FINANCE AND DEVELOPMENT RESEARCH PROGRAMME

WORKING PAPER SERIES

Paper No 17

THE IMF AFTER THE ASIAN CRISIS: MERITS AND LIMITATIONS OF THE 'LONG-TERM DEVELOPMENT PARTNER' ROLE

Paul Mosley
Sheffield University

June 2000

ISBN:	**1 902518861**
Series Editor:	Colin Kirkpatrick
Further details:	Maggie Curran, Marketing and Publicity Administrator
Published by:	Institute for Development Policy and Management, University of Manchester, Crawford House, Precinct Centre, Oxford Road, MANCHESTER M13 9GH Tel: +44-161 275 2804/2800 Fax: +44-161 273 8829 Email: idpm@man.ac.uk Web: http://www.man.ac.uk/idpm/

The IMF after the Asian Crisis: Merits and Limitations of the 'Long-Term Development Partner' Role

Paul Mosley*

Page

Executive summary 2

1. Introduction: The origins and context of the IMF's 'broader role' 3

2. The case for a 'return to basics': 10

- Opportunity costs
- 'Crowding-out' of aid and the private sector
- Relations with government and the effectiveness of conditionality

3. The case for a broader role: 13

- More effective correction of fundamentals
- Inter-institutional coordination
- Poverty reduction

4. Integration with other initiatives 32

5. Conclusions and new proposals 34

Bibliography 38

*Department of Economics, University of Sheffield, 9 Mappin St., Sheffield S1 4DT, South Yorkshire, England. 01142-223397(phone), 01142-223458 (fax) p.mosley@sheffield.ac.uk. Many thanks to Graham Bird, Hugh Bredenkamp, Christopher Melliss, Nick Snowden, Rachel Turner and Tessa van der Willigen for valuable comments on a previous draft. All errors are mine.

Executive summary

We examine the view, espoused by a number of commentators in recent months, that the International Monetary Fund (IMF) should seek to withdraw from its long-term lending operations, in the wake of the recent financial crisis in Asia and elsewhere, and restrict itself to its 'core competency' of preventing and where necessary lending into financial crisis. This view is based on a belief that such long-term lending crowds out both private sector operations and short-term IMF lending; and that it is ineffective, because of weaknesses in the IMF's conditionality.

Both of these propositions, we argue, can be challenged, essentially because the Fund's client base has changed, gradually over the past 25 years, in such a way as to alter the definition of its 'core mission'. Much of that client base now is too weak, economically and/or politically, to be able to assimilate and pay back short-term emergency credits on schedule without consequences which vitiate the short-term rescue operation. As a consequence medium-term operations, both in poorer and in some middle-income countries, may be preconditional to the success of shorter-term operations such as standbys. In the poorer developing countries there is virtually no private sector to crowd out, and Enhanced Structural Adjustment Facility (ESAF) operations have been conspicuously successful, not only at promoting growth, but also at achieving structural changes not at all achieved by aid donors such as strengthening the tax base. Such changes inevitably require a longer time-period than the standard three years of an IMF standby, not only in order to induce a production response but also in order to achieve the necessary measure of stabilisation and economic reform without imposing social pressures which wreck the production response. The latter argument is particularly powerful in middle income countries, and provides an argument for IMF support to these countries also whilst they are temporarily excluded from international capital markets. Often also a long-term presence is needed to achieve effective leverage in short-term operations. We therefore argue for the retention of the Fund's long-term balance of payments lending function; and for this function not to be transferred to the World Bank, which has less credibility in global financial markets, less leverage in conditionality and less comparative advantage in macro-economic management. Measures are indeed needed to reduce the level of the IMF's exposure to risk in poorer developing countries, but those, we believe, should consist of the preventive measures currently going on, and measures to increase the ratio of equity to debt, rather than measures which would jeopardise the progress in long-term poverty alleviation capacity achieved by the Fund over recent years.

