IMF Is a Power Unto Itself
Jeffrey Sachs, Financial Times, December 11, 1997

The head of the Harvard Institute for International Development explains why the IMF needs reassessment

It is time that the world take a serious look at the International Monetary Fund. In the past three months, this small, secretive institution has dictated economic conditions to 350m people in Indonesia, South Korea, the Philippines, and Thailand. It has put on the line more than $100bn of taxpayers’ money in loans.

These bailout operations, if handled incorrectly, could end up helping a few dozen international banks to escape losses for risky loans by forcing Asian governments to cover the losses on private transactions that have gone bad. Yet the IMF decisions have been taken without any public debate, comment, or scrutiny.

While it pays lip service to "transparency", the IMF offers virtually no substantive public documentation of its decisions, except for a few pages in press releases that are shorn of the technical details needed for a serious professional evaluation of its programmes. Remarkably, the international community accepts this state of affairs as normal.

The world waits to see what the Fund will demand of country X, assuming that the IMF has chosen the best course of action. The world accepts as normal the idea that crucial details of IMF programmes should remain confidential, even though these "details" affect the well-being of millions. Staff at the Fund, meanwhile, are unaccountable for their decisions.

The people most affected by these policies have little knowledge or input. In Korea, the IMF insisted that all presidential candidates immediately "endorse" an agreement they had no part in drafting or negotiating - and no time to understand.

The situation is out of hand. However useful the IMF may be to the world community, it defies logic to believe that the small group of 1,000 economists on 19th Street in Washington should dictate the economic conditions of life to 75 developing countries with around 1.4bn people.

These people constitute 57 per cent of the developing world outside China and India (which are not under IMF programmes). Since perhaps half of the IMF’s professional time is devoted to these countries - with the rest tied up in surveillance of advanced countries, management, research, and other tasks - about 500 staff cover the 75 countries. That is an average of about seven economists per country.

One might suspect that seven staffers would not be enough to get a very sophisticated view of what is happening. That suspicion would be right. The IMF threw together a draconian programme for Korea in just a few days, without deep knowledge of the country's financial system and without any subtlety as to how to approach the problems.
Consider what the Fund said about Korea just three months ago in its 1997 annual report. "Directors welcomed Korea's continued impressive macroeconomic performance [and] praised the authorities for their enviable fiscal record." Three months ago there was not a hint of alarm, only a call for further financial sector reform - incidentally without mentioning the *chaebol* (conglomerates), or the issue of foreign ownership of banks, or banking supervision that now figure so prominently in the IMF's Korea programme.

In the same report, the IMF had this to say about Thailand, at that moment on the edge of the financial abyss. "Directors strongly praised Thailand's remarkable economic performance and the authorities' consistent record of sound macroeconomic policies."

With a straight face, Michel Camdessus, the IMF managing director, now blames Asian governments for the deep failures of macroeconomic and financial policies that the IMF has discovered. It would have been more useful instead, for the IMF to ponder why the situation looked so much better three months ago, for therein lies a basic truth about the situation in Asia.

There is no "fundamental" reason for Asia's financial calamity except financial panic itself. Asia's need for significant financial sector reform is real, but not a sufficient cause for the panic, and not a justification for harsh macroeconomic policy adjustments. Asia's fundamentals are adequate to forestall an economic contraction: budgets are in balance or surplus, inflation is low, private saving rates are high, economies are poised for export growth.

Asia is reeling not from a crisis of fundamentals, but from a self-fulfilling withdrawal of short-term loans, one that is fuelled by each investor's recognition that all other investors are withdrawing their claims. Since short-term debts exceed foreign exchange reserves, it is "rational" for each investor to join in the panic.

Without wider professional debate, the IMF has decided to impose a severe macroeconomic contraction on top of the market panic that is already roiling these economies. Consider the Korea programme (or at least those parts that have been announced to the public). The won has depreciated by around 80 per cent in the past 12 months, from around 840 a dollar to a record low of 1,565 yesterday; this currency depreciation will force up the prices of traded goods. Yet despite that, the IMF insists that Korea aim for an essentially unchanged inflation rate (5.2 per cent in 1998, in comparison with 4.2 per cent in 1997). To achieve unchanged low inflation in the face of a huge currency depreciation, Korea will need a brutal monetary squeeze. And indeed this is just what the Fund has ordered. Short-term interest rates jumped from 12½ per cent to 21 per cent upon the signing of the programme, and have since risen further.

The Fund argues that these draconian monetary measures are "to restore and sustain calm in the markets" and "[to] demonstrate to markets the government's resolve to confront the present crisis". It is hard to see how recessionary monetary policy will restore calm. Indeed the panic has so intensified since the signing of the agreement that Korean banks may now be on the verge of outright default. Just one day after the measures were unveiled, the 11th largest-conglomerate declared bankruptcy when Korean banks abruptly refused to roll over its short-term debts. In recent days more well-known local companies have gone under.
In addition to the rise in interest rates, the IMF is insisting that fiscal policy be tightened by 1-1½ per cent of GDP. On top of this, the IMF required that 9 out of 30 merchant banks suspend operations. The IMF is aiming for Korean growth to fall to 2.5 per cent in 1998 from 6 per cent in 1997. But the projected slowdown may turn out to be the least of Korea's worries by next year, since the underlying macroeconomic measures could easily push the economy into outright contraction. None of this overkill makes sense for an economy that was (rightly) judged to be pursuing sound macroeconomic policies just months earlier.

A better approach would have been for the IMF to stress the strengths rather than the weaknesses of the Korean economy, thereby calming the markets rather than further convincing them of the need to flee the country. Months ago, when the financial crisis began, the Fund could have quietly encouraged Japan, the US and Europe to provide some credit support to the Bank of Korea. It might well have worked with the major banks to encourage them to roll over their short-term debts without inflaming the panic. With appropriate confidence-building measures, Korea could probably have got by with a modest slowdown in growth, no credit crunch, and a realistic time horizon of a few years to complete its needed financial reforms.

In more than six dozen developing countries, the IMF is in a position to choose make-or-break financial policies. While its instincts are often correct, they can sometimes be wrong, with serious consequences.

In recent years, the IMF mishandled the Russian reforms (for example, by insisting for more than a year that all 15 successor states to the Soviet Union share a common currency, thereby delaying stabilisation and undermining the political support for reforms). In Bulgaria, the IMF signed a programme in July 1996 based on 2.5 per cent growth and 20 per cent inflation in 1997. Instead, Bulgaria has suffered an outright collapse of gross domestic product of more than 10 per cent, and inflation in the hundreds of per cent. The IMF (in common with others) failed to foresee the Mexico crisis in 1994, and the Asian crises in 1997.

Three general conclusions can be reached. First, the IMF is invested with too much power: no single agency should have responsibility for economic policy in half the developing world.

Second, the IMF's executive board should do its job of overseeing the staff, rather than simply rubber-stamp the staffs' proposals. It is high time the board consult outside expertise in the exploratory stages of IMF operations; it should also canvas international opinion about the origins and policy implications of the Asian crisis.

Third, IMF operations should be made public, so that professional debate and review can help ensure the highest possible professionalism of the institution, especially since (for all its faults) the Fund will surely continue to play an important role for many years in the future.