A Blueprint for IMF Reform
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The International Monetary Fund and the World Bank, set up respectively to preserve global financial stability and to promote economic development in poor nations, have made important contributions in the past half century. But both institutions require deep reforms. In 1998 Congress created the International Financial Institution Advisory Commission to advise on the kinds of changes that were needed. The commission, on which we both served, issues its report today.

Our report steers a course between the growing number of critics calling for the abolition of these institutions and the dwindling number of officials who still believe that tinkering is enough. The U.S. Treasury, the leading shareholder of both institutions, has now called for fundamental reform. Our report strongly supports Treasury Secretary Lawrence Summers in his call for the IMF to refocus its lending on emergencies rather than long-term finance. In fact, we urge the IMF to get out of long-term development finance altogether.

The IMF was created to preserve stability in the world's currency markets, in part by making short-term emergency loans to countries whose currencies came under attack. The idea was to help preserve a global system of stable exchange rates. When exchange rates between the major currencies became flexible and market-driven in the 1970s, part of the original rationale of the IMF was lost.

The fund soon took on other tasks. In the 1980s it tried to bail out developing countries that had gone bankrupt after a burst of overborrowing in the 1970s. But it took far too long to recognize that bad loans made between poor-country governments and private creditors needed to be canceled rather than simply rolled over or paid off by IMF and World Bank loans that in turn became unpayable.

In the early 1990s, the IMF was given the lead in Western assistance to Eastern Europe and the former Soviet Union. In part because the IMF turned a blind eye to massive corruption in Russia and its neighbors, its record in the transition process has been mediocre at best.

In the second half of the 1990s, the IMF organized unprecedented rescue packages for financially beleaguered countries in Asia, Eastern Europe and Latin America, raising several questions: Why had the IMF failed to foresee those crises? Why had its "remedies" failed to prevent deep recessions in the affected countries? Did the IMF's own lending packages create expectations of further bailouts, thereby encouraging speculation? Why did countries that shunned IMF advice, such as Malaysia, recover alongside those with IMF programs?
Our commission found that the starting point for reform is for the fund to return to its original purpose: short-term, emergency lending. We also urge that as the IMF cease its long-term lending operations in Africa and other poor countries, it should simply cancel the IMF loans owed by the poorest countries (as should other creditors such as the World Bank and donor governments, including the U.S.).

While the IMF's role as a quasi-lender of last resort is still needed in emergency circumstances, this role needs fundamental restructuring. The expectation of future IMF bailouts actually helps to fuel the volatile short-term capital flows that have played a key role in recent crises. Therefore, a requirement should be phased in that member governments seeking emergency IMF loans must satisfy preconditions designed to prevent future crises.

We identified four such preconditions. First, governments should ensure the adequate capitalization of domestic banks, so the IMF won't have to bail them out. Second, developing countries should allow foreign banks to enter the market, in order to increase the capital base and efficiency of the banking sector and to reduce corruption. Third, member governments should commit to fiscal standards so that IMF funds do not merely feed their profligacy. Fourth, governments should guarantee much more timely and accurate financial information.

We recognize that rare emergencies on a global scale might still arise in ways not foreseen today. Thus, if a truly global financial crisis explodes, the IMF should retain freedom of maneuver even when key countries do not qualify for loans. Other hallowed traditions of lender-of-last resort operations should also be observed. IMF lending should be short term, not stretching out over years or decades as it does now. The loans should be at penalty interest rates, so that governments would come to the IMF only as a last resort. And the IMF should demand priority over all other creditors. Private creditors would have to take their lumps if they overborrow to sovereign borrowers.

The IMF would remain an integral part of the global system, but in a very different form. Rather than routinely lending to 50 or more countries, there might be a handful of emergency operations in a year. The IMF would stop trying to micromanage the governments of the developing world. The terms for emergency borrowing would be based on prequalifications, rather than conditions imposed after the fact. Member governments would still consult the IMF about macroeconomic and financial policies, but these consultations would be advisory. And of course the IMF would continue its useful work of standardizing and publishing global data.

The World Bank needs equally dramatic changes. The commission found that the World Bank, even more than the IMF, had failed to adjust to fundamental changes in the world economy. As a result, the bank has fallen far short in its basic goal of combating global poverty.

When the World Bank opened its doors in 1946, international financial flows were negligible, and the new bank aimed to compensate for the absence of private-sector finance. Today, by contrast, foreign direct investment is the key fuel of development finance, and the World Bank is a small player in cross-border flows to developing countries. But the World Bank persists, amazingly enough, in focusing most of its lending on a dozen or so of the developing countries -- including Argentina, Mexico, Brazil and China -- that have ample access to private capital.
In the process the bank falls disastrously short where it is really needed, in helping the poorest of the poor. The commission's most important recommendation is that the World Bank phase out its lending operations to the richer developing countries and those with ample access to private capital, thereby refocusing its efforts on the poorest countries. It should cancel its claims against the highly indebted poor countries. For the future, the World Bank and regional development banks should stop the pretense of "lending" for poverty relief and instead provide grants. The development banks should use subsidized loans only to support basic institutional reform.

Rename the World Bank

With its banking function largely supplanted by private capital flows, we suggest renaming the World Bank the World Development Agency. To improve effectiveness and reduce corruption, its grants should be provided in return for actual delivery of services, not for mere promises. Payments would be made only upon successful performance, verified by outside auditors. The primary responsibility for country-level assistance should lie with the regional development agencies, which are closer to the local realities.

Impoverished countries are often trapped not just by bad policies or a lack of funds, but also by a lack of scientific knowledge. New technological approaches are needed to battle malaria, adjust to climate change and increase tropical food production. The new World Development Agency should use much more of its income to promote research in these areas --often in partnership with private companies -- rather than relying on traditional lending programs that don't focus on the needs of poor countries.

Each year U.S. foreign assistance to the poorest countries amounts to only about $6 for each U.S. citizen. Americans and their representatives in Congress should, and would, support significantly increased aid if they were assured it would be used effectively. The commission's bipartisan proposals seek to restore the efficacy of the international institutions, providing the basis for a renewed U.S. consensus on this country's role in support of global financial stability and the struggle against poverty in the world's poorest nations.