low-income members, defined principally on a basis of per capita income and eligibility for the concessional lending of the World Bank Group under IDA (International Development Association), are known as the Enhanced Structural Adjustment Facility. The loans are made available in three installments over a three year period, carry an interest of 0.5%, and are repaid over a period from 5 ½ to 10 years after the loan disbursement. At the end of July 1999, the IMF had SDR 6.5 bn. in credit outstanding under this subsidized credit arrangement (or

10.2% of its total outstanding credit). The subsidy is paid in part from interest from the Trust Fund created in the 1970's, and in part from donations and loans from member countries .

The provision of low-interest credit developed in the following way:

Figure 4: Low Interest IMF Lending

Such credit brought the Fund into development work. It is a task that lay outside the traditional areas of IMF responsibilities.

4. The IMF also has the task of creating supplementary reserves, in the form of the SDR (Special Drawing Right). The issue of SDRs is linked, according to the first Amendment of the Articles of Agreement), to a general need for liquidity. In a world of liquid capital markets it is hard to see a case for such a general requirement, short of a general world deflation, and there has been no issue of SDRs since the 1970's. The consequence is that more recent members have received no allocation of SDRs, and in general the SDR plays a relatively minor role in world monetary policy.

5. In the course of surveillance, the IMF collects a great amount of data, which it has presented in a standardized and systematized way in such publications as International Financial Statistics. There has developed an increasing awareness that surveillance can be more effective if its results are made available to a wider public, that is market participants. The World Economic Outlook material is also published. Recently, in 1996, in response to the Mexico crisis of 1994-5, it provided a systematic standard for the presentation of national data relevant to the operation of capital markets, the "Special Data Dissemination Standard". Information supplied is displayed on an electronic bulletin board, and the IMF monitors compliance. The IMF also publishes regular reports on international capital markets.

6. The IMF provides training and technical assistance through the IMF Institute to member countries on matters such as the operation of central banks, Finance Ministries, tax regulation etc.. This educational function accounted for 22.5% of the IMF's operating budget in 1997/8.

How much does it cost? Unfortunately a breakdown of its expenditures between categories has only been available since 1995. For the latest year for which we have data, 1998, we have broken down the IMF's activities into three categories: surveillance was $218.2 million and represented 42% of the budget; the use of IMF resources (the IMF's role as a financial institution) was $184.2 million and 35.5% of the budget; technical assistance was $117.1 million and 22.5% of the budget. The data to extend these calculations backward is unavailable. General overhead costs are allocated to each of these three activities in accordance with their proportionate importance. The costs of the IMF Research Department are not shown separately. Research is directed toward these three categories, and the costs allocated accordingly.

3. Origins and original aims

The best way of thinking of the IMF and its functions during the period of the so-called Bretton Woods regime (1945-1973) is not so much as an institution, but as the institutional embodiment of a system of rules (the IMF's Articles of Agreement). The construction of the postwar international monetary system, built around the IMF, came as a result of a general agreement that a repetition of the economic and political nationalism of the 1930's could and should be avoided.

The IMF was established in the aftermath of the disasters of the Great Depression to overcome perceived market failures of the 1930's, including destabilizing short-term capital flows (hot money movements), then the breakdown of capital markets, the consequent inability to finance payments deficits in a time of depression, the widespread imposition of exchange controls, competitive devaluations ('beggar thy neighbor'), and a turn to trade protection.

The Articles of Agreement drafted at Bretton Woods, NH in July 1944 represented a compromise between the plans of the U.S. and U.K., the leading Allied economic powers during the war. For the U.S., restoration of a multilateral payments system based on convertible currencies was paramount. The British wanted the freedom from the

external constraint to pursue full employment policies. In the end the American Plan proposed by Harry Dexter White for a Stabilization Fund modeled in part on the U.S. Exchange Stabilization Fund was dominant. The par value adjustable peg system was based on the nominal anchor of gold with the U.S. as the reserve center country. The IMF was designated as the umpire of the system with an initial Fund of 8.8 billion dollars to lend to members when balance of payments pressure threatened adherence to the par values.[7,8]

In the vision that lay behind the Bretton Woods conference of July 1944, the IMF's major functions were to:

1. facilitate an end of exchange controls and transition to current account convertibility (countries maintaining controls were obliged to hold regular consultations with the IMF referred to as Article XIV consultations).

2. deal with the fear of competitive devaluations (which may have been an instrument of trade warfare in the 1930's) in response to the belief, based on the experiences of the 1920's, that flexible exchange rates were destabilizing. It instituted pegged, but adjustable, exchange rates based on the stable nominal rate of the U.S. dollar or on a specific gold value. Adjustment beyond a certain margin (10%) required the concurrence of the IMF.

3. provide short term finance to deal with temporary balance of payments disequilibria (such problems were assumed to arise from the current account, since it was believed that capital flows in the post war would be minimal and moreover the Articles encouraged capital controls). The pursuit of inappropriate demand management policies by a member country would lead to danger signals, in the form of balance of payments imbalances. If the imbalance reflected a fundamental disequilibrium (never explicitly defined but generally meaning an unsustainable payments imbalance), the exchange rate would be altered with the approval of the Fund. If the problem was perceived to be temporary, the IMF would provide financial assistance. Through the quota mechanism,

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7 See Bordo (1993).

8 The World Bank (IBRD) was founded at the same time to provide capital to the war torn countries of Europe and Asia and to the developing world.

the IMF de facto created an additional pool of reserves (it functioned analogously to a credit union).[9]

4. constitute an economic equivalent of the United Nations (the five largest quota holders as calculated at the time of Bretton Woods, United States, USSR, UK, China, France, with an automatic right to seats on the IMF's Executive Board, correspond to permanent members of Security Council).

The successes and failures of the original vision

World trade expanded quickly from the 1950's. There was no worldwide depression immediately after the Second World War as had occurred after World War I. The absence of such an economic catastrophe had little to do with the IMF, which actually undertook little activity in the first ten years of its existence, but was rather due to the Marshall Plan, the Pax Americana and the institution of stabilization policies across the advanced world. Implementing the Bretton Woods Articles - in particular the attainment of current account convertibility (Article VIII) - took a long time for the advanced countries of Western Europe. Other parts of the original vision ran into increasing problems.

1. Current account convertibility in the advanced countries of Western Europe took much longer than had initially been envisaged, until December 1958. It was achieved through the efforts of the European Payments Union funded partially by the Marshall Plan. The attainment of convertibility was preceded by a surge of IMF credit in 1956-7, and by 1958 most European countries had accepted the relevant article (Article VIII) of the Articles of Agreement. Japan did so in 1964. Most developing countries however retained current account restrictions until the 1980's or 1990's. In 1960, 13% of the IMF's members had accepted current account convertibility under Article VIII, in 1970 30%, and by 1990 45%. By 1998, however, of the IMF's 182 members, 142 (or 79%) had accepted Article VIII.

[9] See Kenen (1986).

2. The strains on the par value system increased in the 1960's. Strains included a continuous tension between countries in chronic deficit like the UK, which was prevented by external constraints from expansion and was under continuous pressure to devalue. The UK, at that time the issuer of the world's second most important reserve currency, thus faced almost continual crisis. The surplus countries, Germany and Japan, who found it difficult or impossible to revalue. In addition, the system itself faced considerable strain as the center country the U.S., ran almost continuous balance of payments deficits and persistent gold drains. Numerous efforts to prevent the inevitable collapse of the system included U.S. drawings from the IMF, and the system eventually broke down in a series of currency crises between 1971 and 1973. After the breakdown, the threat of trade wars increased.

3. After 1978 no major industrial countries drew on the IMF for short term finance, because the international capital markets now provided such funds. The growth of capital markets, which had contributed to the breakdown of the fixed exchange rate regime in 1971-3, surprised everyone.

4. The IMF was not initially a global institution, as had been envisaged at the time of Bretton Woods, but became a part of Cold War politics. The USSR had refused to join in 1945, and the IMF became an institution of the non-communist (free) world.

4. The IMF's Role in the Post Bretton Woods era: externalities and public goods?

The decades following the breakdown of the par value system in 1973 witnessed a sea change in the international environment from that envisioned by the architects of the Bretton Woods system.[10] The par value system was gone and with it the IMF's main function as the umpire of the rules of the game of that system. In the new environment, member countries could freely choose their exchange rate arrangements—pegged exchange rates to secure the benefits of a nominal anchor and monetary and fiscal discipline, or floating rates for policy independence and insulation from external shocks. The move by most advanced countries towards floating, which in theory at least provided

[10] See Masson and Mussa (1996).

policy independence and a reduced need for international reserves, meant that the only role seemingly left for the Fund was surveillance designed to achieve responsible exchange rate policies under the amended Article IV. The IMF provided information and policy advice, and acted as a medium for policy coordination.