An appendix develops the argument that these should take the form of a two-part tariff for Fund lending, with a profit margin being levied, at a profit-maximising rate, once the recipient country returns to growth. This would link recipient payments to capacity to repay, give recipients an incentive to use private markets if they are available, and counter the procyclical tendency of IMF lending.

1.Introduction: The origins and context of the IMF's 'broader role'

On December 14, 1999, Laurence Summers, the US Secretary to the Treasury, proposed a scaling-back in the role of the International Monetary Fund (IMF) in order to allow the private sector a greater role in providing finance to poorer countries. He called for the IMF to focus on its 'core competencies' of preventing crises (by collecting, assessing and sharing financial information) and mitigating them if they occur (by providing short-term financing for countries threatened by balance of payments problems, financial contagion or market panics).'The IMF', he said, ' should not be a source of low-cost financing for countries with ready access to private capital, or long-term welfare that cannot break the habit of bad policies'[1] . This message that the IMF should return to its 'core' function of short-term emergency lending has been echoed in articles and papers by, *inter al*. Collier and Gunning(1999), Wolf(1999) and editorials in the *Financial Times* (January 18, 2000)the *Independent* (March 13, 2000) and the *Economist* (March 18, 2000). It is also, allegedly, a key message of the Meltzer report on the future role of the Fund (*Independent,* 24 March 2000 and *Economist,* 18 March 2000).

This proposal valuably focusses our attention on one of the major debates which has emerged from the desire to protect the world economy, in the new century, from the instability which characterised it in the 1990s, most notably embodied in the crises which hit Mexico (in 1994), the Far East (in 1997-8), Russia (in 1998) and Brazil(in early 1999). The debate concerns whether the IMF should retain, improve or abandon a set of additional policy instruments and responsibilities which it has taken on over the last twenty years, which are described in the remainder of this section. In this essay, we shall review both sides of the debate, and will conclude that the available evidence does not allow the case for the alternative IMF role to that proposed by Summers – that of 'long-term development partner' – to be rejected. The case against this role is summarised in Section 2, and the case for it in Section 3. In Section 4 we examine the interlinkage between the role of the IMF and that of other current initiatives to strengthen the international financial architecture. Section 5 summarises, and presents new proposals, some of them indeed requests for new data but some of them also designed to refocus the debate on a possible 'middle way' which retains those aspects of the IMF's expanded role which are still necessary and discards others.

The IMF's articles of agreement, as established at Bretton Woods in 1944, require it to take major responsibility for the restoration of

---

[1] Laurence Summers, speech at London Business School, 14/12/99, as reported in *Financial Times,* 15 December 1999, front page. The full text of the speech is reported at www.lbs.ac.uk/news-events/…scripts/summers.

.

economic stability in countries suffering from foreign exchange crises too severe to be resolvable by ordinary borrowing in the markets [2] This continues, nearly sixty years on, to be its fundamental role: it provides the public good of counteracting movements in foreign exchange markets which often result from imperfect information or imperfect coordination among lenders, and which borrower governments are often powerless to remedy by themselves(IMF 2000). The role is exercised partly through *surveillance* operations designed to prevent countries from falling into crisis, and partly through *lending* operations intended to enable clients, if they do fall into crisis, to stabilise their economies and prevent outflows of foreign exchange reserves. The policy conditions attached to such loans now, as then, typically require cuts in public expenditure and in central bank borrowing, sometimes also devaluation; none of these things has changed since 1944, although the need for the exchange-rate flexibility instrument has become increasingly urgent, and increasingly featured in the Fund's conditionality[3].

