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How can IMF policy eliminate country moral hazard and account for externalities?

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Abstract

Costly crisis prevention has positive external effects, which leads to free-riding of governments on each other's efforts. ''Ordinary'' IMF loans aggravate existing externalities, reinforcing the under-investment problem. We consider the reform proposals of the ''Meltzer commission'' in both loan and insurance models and show how the IMF can eliminate country moral. The efficiency-ensuring loan policy accounts for given externalities and involves effort-contingent discounts on interests or the extension of credit volume. Similar results hold for the insurance framework. Ex ante participation requires that smaller countries be ''subsidized'' by large ones, or that IMF policy consider distributional aspects in addition to efficiency.

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1. Introduction

Calls for fundamental reform of the International Monetary Fund (IMF) and the World Bank are common, yet what type of measures need to be taken appears to be a very controversial issue. Nobel prize winner and former chief economist of the World Bank Joseph Stiglitz focused his criticism on the ''market ideology'' of the Fund and claimed that the ''Washington

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Consensus'' was not considered as a means to the ultimate objective of reducing unemployment and poverty, but was regarded as the Holy Grail itself (Stiglitz, 2002). He accuses the IMF of having deepened, if not caused financial crises by forcing austerity on countries in recession, and by implementing liberalization and privatization before the necessary institutions, regulation, and supervision had a chance to build up and accompany the process.

On the other hand, influential economists and critics of the IMF such as Jeffrey Sachs and Allan Meltzer have been proposing for long reforms in a different direction. Back in 1998, as part of a $18 billion funding package for the IMF, the US Congress established the International Financial Institution Advisory Commission, chaired by Allan Meltzer and therefore better known as the ''Meltzer commission''. It concluded its work in March 2000, sharply criticizing the two Bretton Woods institutions and offering detailed proposals for far-reaching structural changes.[1]

Meltzer and the majority of the commission members argue that the programs often overlap, are inefficient and tend to distract resources from their primary targets. According to Meltzer, the inefficiency of the current system is partly due to the delays when a crisis occurs: the IMF is called for financial aid, but since it wants to make sure the money is not wasted, it conditions help on detailed structural reforms. This is usually inconvenient to the government concerned, so time-consuming negotiation takes place, while international investors withdraw their capital, reinforcing the crisis. A second criticism concerns the observation that IMF lending often ends up bound on a long-term basis, thereby allowing countries to delay reforms, whereas the Fund's statutory mission is to provide short-term liquidity when markets threaten to close, acting as a quasi lender of last resort. Therefore, Meltzer concludes, the IMF's main tasks could best be achieved if countries had to qualify in advance in order to receive aid without delay in the event of a crisis.[2] In addition, the country moral hazard problem[3] (anticipated bailouts dampen incentives to prevent crisis[4]) could be mitigated this way. Pre-qualification would serve as a seal of approval to private investors.

One obvious problem with Meltzer's proposals is the credibility of not supporting ''unqualified'' countries struck by a crisis.[5] As Feldstein (2002) points out, there is the further problem that a pre-qualified country would presumably have to be re-approved from time to time. If the country failed to be re-approved, that would be a very serious signal to the markets, indicating that financial aid is no longer available and that the IMF had concluded that the country's policies were such that it no longer met the standard. The approach proposed in this model partly overcomes these drawbacks. We show what the optimal IMF policy would look like *if* a

[1] For details, see the final report by Meltzer (2000).

[2] The report proposes to have the Fund lend only for short periods, at a penalty rate, and only to countries with strong banking systems, strong fiscal policies, and a willingness to treat obligations to the fund as senior to other liabilities. Jeanne and Zettelmeyer (2001a) support this view in that they argue ''the weight of conditionality [should be shifted] from traditional conditionality ex post, as an accompanying element of official lending *after* the crisis, to conditionality ex ante, in the sense that the availability and size of official lending need to be conditional on government policies *before* the crisis.'' (p. 4)

[3] Eichengreen (2000) introduces the useful distinction between investor moral hazard and country moral hazard. This model focuses on the latter.

[4] Empirical work, however, suggests that country moral hazard does not play the major role that it is widely believed to do, see Lane and Phillips (2000) and Jeanne and Zettelmeyer (2000).

[5] It is worth quoting Eichengreen (2000, p. xv): ''… Unfortunately, those who propose to prohibit IMF lending to certain countries assume that the Fund can simply stand aside when a crisis erupts in a country with problematic policies. The reality is that the costs of inaction … are too painful for the official community to bear.''

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