A second development that had profound implications for the IMF was the increasing integration of the world economy. This reflected a reduction in trade and transportation costs and especially financial integration.[11] The dramatic opening up of private international capital markets, which had been suppressed through the Bretton Woods years by IMF sanctioned capital controls, implied that private capital could substitute for official financing of payments imbalances. This indeed became the case for the advanced countries. The final change in the environment facing the IMF was a dramatic growth in membership with the collapse of colonialism in the 1960's to 1980's and the dissolution of the former socialist bloc in the late 1980's.

New Externalities

In this new environment the IMF redefined its role aided by major political and economic shocks and the rise of new constituencies for its services as we document in section 5 below. A new rationale for the Fund's role in the new environment has been provided by the Fund's staff and those who see it continuing to take a central part in the institutional structure of the world economy—new sources of externalities (market failures) and new public goods for the Fund to provide.[12]

The advent of managed floating exchange rates is viewed as creating a set of problems that, in their impact, are not substantially different from those facing the par value system: incipient balance of payments pressures were said not to be smoothly adjusted to, and exchange rates were said to be prone to overshooting and to have produced substantial adjustment costs to the real economy. These problems dictated the need for active demand management and IMF policy advice and also the need for IMF resources and conditionality as before.

[11] See Bordo, Eichengreen and Irwin (1999), Obstfeld and Taylor (1998).
[12] See Guitian (1992), Masson and Mussa (1996), Krueger (1998).

Growing interdependence and especially capital market integration in turn meant that the independence from external shocks that floating rates would provide was greatly eroded, again dictating a demand for IMF surveillance and financing. Financial integration which serves the welfare enhancing roles of allocating resources both secularly and cyclically between countries with surplus and deficient savings, and optimal portfolio diversification, however, brings perils. These include the following:

a) that although private capital could serve as a source of reserves for advanced countries in facilitating adjustment, it would be expensive in times of crisis;
b) private capital is only available to advanced countries or middle-income developing (emerging) countries and not to low income or former socialist countries.
c) private capital flows are subject to sudden reversals which can precipitate currency crises, costly current account reversals, and serious economic hardship. A number of stories proliferate including the role of asymmetric information, changing investor sentiment in the face of news that reveals policy inconsistencies, multiple equilibria and contagion effects.
d) The problem of debt crises. Fears that a sovereign borrower will be unable to service its debt can lead to a run, in an environment without some authority providing coordination, by lenders fearful that they will not be repaid.
e) Finally, there has been an expanded Fund membership by low income countries, which are too poor, do not have any, or if they do, have primitive credit markets, and do not have the institutions for sound policy. Such countries do not have access to the international private capital markets and moreover require medium term structural loans as well as temporary balance of payments assistance. Similar problems face many of the transition economies.

New Public Goods

In the face of these new problems a.k.a. 'externalities' of the 'New Order,' the IMF is viewed as providing new solutions and new public goods. Most of these developments pertain to developing countries. For the problems arising for the new international monetary regime of free choice in exchange rate arrangements, the Fund no

longer is regarded as the umpire of the rules of the par value system but as the protector of the system from instability, 'the overseer of the code of conduct' (Guitian 1992), according to Article IV. Fund surveillance includes fostering policy coordination, policy advice and providing extensive information on the state of the world economy and of the individual members. In addition Fund financing through standby loans and other facilities can reduce the costs of adjustment to payments imbalances.

To alleviate the problems associated with increased international integration and capital mobility the Fund has taken on a number of roles including:

a) the provision of short to medium term capital for low income (credit constrained) countries;
b) the provision of a 'good housekeeping seal of approval' or signal to potential private lenders for sovereign borrowers who have successfully followed Fund programs and conditionality;
c) insurance against shocks, including crises facing countries which cannot access private markets, with surveillance serving in the role of 'a fire marshal' and conditionality as a form of coinsurance.
d) an 'honest broker' serving as a coordinator of lenders in a debt crisis. Here the Fund is to solve a collective action problem by arranging concerted lending.
e) a crisis manager by providing international liquidity to emerging countries in financial crises.
f) a crisis preventor by providing 'early warning signals' and as a 'policeman' forcing disclosure of information.

Finally to help solve the problems of the new impoverished and institutionally backward members, the Fund provides advice and technical assistance on policy reform as well as longer term financial assistance to correct structural imbalances.

Counterarguments

Critics contend that many of the IMF's new roles are not necessary in the environment of exchange rates regime choice and global financial integration. They argue that most countries should and can follow sound independent macro policies and,

should they do so, can insure themselves against shocks by turning to the private capital markets.[13] Furthermore that much of the Fund's surveillance activity could be provided by the private sector.

With respect to medium term structural assistance to poor countries, it is argued that it creates dependency (analogous to welfare dependency), with many IMF clients rarely leaving the Fund.[14] Moreover the record on the success of Fund programs is mixed. IMF programs generally have been associated with improvements in the current account, reduced fiscal deficits, money growth and inflation but at the expense of declining real growth for a number of years.[15] The proliferation of structural adjustment facilities is also viewed as encroaching on the province of the World Bank and the case has been made for merging the two institutions.

The IMF's role as honest broker in debt crises is also seen as overblown. In the absence of the IMF it is asked why couldn't private lenders and borrowers strike a deal as they did in crises before 1914.[16]

Finally, the Fund has been heavily criticized in recent years for its role as a crisis manager. The rescue loans provided by the IMF and other authorities to Mexico and the recent Asian crisis victims are seen as engendering moral hazard both for policy makers who may follow too lax policies in the knowledge that the Fund will intervene, and for lenders who believe they will be bailed out.[17] Such critics also regard the contagion argument for massive and rapid intervention as overblown. Contagion may reflect a wake-up call that other countries are following the same inconsistent policies or have the same financial sector weaknesses as the first country attacked, or the transmission of shocks reflecting common fundamentals.

Finally the Fund's conditionality has been criticized for imposing too harsh a burden on the victims of crisis.[18]

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[13] See e.g. Schwartz (1998).
[14] Bandow and Vasquez (1994).
[15] Edwards (1987), Khan (1990), Khan and Ul Haque (1998), Conway (1994).
[16] See e.g. Bulow and Rogoff (1990) who argue that coordination problems among private sector banks blocked efficiency-enhancing debt workouts in the Latin American debt crisis of the 1980's. See Chari and Kehoe (1998).
[17] Meltzer (1998), Friedman (1998), Schwartz (1998), Shultz (1998).
[18] Sachs and Radelet (1998).

With these issues in mind, we turn to a description of the historical evolution of the IMF from its original to its present mission.

5. The IMF in search of a mission

How adequately, and with what results, has the IMF been able to meet the problems raised by the new externalities in the world of mobile capital? What interests shaped the development of the IMF? To what extent was it simply driven by an instinct for internal bureaucratic self-preservation?[19]

With the end of the par value system, it appeared that the IMF had lost its major purpose as the guarantor of an exchange rate system. For some time, some countries - especially France and Japan - pressed for a return to par values. A "Committee of Twenty" discussed proposals for a new international monetary order. In 1978, the Second Amendment of the Articles of Agreement set out a carefully worded compromise whose function it was to indicate that there would be no return to fixed exchange rates in the near future. The new Article IV Section 1 spoke of the obligation of Fund members "to assure orderly exchange arrangements and to promote a stable system of exchange rates" (i.e. not "a system of stable exchange rates"). Expectations that major currencies would be relatively stable against each other were disappointed, and there were large movements between the world's major currencies, the dollar, Japanese yen and the German mark. In any case, the IMF was no longer at the center of an institutionalized exchange rate regime, and thus completely lost its major original function.

The IMF survived as a financial institution, and four surges in lending corresponded to major upheavals in the international system: the oil crisis of the 1970's, the developing country debt crisis of 1982, the transition of formerly planned economies to the market, and the 1997 Asia crisis. The new activity was explained in terms of different and in part incompatible suggestions for new directions for the IMF, including the following:

[19] This is the case made most forcefully by Vaubel (1994).

1. The breakdown of the par value system was quickly followed by a dramatic increase in petroleum prices, and major new imbalances in the international financial system. According to one suggestion, the new surpluses of the 1970's arising from the oil price hike (so-called petro-dollars) should be deposited at the IMF and then relent to countries facing balance of payments problems as a result of their increased import prices. In 1974 the IMF established for this purpose an "oil facility".

Who wanted this function for the Fund? The oil facility was an initiative of the Fund, and its Managing Director, Johannes Witteveen. The U.S. Ford administration was initially skeptical, but supported some sort of oil facility. Initially it preferred the idea of working through the OECD.

But both the oil producers and many developing country debtors preferred to use the private market. An attraction of the international capital markets lay in the absence of any policy control, and developing country finance ministers reacted against attempts of the IMF to warn against over-borrowing. The result was a lending boom, and substantial growth in many developing countries (especially in Latin America). In the 1970's, the overall proportion of developing countries' current account deficits financed by the IMF was actually lower than it had been in the 1960's.

2. Another possible new role of the IMF was as an international policy coordinator. The shocks of the 1970's - the oil price hikes, recessions, increased inflation - posed major challenges to policy.