What has changed, of course, is the Fund's client base. Formally, any Fund member can borrow ; in practice, since the 1970s, those needing to borrow have been from developing and transitional countries only. Such countries, broadly speaking, have two characteristics. The first is that because of the restricted production base, especially of the poorer developing countries, the response of both the current and the capital account of their balance of payments to the Fund's price-based stimuli is relatively small and hesitant (elasticities of supply and demand are low), and this makes it painfully slow and difficult for them to escape from economic crisis by the use of price-based instruments, to the point that by the early 1980s, on account of the extreme difficulty for poorer countries of exit from the crisis of that time, it had become in the view of one commentator 'increasingly difficult to distinguish the need for development finance from the need for balance of payments finance' (Helleiner 1983: 5): in other words, balance of payments finance was needed on a long-term and not the Fund's traditional short-term basis. Recognising this, the Bank and Fund have brought in medium-term lending instruments, and associated with those instruments[4], additional conditions of a more structural and micro-economic nature related to tax systems, public enterprise reform and price liberalisation. But the second characteristic of developing and transitional economies, not confined to the poorer countries, is that they often have a relatively weak *political* capacity to withstand adverse shocks such as those with which

[2] However, they put limits on the extent of the Fund's exposure, and explicitly forbid it (Article VI) from making its resources available to finance a sustained outflow of capital. Giannini(1999):1,19

[3] The proportion of programmes that required exchange-rate action has increased continuously,' from 32 per cent in 1963-72, to 59 per cent between 1973-80, to 82 per cent from 1981-83, to nearly 100 per cent in more recent years'. Polak 1991:36. The detail of conditionality is further considered in Section 3.

[4] Formally, the fit between 'new lending instruments' and 'new conditions' is not one-to-one; structural conditions such as tax reform can be, and are, attached by the Fund to its short-term as well as its medium-term lending.

the IMF attempts to deal. Consensus behind the kind of measures needed to recover from such shocks, in such countries, is hard to build, and the consequence is that governmental actions to bring about reform too quickly or with the 'wrong' instrument easily collapse, often taking public order and/or democracy with them. Over and above the cases discussed in more detail in Section 3 below, this has during the recent past involved loss of life in Peru (1983-4), Zambia (December 1984), Tunisia(January 1984), Ecuador(October 1985), Nigeria(August 1988), Venezuela(February 1989), Madagascar(August 1989) and Cote d'Ivoire(1990). In such a case the supply side of the economy is damaged, frequently to the point of being unable to sustain debt repayments,fails to recover, sometimes even to sustain debt repayments, whether or not the momentum of stabilisation and liberalisation is kept up.

It was to respond to these old and enduring problems in its new client base that the instrument of long-term balance of payments finance was conceived in the middle 1970s, initially in the form of the Fund's Extended Facility and latterly (from the 1980s on) in the form of policy-based lending (by the World Bank) and the ESAF, or Enhanced Structural Adjustment Facility (jointly financed by the Bank and Fund). It is this form of finance (which, strictly, neither the Fund nor the Bank, even now, is empowered by its Articles of Agreement to provide) which the new consensus quoted at the beginning of these paper is seeking to eliminate from the portfolio of the IMF. In detail, it consists of:

- The Compensatory and Extended Facilities, created in 1963 and 1974 respectively;
- The Fund's involvement in long-term or repeated stand-by operations, most notably in Russia since 1996, but also in Brazil, Ukraine, Argentina, Bulgaria, Pakistan and Peru.
- The Fund's involvement in structural adjustment, embodied through a range of instruments, but notably in the Enhanced Structural Adjustment Facility (ESAF), initiated in 1988 and recently converted into a Poverty Reduction and Growth Facility[5];
- The Fund's involvement in other social objectives…among which may be specifically mentioned disarmament[6], environmental protection and conflict prevention.

---

[5] This is an initiative strongly identified with the outgoing Managing Director, Michel Camdessus, who in a farewell speech at UNCTAD's annual conference in Bangkok (13 February 2000) described the IMF as 'the best friend of the poor'. However, the 'extended' role for the IMF described here goes beyond poverty reduction – it may be described as long-term financial (and other) operations designed to promote growth by removing the roots of structural deficits.

[6] This originated with an (unsigned) article in the joint Fund/Bank journal *Finance and Development* in

The Fund's 'expanded role', for the purposes of this paper, therefore consists of its involvement in longer-term operations designed to influence the structure of incentives and of economic policy-making; it does not embrace recent short-term modifications to the international financial architecture such as the Supplemental Reserve Facility. [7]As shown by Table 1, these enhanced commitments, inasmuch as they can be given a monetary value[8], now amount to some $30 billion, or about 40% of a lending total which has more than doubled, at current prices, since 1994. The number of countries with Fund agreements has increased to more than one-third of the membership, and 'the Fund has become reconciled to the proposition that many members will require its assistance [both financial and technical] over an extended period' (Polak 1991:3).

December 1990 suggesting that developing countries were spending as high a proportion of total government expenditure on military purposes as industrial countries.

[7] This was created in December 1997 to counteract massive capital outflows, and used for this purpose during the South Korean, Brazilian and Russian crises. (This is technically illegal under the Articles of Agreement, see footnote 2 above.)

[8] There are two arbitrarinesses in particular in Table 1: one in the specification of 'long-term' standby operations, and the other in the omission of initiatives, e.g. on disarmament and environment, which have no specific lending budget attached to them.

Table 1. IMF disbursements to developing countries

(billions of SDRs)

	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Number of agreements in force	51	45	53	45	47	56	57	60	60	56
Lending from: General Resources Account	29.0	31.8	23.4	24.6	25.5	32.1	36.2	34.5	49.7	60.6
Of which: Stand-by	6.0	7.0	9.4	10.5	9.4	15.1	20.7	18.0	25.5	25.2
(long-term)				*1.0*			*1.5*	*7.0*	*13.0*	*4.0*
Compensat-Ory facility			*5.3*	*4.2*	*3.7*	*3.0*	*1.6*	*1.3*	*0.6*	*2.8*
EFF	*7.0*	*7.8*	*8.6*	*9.8*	*9.5*	*10.1*	*9.9*	*11.1*	*12.5*	*16.5*
Trust Fund	0.3	0.2	0.2	0.1	0.2	0.2	0.1	0.1	0.1	0.1
SAF/ESAF	*3.3*	*4.4*	*3.1*	*3.6*	*4.2*	*4.5*	*5.6*	*5.8*	*6.2*	*6.4*
Total disbursement	32.3	36.4	26.7	28.3	29.9	36.8	41.9	40.4	56.0	67.1
Total 'long-term finance'	*10.6*	*12.0*	*17.2*	*15.0*	*17.6*	*17.8*	*18.7*	*25.3*	*19.4*	*29.8*
Percentage 'long-term finance'	*32.8*	*32.9*	*64.4*	*53.0*	*58.8*	*48.3*	*44.6*	*62.6*	*34.6*	*44.4*

Source: IMF, *Annual Report* 1999, table II.9.

Notes: 'Long-term standbys' are those granted with a disbursement period longer than three years or a repayment period longer than seven years. This applies, in the 1990s, to the following countries: Ukraine, Bulgaria, Indonesia, Brazil, Peru, Argentina, Pakistan.
EFF= Extended Fund Facility
(E)SAF= Enhanced Structural Adjustment Facility

Most of these longer-term commitments, as shown by Table 2, are in two areas: Africa, and more recently Eastern Europe and the former Soviet Union. These are of a radically different nature: the African agreements, which are mostly with low-income countries, consist largely of ESAFs and other concessional long-term agreements, whereas the Eastern European arrangements, mostly with middle-income countries, are either EFFs (in the case of Russia) or standbys which found themselves, partly by intention and partly by accident, stretching out over a much longer term than the planned three years. (Table 2). A further common factor between them, is that much of the conditionality, in both regions, consisted not of demand management but of supply-side measures designed to reform the structure of pricing, public finance and corporate governance; this is clearly complementary with loan duration in the sense that the implementation of such conditions clearly takes a longer time than those which simply involve adjustment of expenditure totals or exchange rates.

Table 2. Regional distribution of IMF operations by maturity, 1995-9 (billions of SDRs)

	Long-term operations (ESAF, EFF, CF)	*Extended standbys**	*Short-term operations*
Africa	*19.0*		*0.4*
EE/FSU	*15.5*	*3.0*	*0.6*
Asia	*1.1*	*8.0*	*20.5*
L. America	*0.2*	*13.0*	*21.6*
Other	*0.7*		*0.3*
Total	*36.5*	*24.0*	*44.0*

Source: IMF, *Annual Reports,* 1996 to 1999, Tables II-1.
*Note: an 'extended standby' is a stand-by agreement with a disbursement term three years or longer, or with a repayment term seven years or longer.