Such discussion also took place in other institutional settings, in the G5/G7 meetings of Finance Ministers (there were informal meetings from 1973), in economic summits (which became an annual feature after the Rambouillet meeting in November 1975), and bilaterally, and by other institutions.

The need for international policy coordination is less evident than might at first sight appear. There have been phases in international financial history since 1973 of almost no coordination (1981-85), and periods of quite intense efforts at coordination (1978, 1985-89). It is not clear that the phase of no coordination was more unstable than the previous or subsequent periods.[20] In addition, both major exercises in coordination

[20] See Feldstein (1994); Frankel (1994).

left substantial resentments. After 1978 Germany and Japan rejected what they termed "ambitious international demand management".[21] The phase between the Plaza (1985) and Louvre (1987) meetings of the G7 Finance Ministers was blamed in retrospect in Japan as being at the origin of the disastrous "bubble" economy, because of the pressure placed on Japan in these exercises by the United States to pursue a looser monetary policy and a devaluation of the yen.[22]

Who wanted the Fund to be a policy coordinator? There was some institutional momentum: the IMF was looking for a role that it might play in a world in which rules (the par value rule) had become less important and in which more room for maneuver and more policy choices seemed to be open to national governments.

The governments of major countries found it useful to have a forum that was less directly political than the G7 summits, for assessing the likely outcome of a country's economic policy on the world economy, and pressing for changes: e.g. for greater Japanese or German expansion (1977-78, 1987), a reduction of U.S. deficits (mid-1980’s). But it can hardly be said that the IMF and its advice contributed greatly to the solving of any of these problems.

3. The most useful function that the IMF contributed to the debate about policy coordination was through the provision of data and forecasts, in the World Economic Outlook exercise, that might be used as a basis for such policy discussions. More recently, the IMF extended its role in the coordination process via the supply of a wide range of national data through the institution of the Special Data Dissemination Standard.

There are two major arguments as to why the IMF rather than another, private sector, agency should play this role. One is concerned with the desirability of a general or common standard for data provision as a public good. The second is that because the IMF provides financial and other assistance to governments, these are likely to have incentives to provide the IMF with quick and accurate data. Anne Krueger concludes that "It is at least as likely that, in the absence of the other relationships between the multilateral institutions and individual governments, the data would be forthcoming later,

[21] See Guth (1988) p.211.
[22] See Funabashi (1989).

in less reliable form, and be less accessible for researchers and other users."[23] There have been some prominent cases in which countries, especially borrowers, have supplied misleading data or deceived the Fund: Hungary and Yugoslavia in the 1980's, and most recently Russia in relation to its foreign exchange reserves in 1996 and subsequently. Such experiences suggest that the penalties imposed for the supply of wrong data may not be sufficiently deterrent.

4. The IMF also developed as a purveyor of policy advice, in regular consultations with member countries (Article IV consultations), whether or not these members were currently involved in a financial program. Already under the Bretton Woods system, the IMF had given policy advice, and conducted consultations with governments. The most influential and effective policy advice, however, was given as part of IMF programs, and was thus much more difficult to ignore than similar advice given for instance by the OECD. Moreover, the fact that the IMF as a lender has to put its own money behind its advice should make it more careful, and less likely to be "influenced by political demands".[24]

It is hard to judge the extent to which the policy advice given in such cases produced a positive outcome in terms of "good policy" and enhanced growth. The willingness to take outside advice varies greatly between countries. One example of a long term success is Korea, which had annual programs with the IMF from 1965 to 1975, and then again in the early 1980's. These "stand-by arrangements" involved funds, which were often not actually drawn, but which provided a significant element of support for a trade liberalization program. This constituted an important element in Korea's spectacular economic success in this period.

The response to the Latin American debt crisis of the 1980's also involved a commitment to liberalize trade and to dismantle over-extended public sectors, and such policies have made many Latin American economies much more robust. Chile, which was a long-standing borrower from the Fund, and had programs from 1983 to 1990, in particular, constituted a model of success. Even repeated failures in programs are not

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[23] See Krueger (1998) p. 1997.

[24] See Rodrik (1995) p.174, Krueger (1998) p.1999.

necessarily an indicator that the next program will also fail. Turkey's successful adjustment in 1980, for instance, had been preceded by numerous failures.
On the other hand, some countries - often very poor economies - became long-term clients of the IMF, with little policy reform. (see Table 1) Here policy advice was clearly ineffective. The major criticism of the IMF's effectiveness at first in the 1970's and early 1980's concentrated on the short-term character of IMF support, which could not be an adequate basis for longer term sustained reform programs. In response to this criticism, the IMF developed longer-term packages (see below).

Table 1: Average Time Spent in IMF Programs by Class of Borrower

In assessing the overall success of the IMF in policy reform, it has proved extremely difficult to separate the influence of the IMF from that of other sources of finance, and to make counter-factual calculations of what would have happened in the absence of IMF programs and advice.[25] Frequently, the criticism has been made that Fund programs are "anti-growth" and that they hurt especially poor people.[26] The anti-growth complaint is apparently borne out by research that shows short-term reductions in balance of payments deficits accompanied by lower output growth as a characteristic outcome of IMF programs.[27] But these programs are often the response to the dramatic failures of previous policies, and it is unfair to attribute the pain experienced simply to the remedy rather than the underlying sickness. On the poverty issue, there has been an increased sensitivity to the need to accompany reform programs with anti-poverty measures and with safety nets.

Who wanted this consultancy function for the Fund? Advice-giving is part of the self-image of the IMF, and has long been a powerful concern of Fund staff. It follows from the logic of the provision of funds conditional on policy criteria (conditionality).

[25] For a balanced attempt to state the IMF view, see Khan (1990) and Ul Haque and Khan (1998). Also Guitian (1995).
[26] Bandow and Vasquez (1994). For a critique from a different political angle, George (1992).
[27] Edwards (1989) and items cited in footnote 20 above.

For whose benefit is such advice provided? Following good policy may be thought to be in the interest of a country concerned as a whole. It might well be argued that countries would do better to hire consultants, who might devise reform strategies more closely attuned to the concerns of a particular country.

The argument against such a privatization of advice is a matter of public policy on an international level. The interests of a country and its population as a whole do not coincide with those of its elites or its government. To take one example that was common to policy debates in many developing countries: many countries maintained over-valued exchange rates, which they defended by exchange controls. The government could then allocate to its preferred clients foreign exchange at cheap prices, which might be used to import cheaply foreign food (to pacify urban populations) or luxury goods for the elite. Devaluations as recommended by the IMF in consequence frequently hurt powerful political lobbies, but raised the incomes of politically under-represented rural communities, whose products became worth more as a result of the exchange rate alteration. Such measures created a potential for longer term growth: one example is Ghana in the 1980's. In general, because of the income redistribution associated with the politics of devaluation, private consultants hired by and responsible solely to the national governments concerned might well be less likely to recommend a policy that in the long run is likely to enhance economic growth.

The IMF as a tool of the international community can afford to go against the immediate and direct interest of individual member governments in giving policy advice. In doing this, it should aim to address a general interest, which is not provided by other market providers (consultancies, or investment banks) which give useful advice on many aspects of government policy.

5. An extension of the surveillance function was that from the mid-1980's the IMF became increasingly popular as a purveyor of financial credibility, or a provider of a good housekeeping seal of approval. In the era of fixed exchange rates and the gold standard, before the First World War, linkage to the metallic standard had provided such

a seal of approval.[28] In the world of floating rates, and increased capital mobility, many countries saw the IMF as a provider of credibility. The IMF thus had a function that went well beyond its own relatively modest resources. This interpretation is supported by the increased popularity of "precautionary programs", undertaken without an immediate intention of borrowing; and especially by the steady decline since the mid-1980's in the ratio between actual and potential borrowing. Curzio Giannini has formulated the point in a striking way: that at the same time as this ratio has reached a historic low (i.e. countries are concluding programs but not using the financial resources), "the number of countries with IMF programs has risen to all-time peaks".[29] A potential corollary of the current situation is that a seal of approval might be given for policies or economies that are not as strong as might be desired. This phenomenon produced the suggestion that, as a further confidence-inducing measure, the quick provision of IMF resources in a crisis should be linked to the prior compliance with a tough set of regulatory requirements.[30] This proposal was realized in April 1999, in the creation of Contingent Credit Lines, providing short-term support in the case of a sudden and disruptive loss of market confidence.

Figure 5: Transactions of the International Monetary Fund, 1955 – 1997

6. The IMF developed as a lender at subsidized interest rates to very poor countries, where there existed no hopes of market access (see Figure 4). In practice, it *thereby* became in part an aid agency. Such financing has given rise to much of the debate about the effectiveness of IMF policy-advice outlined in the previous section.

Who wanted this function for the Fund? The IMF moved into a vacuum, and took on a function that many believed it was not well prepared for (the original intention was for the Fund to be like a credit cooperative, with short term ad hoc support and no long term programs). It moved beyond short-term programs in large measure as a response to

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[28] Bordo and Rockoff (1996). The restored gold standard also served as a good housekeeping seal of approval in the interwar period: Bordo Edelestein and Rockoff (1999).
[29] Giannini (1999), p.50.
[30] Calomiris (1998).

widespread political (and also academic) criticism that such arrangements were ill-suited to the encouragement of long-term policy reform. This development often occurred at the instigation of the IMF's members, especially of some of the large industrial countries (France and the UK), who looked for a mechanism of giving support at arm's length, without a direct involvement. In the United States, too, the experience with USAID led to a belief that more effective policy support, and an avoidance of duplication in aid efforts, could be achieved through a multilateral approach.

In 1975, a new Extended Fund Facility was established aimed at a longer time framework for the adjustment process. Drawings (i.e. borrowings) occurred over three years, with repayment over 4 to 8 years. Some of the earliest programs under the facility were unsuccessful, in some case because of the absence of policy reform (Kenya) and because favorable external circumstances made the IMF and its advice appear unattractive (Mexico).

Such programs did not deal with very low income countries, in which debt service at conventional interest rates was impossible. In 1986, the IMF created the Structural Adjustment Facility (SAF), with a concessionary rate of interest (0.5%) with repayment over 5-10 years after a 5 year grace period. In 1987 larger funding for such programs came with the Enhanced Structural Adjustment Facility (ESAF). These facilities brought the IMF into what had traditionally been the domain of the World Bank. Most ESAF cases were in sub-Saharan Africa, and required, as part of the package, debt relief. In some ESAF cases, reform has been effective, and some private funds began to flow (Ghana, Bangladesh, Sri Lanka). But there are also many disappointments, which have produced more radical demands for debt relief.

Long-standing arrears in making repayments to the IMF have arisen mostly in the cases of states with major political problems: civil war, disintegration, or a transition to uncooperative and aggressive dictatorship (pariah states). In April 1998, the following had arrears overdue by more than six months: Afghanistan, Democratic Republic Congo, Iraq, Liberia, Somalia, Sudan, Yugoslavia (which is currently no longer a member of the IMF). In other cases, arrears have been dealt with by a mixture of policy reform and

bilateral and multilateral assistance. In April 1998, arrears amounted to 4% of the IMF's outstanding credit.

Table 2: Arrears to the IMF

7. In the 1990's, the IMF became a manager or facilitator in the transition of the former socialist countries into market oriented economies. The IMF was not really prepared for this role, but already in the 1980's, the IMF had played an important part in implementing liberalization strategies in communist economies (China, Poland, Hungary). Many reformers believed that the IMF would be valuable as an external source of advice. In 1985, for instance, the office of the Polish underground opposition Solidarity organization sent a message to the IMF's Managing Director stating that the movement welcomed Polish membership of the IMF, but that only "extensive, all-embracing economic reforms" could hope to be successful.

After the political changes of 1989-91, economic reform in the formerly centrally planned economies was accompanied by a substantial commitment of IMF resources.[31] Individual aspects of IMF advice have been criticized. For too long, the IMF recommended a single currency, a ruble bloc, for former Soviet Republics. In 1992, the IMF may have been too cautious in Russia, and missed the opportunity to support a far-reaching reform on the model successfully adopted by Poland in 1989-90.[32] Most of the criticism of the IMF's Russian programs has focused, in our view rightly, not on over-tough but rather on too lax conditionality.[33] Overall, however, the IMF played a significant role in the transition to market economies.

In the successful cases, such programs fit well with the IMF's original mission of encouraging convertibility of currencies, and more generally a path of liberalization. A short-term measure of support is needed when there is as yet no market confidence, perhaps because of a pre-existing debt overhang dating back from the pre-reform period.

[31] James (1996) p. 567.
[32] Sachs (1995).
[33] Meltzer (1998).

The support is limited to a relatively short duration, and is followed by a renegotiation of old debt and access to markets.

The Central European experience in the 1990's gives a good model of how IMF support should work. Poland used IMF resources in this way from 1990-6, and Hungary had Fund programs from 1990 to 1998, but drew little in the 1993-8 program and nothing in the 1996-8 program. An IMF setting was used in these cases to achieve market confidence.

Who wanted this function for the Fund? At first, the main demand for this function comes from reformers in the countries concerned themselves, who wanted external support for their policies. With the political changes of 1989-91, such support became an objective of the large industrial countries.

8. The new role of the IMF that has attracted the most attention - especially after the experience of Mexico in 1994-5 and Asia after 1997 - is as a crisis manager. Here its clients are countries where there was access to the private capital markets that was suddenly cut off. In cases where confidence was maintained, there would be sufficient liquidity from private sources. However, because their track record as good borrowers or as examples of financial probity was not as good as in the advanced countries, nor had they set up a contingent line of credit, so that in the event of a crisis, the funds would not be available for them.[34] In such cases where confidence disappeared, it was argued that the Fund should become a substitute for the private market, as a way of financing imbalances and restoring expectations of stability: in short, as a reserve center or as a lender of last resort.[35]

There are two ways of providing such assistance. The first, immediate support in the case of a liquidity crisis, in order to forestall an imminent collapse of the financial markets, is conventionally undertaken in a national setting by central banks or conceivably, internationally by the central bankers' central bank, the Bank for International Settlements (BIS). The second, in which policy changes as well as persuasion of financial markets that a new leaf has been turned are required in order to restore confidence, after a collapse has already taken place, has been the domain of the

[34] At least at tolerable rates of interest.

IMF. This intervention requires the longer-term supply of resources than could be possible for the BIS.

In the 1982 developing country debt crisis, the IMF saw itself acting as a crisis manager, as an honest broker in preventing a creditor panic by the major bank lenders, and - in the eyes of some - as a substitute for the absence of a genuine international lender of last resort. This function was replayed in cases where there was fear of contagion, in 1994-5 in the Mexican crisis, and in the aftermath of the 1997 Asia crisis.

In the late summer of 1982, the announcement of difficulties in servicing Mexico's external debt led immediately to fears of a systematic collapse of the international banking system, since exposure to Mexico and other troubled debtor countries amounted to substantially more than the capital of many major banks. At this point, the IMF was quite ill prepared to act as crisis manager. To do so would require quick and decisive action in the face of a sudden crisis. The IMF makes decisions in its Executive Board, subject to voting by Executive Directors who consult their national authorities (and, in the case of the elected Executive Directors, usually a substantial number of national governments). These decisions, as in the Mexican case, depend on an often lengthy negotiation of the reform program with the borrowing country. On the other hand, central banks, with their traditions of secrecy and clear operational guidelines, are able to act very speedily; and, in the Mexican crisis, both the U.S. Federal Reserve and the central bankers' central bank, the BIS, did act extremely promptly in August 1982. But they wanted assurance that they would not be left on their own, and that their short-term assistance would be used to mobilize the rest of the financial community.

In the 1982 debt crisis, the IMF was at the center of a triangular conflation of the functions of an international arbiter, a domestic regulator, and the market. First, the IMF had become, for practical purposes, a part of the domestic regulatory mechanism of U.S. banking. Linkage of commercial bank loans with IMF programs could offer a way of avoiding the consequences of non-accruing or non-performing loans. The definitions of what constituted sound banking were being rewritten in accordance with the requirements of the world financial system as a whole. Secondly, the banks themselves became part of

[35] See for instance Kindleberger (1978).

the IMF's international lending exercise. Their funds greatly enhanced the facilities that the IMF could hold out as the reward to a country for the successful completion of a program - in effect for rejoining the international financial system. An agreement with the IMF was supposed to have a "catalytic" effect on the private sector. Finally, the IMF would do the work that the banks had hitherto neglected to perform themselves: negotiate sound criteria for the use of funds, which would make economic stabilization and adjustment possible and would allow for banks to be repaid. In order to get this service, however, the banks would have to pay the price of putting up additional resources. By acting in this way, the IMF ensured that lending continued, and that the cutting off of external credit did not produce a world depression of the type experienced in the past.

The 1982 crisis highlighted a failure of banking supervision to take account of the internationalization of capital markets. It was now thought that banking supervision should be carried out internationally in a more systematized and open way than the tentative, informal, and secret coordination and exchange of regulatory experience carried out in the framework of the Basle Committee on Banking Regulation and Supervisory Practices (which had begun functioning in 1974). Part of the pressure came from domestic opinion in the United States and from the widespread fear that a solution to the international debt problem would involve a bailout of the banks. The consequent reluctance of the U.S. Congress in 1983 to increase IMF quotas (as part of the Eighth General Review), in the wake of the Latin American debt crisis, could only be overcome through a legislative measure which extended control of banking. The International Lending Supervision Act (November 1983) gave U.S. regulatory authorities the legal right and the obligation to "cause banking institutions to achieve and to maintain adequate capital by establishing minimum levels of capital." It also included a request for U.S. regulators to pursue a convergence of international bank capital standards. Subsequent negotiations, first with the United Kingdom, then with Japan and the other G-10 members, produced a set of standards embodied as the Basle Accord of 1988.[36]

Unlike 1982, 1994 was not primarily a problem of commercial bank credit. The crisis of 1994-95 followed a period of euphoric confidence in Mexico's prospects and a

[36] See Cohen (1986), Norton (1989), Granirer (1994), Goldstein et al (1992), pp. 10-15.

surge of foreign direct investment but also of portfolio flows. This new Mexican "miracle" raised very intricate problems of how the financial sector and the exchange rate should be managed. In particular, when the return of flight capital and the resumption of capital inflows brought upward pressure on the exchange rate, and the exchange rate was used as an anti-inflationary instrument, a risk arose that the result might be a reappearance of the old problems of an external rate sufficiently high to serve as a deterrent to domestic activity and a disincentive to exporters. The difficulties were exacerbated by an expansionary monetary policy. At first, the Mexican authorities tried to conceal the extent of the diminution of their foreign exchange reserves through the issue of dollar-denominated debt. The political stakes attached to the maintenance of the exchange rate produced a taboo on discussion of the parity in the Mexican administration - a taboo that has often characterized pegged rate systems.