The connection between the 1994-9 crises and this 'expanded' role of the Fund' is obvious in the case of Russia (and, to a much lesser extent, Ukraine and Argentina) but needs spelling out explicitly in the other countries. At first sight, the relationship appears purely to consist of a contagion (and foreign trade multiplier) effect which, on the Fund's calculation, knocked about one percentage point off the 1998-99 growth rate of Africa and Eastern Europe and two percentage points off the growth of the FSU and Central Asia, thereby requiring compensatory action by the Fund: a purely economic impact. However, another effect, as we have already seen, has been intellectual: during 1998 and early 1999 the Fund went closer to the edge than it had ever expected or wanted (in terms, for example, of liquidity ratios)[9], thereby triggering not only the current wave of

[9] The Fund's overall liquidity ratio sank from 175 per cent at the end of December 1994 to 30 per cent at the

contributions to the new international financial architecture, but also a serious increase in the risk aversion of ther international financial community, as exemplified by Summers' claim that the Fund should concentrate on its 'core mandate' and cut out the remaining activities (those italicised in table 1) which are, by implication, 'peripheral'. What has to be discussed, therefore, is whether the relationship between core and peripheral activities is as depicted by Summers, or whether parts at least of the periphery are actually needed by the core; which in turn raises the question of whether the economic and political fragility which caused the need for long-term balance of payments finance in the first place can be addressed by any other means. This will be the point at issue in sections 2 and 3.

Before we proceed, the Fund's 'expanded role' needs to be put into the context of the other Bretton Woods institutions, the G7, and other initiatives for the reform of the international financial architecture currently being floated by both parties. Currently four of these initiatives are on the table (FitzGerald, 1999b) :

(i) a new 'financial architecture' as such: closer monitoring by the IMF and the G7 of macroeconomic stability and exposure to bank debt in emerging markets and emergency credit lines, including the Fund's new Supplemental Reserve Facility and Contingent Credit Facility to maintain confidence in currencies;

(ii) the construction of new rules relating to foreign investment to complement services trade commitments (GATs, TRIPs) at the Millennium Round WTO negotiations expected this year;

(iii) the restructuring of the external liabilities of highly-indebted poor countries (HIPC) in order to allow them to return to international capital markets;

(iv) and the continued intergovernmental commitment to support DAC targets (especially education, health, and the halving of poverty by 2015), which imply the continued commitment of aid funds.

Although the relationship between these initiatives is by no means clear, coherence of IMF efforts with them is clearly one criterion by which possible alternative roles for the Fund need to be judged; there have been several explicit proposals to collapse the Fund's poverty reduction facility into HIPC (see Wolf, 1999, and footnote 27 below), and Collier and Gunning (1999) have argued that the ESAF (now Poverty Reduction and Growth Facility) crowds out aid flows. The issue, in other words is not only whether long-

end of December 1998; it has since risen again, with the help of a general capital increase, to about 90 per cent.

term nonproject support is needed, but who should supply it in what policy framework.

2. The case for a 'return to basics'

The case for the Fund to go back to basics and confine itself to crisis-prevention and crisis-treatment functions (and therefore, in effect, divest itself of the italic parts of Table 1) essentially consists of three propositions:

(i)the diversion of resources from the Fund's basic functions of crisis prevention and management into broader functions has left its capacity to exercise its basic functions harmfully depleted.

(ii) the expansion of the Fund's role has crowded out resources which would have otherwise have been provided by the Bank, by aid donors and in particular by the private sector.

(iii) the expansion of the Fund's role has had harmful influence on the economies of its developing-country clients.

We call these the *opportunity cost,* the *division of labour* and the *moral hazard* arguments, and will summarise each of them in sequence, avoiding any critical comment at this stage.