When, at the end of 1994, the Mexican authorities attempted to correct the exchange rate over-valuation with an ill-prepared devaluation, at the same time as a large quantity of public sector short-term dollar-denominated instruments (the tesobonos) needed to be renewed, a new financial crisis showed the extent of the instability of the financial system. The large current account deficit (over 8 percent of GDP) that in 1994 had been financed by private capital inflows now appeared unsustainable. The magnitude of the deficit was a deterrent to further inflows. Mexico also produced a knock-on blow to other emerging economies, in a manner analogous to the spread of the 1982 debt increase to other middle-income developing countries. In early 1995 there was a "tequila effect" as speculators sold the currencies and financial assets not only of Latin American economies with large current account deficits and similar problems to Mexico, but also in East Asian emerging markets. The Mexican crisis was met by a $17.8 billion IMF stand-by program (amounting to an unprecedented 688 percent of Mexico's quota in the IMF), in combination with $20 billion from the U.S. Stabilization Fund and $10 billion from the G-10, after intense high level diplomacy involving chiefly the U.S. Treasury and the IMF's Managing Director.

The IMF termed the peso crisis "the first financial crisis of the twenty-first century".[37] The speed with which the IMF program had to be put together in January 1995 illustrates the way in which globalization requires faster responses: the IMF program was already fully in place by February 1, 1995. The 1982 crisis became public in August 1982, but the discussions with the banks about the IMF program only occurred in November and December. In 1995 much more rapid action was required, and also a greater commitment of funds, because the number of actors was so much greater. It was impossible to use the strategy of 1982, and corral the foreign investors (who were now not banks, but instead were represented in innumerable mutual and pension funds). There was a fear of a global contagion, and a belief that the only way to limit such contagion lay in the extension of some protection to investors. These considerations imposed a greater immediate burden on the IMF and the U.S. government to act to limit the crisis. However the ultimate beneficiaries of the rescue were holders of the tesobonos who were bailed out. The size and the speed of the package ended the crisis much more quickly than had been the case in 1982, and Mexico very soon was able to return to international capital markets as a borrower. The IMF and U.S. Treasury loans were quickly paid off in the first quarter of 1997 by the Mexican government, borrowing at higher rates, largely from European banks.

According to the conventional view, the Mexican package was a success although the real economy has yet to fully recover; but it created a precedent and expectations. The Mexican peso crisis provided a pattern for crisis management using both global and regional sources of rescue funds. By bailing out the holders of tesobonos it also planted the seeds of 'moral hazard' which may have increased the likelihood and severity of the next set of crises.

The Mexican model from 1994-5 guided the initial response to the 1997 Thailand crisis, where again there was a speedily assembled IMF program ($ 4 bn.), together with assistance not only from the nearby economic great power (Japan put up another $ 4 bn. through its Export-Import Bank), but also from the major players in the region: Australia, Hong Kong, Malaysia, Singapore. This approach in turn was extended in an initial

[37] Boughton (2000).

response to the Indonesian crisis, with a $10 bn. contribution from the IMF, with additional funding through the World Bank, the Asian Development Bank, and Indonesia's major trading partners. But the rapidity by which crises jumped between Asian countries underlined the limits of regional action and the problem of the finite resources of the IMF.

The ensuing Korean crisis, however, in which banks needed to be persuaded to roll over foreign currency denominated debt, resembled much more the Mexican crisis of 1982.

The outbreak of a generalized Asian crisis produced a general "flight to quality" that worsened borrowing conditions for emerging markets and sensitized investors to issues that they had previously ignored, such as poor fiscal performance in countries such as Brazil and Russia. The Russian default and devaluation on August 17, 1998, triggered renewed capital flight from Brazil and Argentina; and in the months that followed there were fears of a widespread crisis. The negotiation and announcement in November 1997 of an IMF package for Brazil postponed the Brazilian devaluation to a moment (January 13 1999) when it did less damage to the international financial system.

In the debt crisis of the 1980's, the involvement of the private sector had been a crucial part of the IMF-led workout (first through the obligation to put up new money; then through the debt reduction proposals systematized in the Brady Plan). In the crises of the 1990's, it was less easy to manage the private sector contribution to the workout. The multiplicity of creditors precluded a repetition of the new money feature of the 1982 packages. Shareholders took substantial losses in the 1990's. Fixed interest debt remained a major problem, and one proposed solution involves a rewriting of bond contracts to include a possibility of deferred repayment under negotiated circumstances.[38]

One response to criticisms that IMF rescue packages constitute bailouts, in which private investors are not appropriately penalized for having taken high risks, is that some IMF programs (notably in Ukraine) have been made dependent on a renegotiation or

[38] See De Gregorio (1999).

restructuring of the conditions of bonds. Such an innovation, which clearly imposes costs on the private sector, has been highly controversial.[39]

Who wanted the crisis management function for the Fund? The financial community wanted and then came to expect a bailout. The response to the crisis in 1982, but especially in 1994-5 in Mexico, created a precedent, and encouraged investors to believe that an international rescue package would protect them against loss. Russia was believed by investors to be in a specially protected category, because of the security implications of any Russian collapse (this was the doctrine of "too nuclear to fail"). To this extent, past responses to crisis, and the existence of the IMF, has created moral hazard. It is worth noting that since most of the inflows to Asian and Latin American economies were private sector credits, they were not protected by IMF rescues, except to the extent that national governments used IMF resources to rescue domestic financial institutions with debts to foreign creditors.[40]

Governments in industrial countries did not want a generalized financial crisis; but in addition were especially sensitive to the problems caused by financial collapses in their region.

It is possible to think of the crisis management function as capable of being privatized. For much of the nineteenth century, the international banking family of the Rothschilds played a role in crisis management quite analogous to the IMF, lending funds to countries as well as companies that were in temporary difficulties, and making judgments about the appropriateness of fiscal reform initiatives.[41] In the interwar period, the Swedish Match Trust took on such a function for many of the emerging markets of the time in central and southern Europe, while J.P. Morgan dealt with more prosperous developed countries, such as Belgium, France and the United Kingdom. But in order to be able to take on such a role, a private firm would need to be so large as to have a clearly recognizable long-term stake in the financial stability of the system as a whole (what Mancur Olson referred to as a "super-encompassing interest").[42] In the event, there were

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[39] See Siebert (1999).
[40] See Chinn, Dooley and Shresta (1999).
[41] See Ferguson (1998) and Bordo and Schwartz (1999).
[42] McGuire and Olson (1996).

problems with the exercise of such power: the Swedish Match Trust was fraudulently run, and its founder, the speculator Ivar Kreuger, killed himself in 1932 as the extent of his defalcation emerged. In the domestic setting, also, a powerful individual or bank could fulfill the lender of last resort function (in the United States, J.P. Morgan played this part in the 1890s and 1900s). Such solutions ran into widespread criticism because they seemed to offer the possibility of an abuse of power by a private individual. The result of such criticism was a demand for a public institution: in the U.S. domestic context, the Federal Reserve System.

In the 1990's, some countries (notably Argentina) have experimented with pre-arranged (stand-by) credit lines from commercial banks, which represent a private sector alternative to IMF support. While these might be a useful support in the case of a localized crisis, in the case of a general or global financial panic the offer of such credits faces the same problem of a limited supply of resources as does the IMF.

A crisis coordinator, even with limited financial resources in comparison with the overall volume of global financial markets, will be more useful if it is able in an emergency quickly to mobilize official resources. It is more likely that an accountable public sector organization, such as the IMF, can take this role, although the history of domestic central banking suggests that if it does it should lend on the basis of sound collateral at a penalty rate. For private institutions to assume this function on a large scale would raise the question of the abuse of private power as it did at the beginning of this century. But smaller institutions are unlikely to perform this function, because of the risk of loss in a panic situation. The main attraction of private market providers - that they will be penalized by bankruptcy in the case of failure - is an attraction only in normal circumstances; in a crisis or panic situation that strength is a weakness.

How far does the existence of the IMF distort the operation of markets by providing crisis lending at less than the penalty rates that a market might charge? To answer this question adequately, it would be necessary to imagine a counter-factual world without an IMF, in other words without the security that a rescue would be mounted by a lender whose debt enjoys a far higher measure of legal protection than that of other (private) creditors. The pre-1914 world provided some of the elements of such a

counterfactual. In that era sovereign debt, even gold denominated, in many emerging countries for example Argentina, Chile, and Brazil, paid higher risk premia in London in non-crises periods than did the recent Asian crisis victims before 1997.[43] The precedent of the earlier Mexican bailout, but more importantly, the very existence of the IMF, provided a security blanket that did not exist before WWI.

To summarize this long section, the reincarnation of the IMF in the three decades after the end of the par value system reflected a supply response by a willing and competent bureaucracy to the demands of both large and small constituents.

6. International Politics and the IMF

It remains to examine a final, and controversial, area, in which the IMF has undoubtedly played a role which has been useful for the general national interest of the United States, but which may on occasion lead to conflict with the more narrowly conceived economic rationale for the IMF. What are the general political and security implications of the existence of an institution such as the IMF?

The IMF was originally largely a creation of the United States, motivated by the belief that - as Treasury Secretary Morgenthau put it when addressing the inaugural session of the Bretton Woods conference - "Prosperity, like peace is indivisible. We cannot afford to have it scattered here or there among the fortunate or to enjoy it at the expense of others."[44] The institution was a way of projecting a particular way of thinking about the world. Behind this thinking lay the calculation that a more prosperous world would also be a safer world, and that the transition to such stability was well worth paying a limited financial price.

Since the collapse of communism, the basic vision of Bretton Woods has become a matter of a global consensus. In the 1990's, a widespread recognition developed that economic stability and political stability go together.[45] But this linkage is interpreted

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[43] See Bordo and Rockoff (1996).

[44] United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, July 1 to July 22, 1944: Final Act and Related Documents (Washington D.C. U.S. Government Printing House, 1944).

[45] See for instance, the Chairman's statement at the end of the G-7 Halifax summit, June 17, 1995: "Democracy, human rights and good governance are indispensable components of development."

much more precisely than at the time of Bretton Woods: this means a move toward the market and at the same time moves toward democracy and accountable institutions. It is in the interest of the United States to promote this development.

The collapse of the communist economies, or (in the case of China) their transformation into market economies was the last stage in the creation of the new consensus. The consequence has been an increasing homogeneity of political outlook, as well as of the economic order. Indeed, one key insight is that the two are linked: that economic efficiency depends on a functioning civil society, on the rule of law, and on respect for private property. Thus in the 1990's, the IMF (and the World Bank) have become intensely concerned with problems of governance.[46]

Such issues raise questions of political costs and limitations that may not always coincide with economic rationality, however. There is a strategic or geo-political element to some of the work of the Fund. Attacking excessive military expenditure, corruption, and undemocratic practices is easier for international institutions in the cases of small countries, such as Croatia, Kenya or Romania, or even in isolated states such as Pakistan or Nigeria. But it is likely to be hard and controversial in large states with substantial military and economic potential, for instance, in say Russia or China. The public position is that expressed by the IMF's Managing Director when he recalls telling President Yeltsin that the IMF would treat Russia in exactly the same way it treated Burkina Faso.[47] But Russia, and its strategic stability, are clearly of direct concern to the United States, and to other major countries, in a way that Burkina Faso is not.

During the Cold War era, there was political pressure from the international community (i.e. the West) to support financially particular states for foreign policy reasons, because they were essential to the stability of a particular region (Egypt, or Zaire). In these cases, IMF programs were concluded on the basis of weak conditionality and the absence of effective reform. From the point of view of the interests of the United States, increased stability may have been worth the price of a wasted program. Such operations had little effect on financial markets, because the countries that received such support generally had little market access. In the post-Cold War era, however, strategic

[46] For instance, Camdessus (1998). See also Pauly (1998).

and security considerations have led to support operations, for states that do have access to capital markets, notably to Russia. Here the result was a major moral hazard problem, which in the summer of 1998 produced a threat to global financial stability. Foreign investment in Russia frequently was justified by the (as it proved in August 1998) eventually erroneous belief that the IMF would never let Russia collapse. Russia had become in the 1990's by far the largest user of IMF resources, and obtained access to IMF loans by concealing the reserve position of its central bank from the IMF.

The IMF's own justification of its Russian policy is also frequently presented in the light of the wishes of the "international community".[48] The mixing of strategic policy and economics has had unfortunate effects, not only in encouraging inappropriate private sector inflows to Russia. The rationale for the Russian policy has also created a precedent and an incentive for other states, notably in the Indian sub-continent, to develop nuclear capacity as a way of obtaining attention (including financial support) from the international community.

A substantial part of the moral hazard problem, which has been particularly acute in the Russian case, should be recognized as deriving, not from the purely financial role of the IMF, but from the way in which security perceptions have led to an extension of that role. This troublesome development, however, has followed directly from the original mission and vision of the Bretton Woods conference, in which world-wide economic well-being was justified primarily as a way of preserving world peace and stability.

7. Conclusion: The Case for Reform in Light of Past Experience

[47] See Camdessus (1999).

[48] E.g. Odling-Smee (1999), p.273: "The world community, through the members of this institution, has clearly expressed the view that Russia continues to deserve support as long as it is taking appropriate steps to tackle the difficult problems it faces."

The IMF's evolution since the 1970s has reflected both the demand for its services and its willingness to provide those services justified by the perception at the Fund that there were new market failures.

There has been a fundamental change of environment: the breakdown of the par value system, and the new mobility of capital, and financial deregulation. Capital flows have taken a role that no-one expected at the time the IMF was created. The international political system has changed too: there are many new countries, with quite new problems, and the Soviet bloc collapsed economically and politically.

The IMF responsed to these external challenges by expanding its activities. It enlarged the scope of policies considered as part of the surveillance exercise. The number and length of duration of stabilization packages increased, but these were successful only in a few cases. In the 1990s, in response to crises in a globalized capital market, the IMF engaged in liquidity crisis management. A response to the new politics of the 1990s involved an expansion into non-macroeconomic policy areas, such as criticisms of military spending, corruption, and non-democratic practices. After the Asian crises in 1997 and since, the IMF also discussed areas such as corporate governance and accounting practices that traditionally lay outside its purview.

The outcome is: IMF surveillance produces highly useful general reports (WEO, Capital Markets); but Article IV consultations have a questionable use in that they frequently lack bite when the country concerned is not engaged in an IMF program. In particular, they seem largely irrelevant for most of the advanced industrial countries. A perceived over-extension of the IMF into new areas of policy concern involves unpopular interventions into national sovereignty. The poorer clients of the IMF often become trapped in a welfare dependency. The management of liquidity crises has contributed to moral hazard and at the same time has not stopped crises from spreading.

In what directions is reform of the IMF likely to proceed? It is clear that markets are powerful mechanisms for discipline, but they can be usefully supplemented by IMF policies and advice. In general, the historical record suggests that the IMF should operate

as a traffic policeman as much as a fireman: anticipating and preventing disasters rather than dealing with their painful aftermath. Such a mission might involve:

-- a commitment to improve the reliability and timeliness of statistics.

-- independence from politics (since the political instrumentalization of the IMF conflicts and harms its core mission, which is aimed at macro-economic stability). transparency of operations.

-- the establishment of as many rules as possible which are contingent and incentive-compatible. This would enhance transparency. Pre-qualification for crisis lending may be desirable, and may become a powerful instrument to achieve better national policies.

-- the willingness to link lending to policy conditionality. Such conditionality, in the past an essential part of the IMF's mode of operations, has been severely criticized by the Meltzer commission,[49] and it has been too complicated and remains potentially politicized. But it at present still remains the principal lever through which the IMF can effect improvement of members' policies. Moreover even if the IMF followed strictly rule-based pre-qualified assistance, policy performance would continue to be an important criterion.

In general, it is clear that the IMF is best equipped to handle a more limited range of tasks that lie closer to its historical mission. Such a realization implies a retreat of its core area of expertise and responsibility. Such a core includes data standards, liquidity management, and surveillance (the provision of information that markets cannot provide). Longer term concessional lending to very poor LDCs does not fit well into this core, and might be handled better by the World Bank.

Such proposals are consistent with the IMF's mandate. To go further than this could not be achieved at the insistence of one country alone, even of the most powerful economy in the world. It would require a new and constructive Bretton Woods conference, which is truly unlikely in the present world conditions.