Opportunity cost. The opportunity cost argument is simply that money tied up in long-term operations is not available for the Fund's short-term operations. Even if the Fund, after its 1998 general capital increase, now has better liquidity ratios[10], even if the principle of being an impartial 'lender of last resort' is compromised by moral hazard considerations (Giannini 1999:39), even if each individual borrower's right to borrow is protected by the size of its IMF quota, any large-scale shift into long-term lending leaves a smaller reserve for the Fund's emergency support function.

Division of labour. Under the Articles of Agreement established for the Bank and Fund at Bretton Woods, there is a sharp division of labour: the Fund provides short-term emergency support to countries suffering from macro-economic instability and the Bank (acting in partnership with aid donors in the poorer countries) provides long-term development assistance, the combination of the two operations being intended to revive private capital flows in those countries which have lost them or had difficulty in attracting them. Since the 1980s, the division of labour between the two institutions has become blurred, with both institutions now providing long-term assistance for policy reform - on the premiss that the long-term and structural problems from which deficit countries were suffering at that time

[10] See note 9 above.

required long-term and structural solutions based on supply-side policies rather than the management of aggregate demand. This blurring was initially resisted by the Executive Boards of the Bank and the Fund, and has been responsible for repeated demarcation disputes concerning which agency should manage which policy instrument (Mosley, Harrigan and Toye 1995: Ch.2); but carried through it has been, and the Bank-Fund turf wars of the 1990s were much less severe than those of the previous decade[11]. In the poorer developing countries, the main instrument of coordination has been the ESAF(PRGF); by contrast, in the middle-income countries which have been the focus of the recent wave of crises, rescue arrangements have been much more informal and often improvised, and frequently - for example in Mexico, South Korea and Indonesia - have involved other actors, in particular the G-7 countries.

It is these long-term arrangements which have now come under fire on the grounds that they crowd out or distort, private sector flows in middle-income countries, and aid flows in poor countries. The private sector argument is put by Summers(1999) and the aid argument has been put by Collier and Gunning (1999: F 647) in the following terms:

> Whereas a poverty-efficient allocation of aid would taper in with policy reform, in fact, aid is provided prematurely, peaking at a level at which it is still ineffective, and then tapers out over precisely the range of policy over which it is highly effective. This tapering out is not directly related to the attempt to use aid to induce policy reform, but rather is a by-product of a particular definition of what constitutes good policy. A major reason for the premature tapering of aid is that Fund programmes define the fiscal deficit so as to exclude both grants and the grant-equivalent of concessional lending. Large aid flows, even if entirely in the form of grants, are thus reported as large fiscal deficits. A major objective of Fund programmes in post-stabilisation environments has been the reduction in the fiscal deficit, so defined. (Collier and Gunning 1999: F647)

These propositions - that IMF concessional flows crowd out productive private-sector flows at the top end of the market, and productive aid flows

---

[11] Now they are threatening to reignite again, partly over the issue of primary responsibility for long-term lending discussed in this paper, partly over the issue of foreign capital-account liberalisation, much criticised (and by Malaysia reversed) in the East Asian crisis, still defended by the Fund (e.g. Fischer 1999:), now vigorously attacked by the Bank. The current draft of the Bank's *2000/01 World Development Report,* for example, insists that

> Of all the reforms implemented, financial liberalisation stands out for having caused severe disruptions in economic performance. The combination of open capital accounts, weak regulation of the financial sector, and the volatility of short-term capital flows lie behind the major macroeconomic crises in the 1990s.
>
> The social costs of rescuing ailing financial institutions have been huge and regressive. During the height of the 'reform rush' the prevailing view was that reforms should be introduced as quickly as possible in order to take advantage of the 'window of opportunity' provided by reform-friendly governments. This view is now changing. The financial crashes of the late 1990s in particular revealed the importance of creating adequate institutions (rules and organisations) and codes of behaviour, or 'social capital' (voluntary compliance with established laws, trust, co-operative behaviour, and basic codes of conduct) before market-oriented reforms are adopted. (World Bank 2000, page 8.5)

at the bottom end - would appear to be eminently testable, and simple tests will be attempted in Section 3 below.