[49] International Financial Institutions Advisory Committee (2000)

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Table 1. Average time spent (in years) in IMF programs by Class of Borrower

A: Stand by Arrangements

Decade	Major Industrial Economies	Other Industrial Economies	Developing Economies	Transition Economies
1951-60	0.5 (0.36)	0.7 (0.93)	0.4 (0.92)	0
1961-70	1.5 (0.66)	0.3 (0.30)	1.8 (2.50)	0.1 (0.54)
1971-80	0.5 (0.36)	0.8 (0.82)	1.3 (1.30)	0.2 (0.74)
1981-90	0	0.3 (0.54)	2.1 (1.84)	0.5 (1.25)
1991-99	0	0.1 (0.18)	0.7 (1.31)	1.6 (1.35)

B: Extended Arrangements (July 75-Dec 98)

Decade	Major Industrial Economies	Other Industrial Economies	Developing Economies	Transition Economies
1971-80	0	0	0.3 (0.78)	0
1981-90	0	0	0.6 (1.24)	0
1991-99	0	0	0.5 (1.34)	1.1 (1.59)

C: Structural Adjustment (Aug86-Dec98)

Decade	Major Industrial Economies	Other Industrial Economies	Developing Economies	Transition Economies
1981-90	0	0	1 (1.54)	0
1991-99	0	0	0.2 (0.69)	0

D: Enhanced Structural Adjustment (July 88-Dec98)

Decade	Major Industrial Economies	Other Industrial Economies	Developing Economies	Transition Economies
1981-90	0	0	0.3 (0.87)	0
1991-99	0	0	2.1 (2.80)	1.2 (2.19)

All IMF programs

Decade	Major Industrial Economies	Other Industrial Economies	Developing Economies	Transition Economies
1951-60	0.5 (0.36)	0.7 (0.93)	0.4 (0.92)	0
1961-70	1.5 (0.66)	0.3 (0.30)	1.8 (2.50)	0.1 (0.54)
1971-80	0.5 (0.36)	0.8 (0.82)	1.6 (1.66)	0.2 (0.74)
1981-90	0	0.3 (0.54)	3.7 (2.77)	0.5 (1.25)
1991-99	0	0.1 (0.18)	3.3 (2.94)	3.8 (2.59)

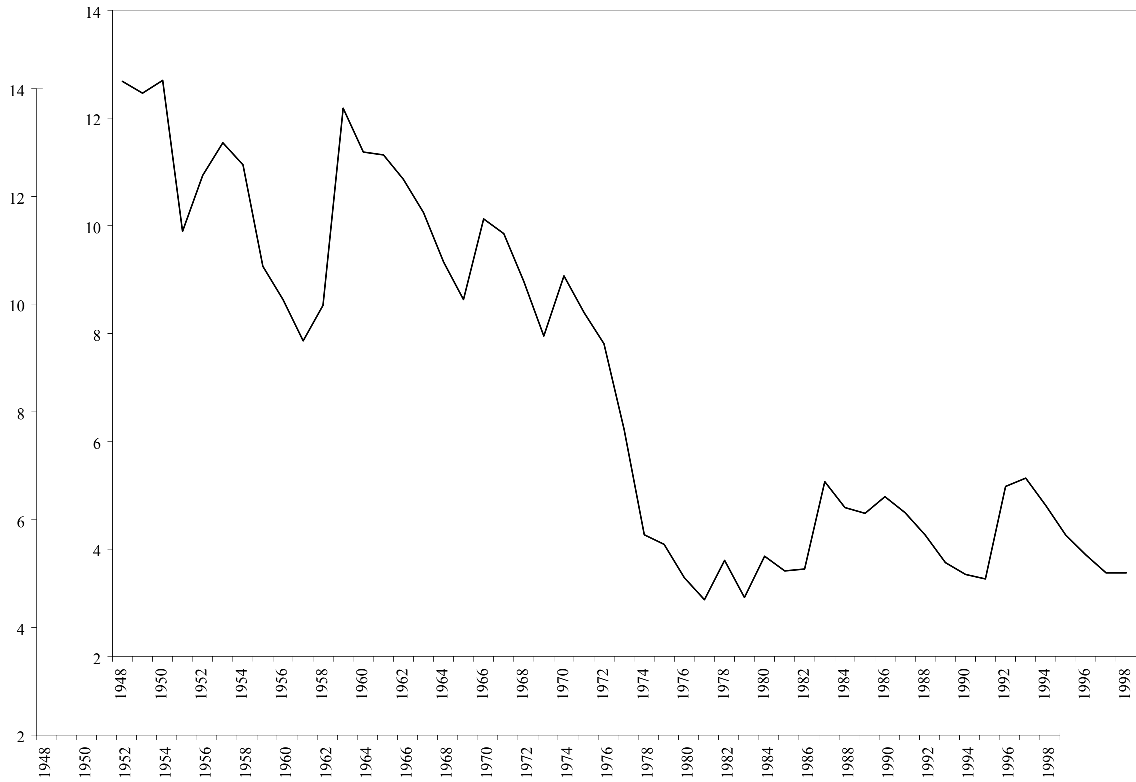
Source: International Monetary Fund, Annual Reports
Note: Numbers in parentheses indicate standard deviations

Table 2. Arrears to the IMF of Countries with Obligations Overdue by More than Six Months (*End of Financial Year: April 30*)

Year	Number of members	Amount (in millions of SDR's)
1986	8	489.0
1987	8	1,186.3
1988	9	1,945.2
1989	11	2,801.5
1990	11	3,251.1
1991	9	3,377.7
1992	10	3,496.0
1993	12	3,006.4
1994	9	2,911.3
1995	8	2,982.6
1996	6	2,174.9
1997	7	2,212.2
1998	7	2,2612.2

Source: International Monetary Fund, Annual Report 1998

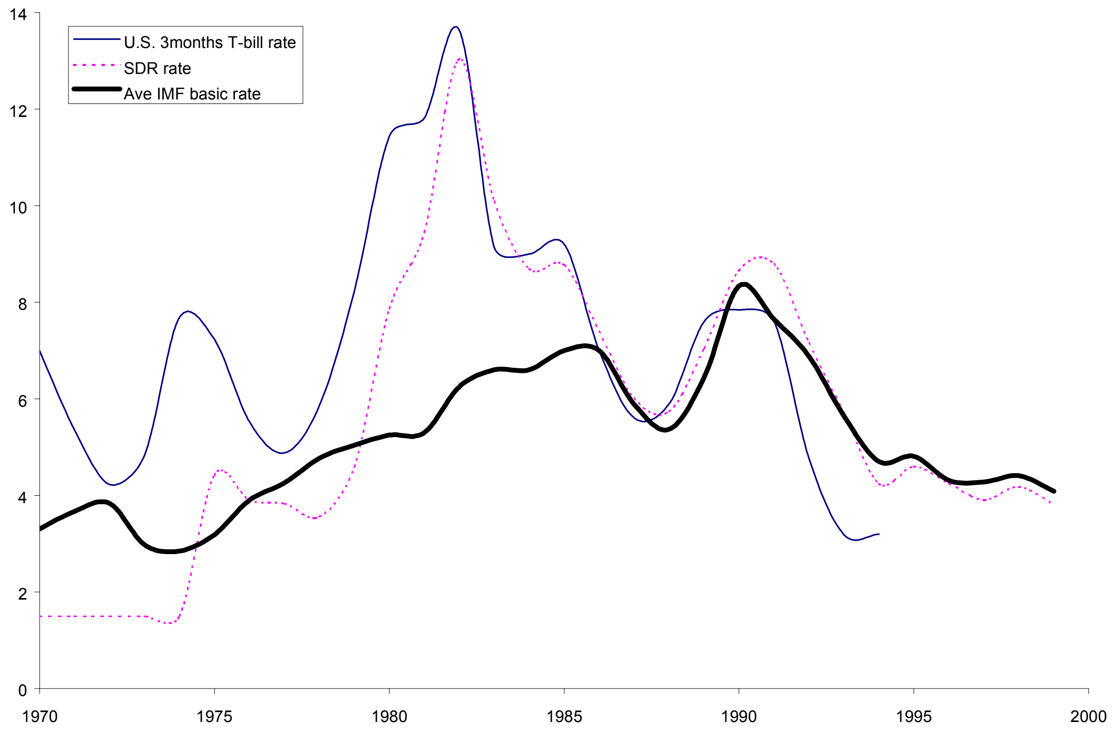
Figure 1. IMF Quotas as a Share of World Imports
(*In percent*)



Source: James (1996), updated by the IMF.

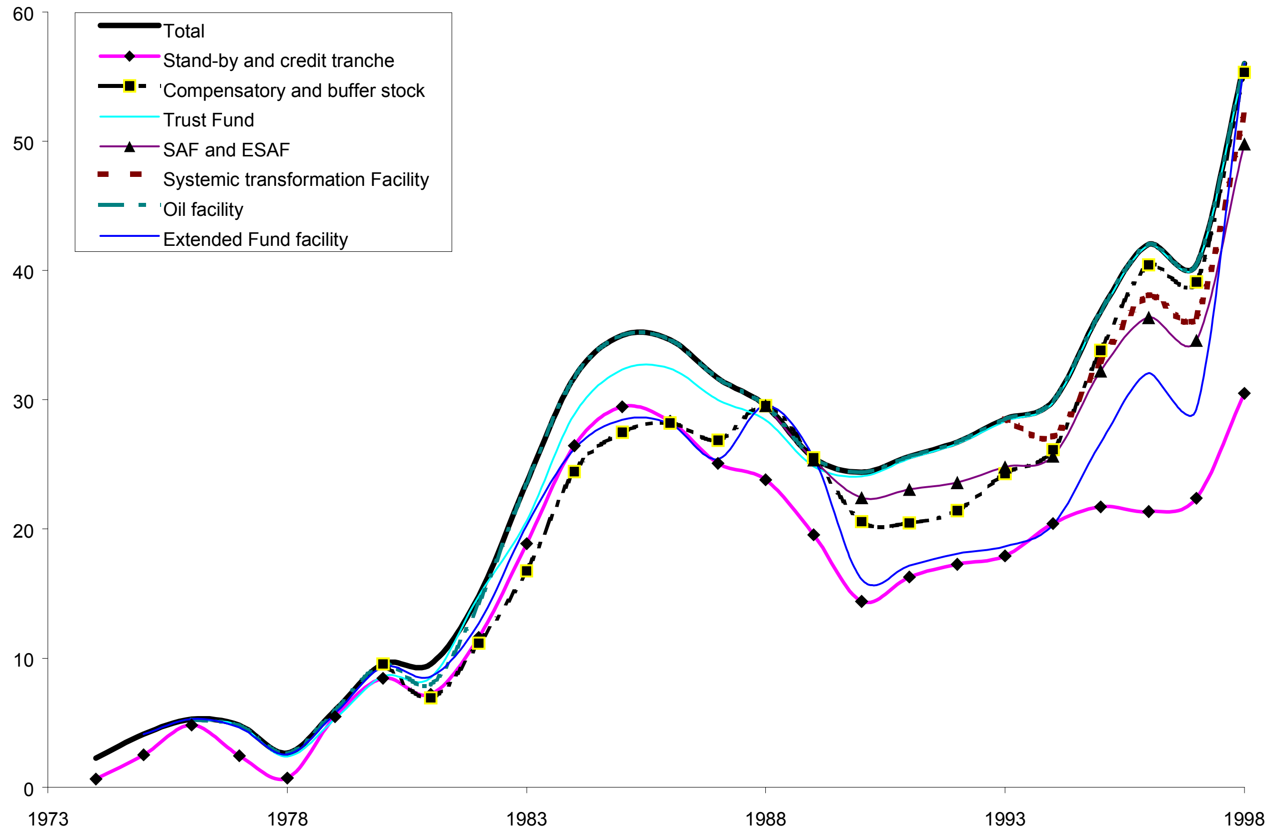
Figure 2. IMF Charges and Commercial Interest Rates

(*In percent*)



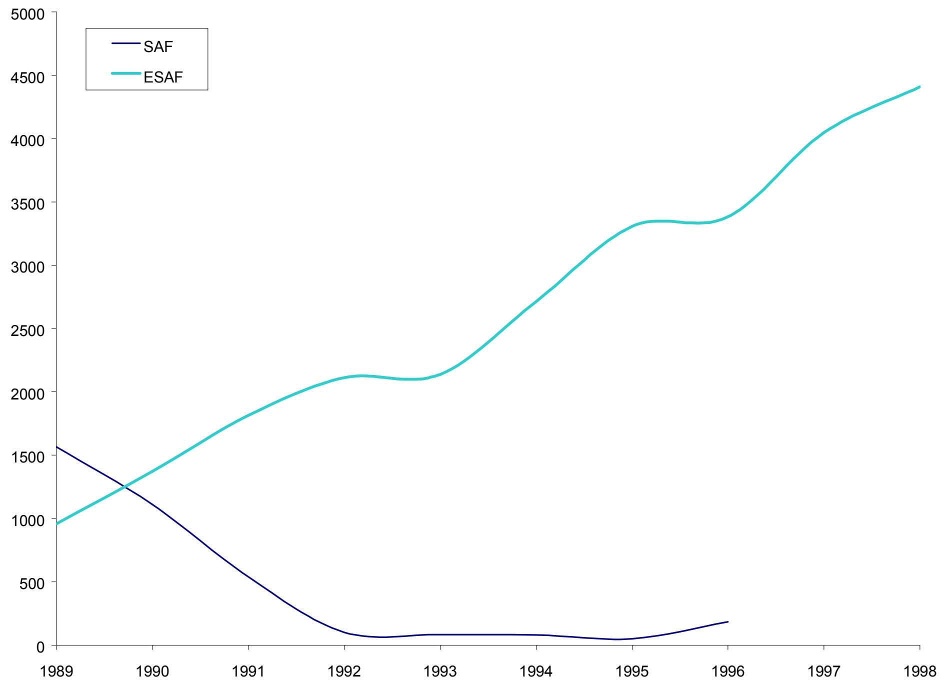
Source: James (1996), updated by the IMF.

Figure 3. Total Fund Credit Outstanding to Members
(*In billions of SDR's; end of period*)



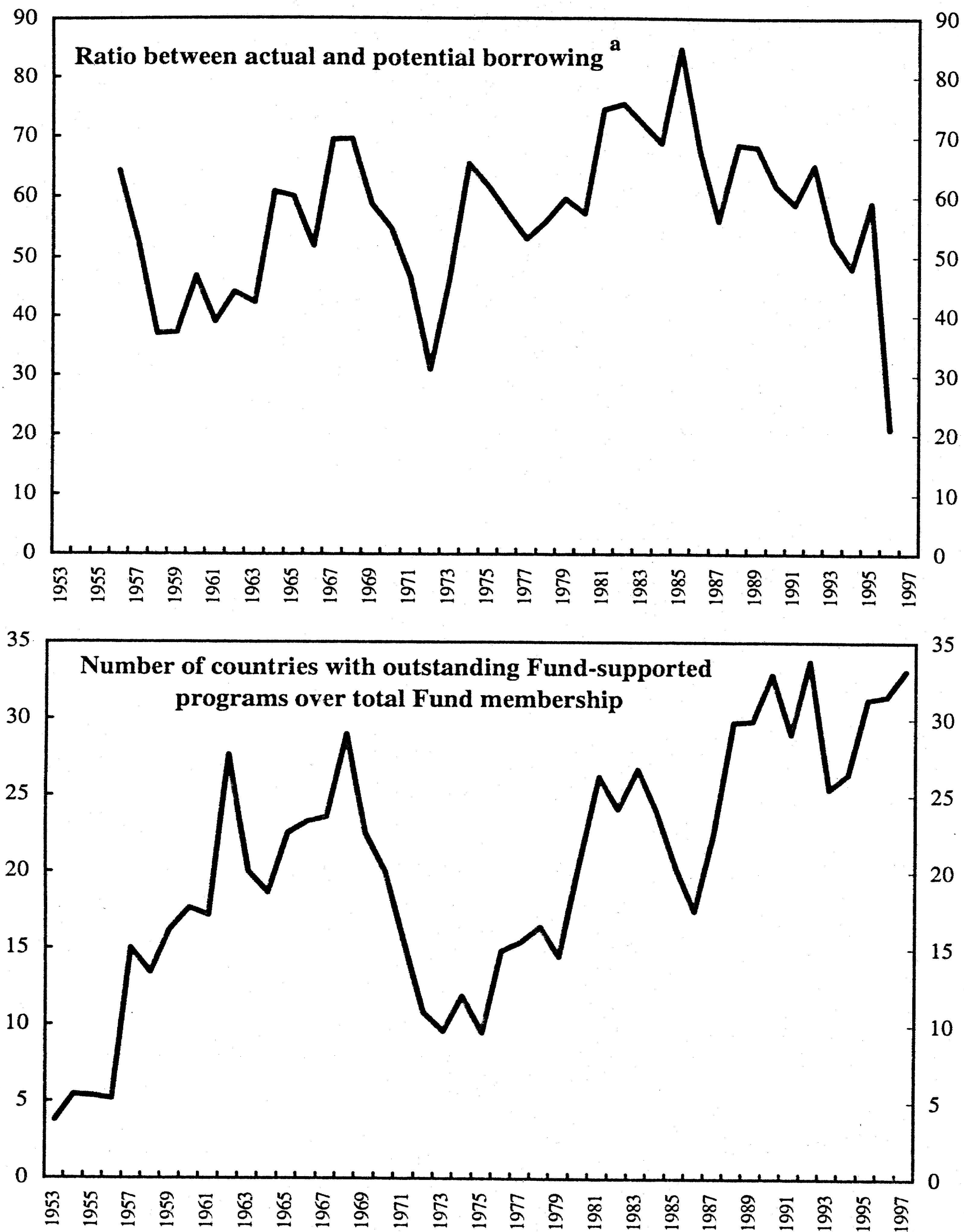
Source: James (1996), updated by the IMF.
[1]Including Trust Fund, SAF and ESAF; financial years ended April 30, 1974-1998.

Figure 4. Low interest IMF lending
(*In millions of SDR's*)



Source: International Monetary Fund, Annual Report 1998.

Figure 5. Actual and Potential Borrowing from the IMF, 1955-1997.
(*In percent*)



Source: Giannini (1999)