(iii) *Moral hazard.* The general moral hazard argument applies to every type of financial flow, whether from IMF, Bank or aid donor - namely that the existence of such flows provides recipient countries with an excuse to avoid policies of thrift and economic reform, knowing that in the event of financial emergency they can always turn to the lender (or donor) of last resort. Summers' reference to '*long-term welfare that cannot break the habit of bad policies'*(1999: 4), however much intended for the consumption of the US Congress, provides an illustration of this line of argumentation. In principle, the policy conditionalities developed ever since the Bretton Woods Conference by the Fund (and in more recent years by the Bank and aid donors) provide a deterrent to such slippage, but these conditionalities have had a bad press in recent months, being dismissed as ineffective, for example, by Wolf(1999)[12]. Agreeing with this verdict, Collier and Gunning (1999: 645) argue that 'if (financial) flows in post-stabilisation conditions continue to be conditional on detailed negotiated promises of policy change they will undermine the government's commitment to .. reforms'. This moral hazard argument is presented as one of general application, undermining conditionality which seeks to introduce pro-poor policies just as much as conditionality which simply seeks to restore financial viability. Indeed, in a rider to their general moral hazard argument Collier and Gunning (1999:634) argue that Fund adjustment programmes 'have sometimes had adverse consequences for the poor, either directly through reducing incomes, or indirectly through reductions in social service provision'. In the following sentence they make it clear that their criticism attaches not to the *content* of the Fund's policy recommendations, but to 'the *sequence* in which (they) are sometimes adopted', which may be due to political pressures on either the donor or the recipient side.

A successful demolition of the IMF's expanded role, therefore, depends on at least one of the following three propositions being proved true across a wide range of poor countries: (1) resources devoted to the expanded role yield less at the margin than resources devoted to a more restricted role; (2) the expanded role has negative consequences for the Bank, the WTO, aid donors and other agents in the system of international economic governance; and (3) the expanded role is not feasible because conditionality cannot be enforced. (The three propositions appear to be independent of one another; but in practice they connect, since if the second and third are true the first follows automatically.) The next step, therefore, is to examine the empirical basis underlying each of the three propositions, which we seek to do in the next section.

---

[12] The precise phrase used by Wolf (1999, p.25) is 'conditionality does not work, except in crisis conditions'.

This page is intentionally blank

3. The case for a broader role

The case for the Fund to retain its broader role consists also of three propositions, which are the obverse of the first three:

(i) without the continued exercise of the broader role, the narrower 'lender of last resort' role cannot be effectively performed in poorer countries (indeed some middle-income countries as well); and it should be performed by the Fund;

(ii) the broader role is necessary for effective coordination between the Bretton Woods institutions, without which the separate effectiveness of each of them would suffer;

(iii) the moral hazard inherent in (especially) long-term conditionality of the ESAF type can be countered, and indeed countered in a way which is consistent with 'adjustment with a human face'.

We now develop each of these ideas.

i) Opportunity cost and the relationship between the Fund's 'broad' and narrow' roles. In essence the effectiveness of Fund stabilisation and adjustment measures in borrower countries, depends on two coefficients: the ability of expenditure cuts to reduce foreign exchange leakage and the ability of foreign trade elasticities to satisfy the Marshall-Lerner conditions in the event of a devaluation[13]. As emphasised by structuralists since the

---

[13] Consider the following simplified version of the Khan-Montiel-Haque(1990) 'synthesis' of the Fund and Bank models (autonomous variables are starred):

1 $\Delta Y = \Delta Y^*$ (growth target) — Y = income
2 $I = v\Delta Y$ (investment accelerator) — I = investment
3 $X = ae$ (export response to exchange rate) — e = exchange rate
4 $Z = mY - ze$ (import response to income and exchange rate) — Z = imports
5 $Y = C+I+X-Z$ (national income identity) — C = consumption
6 $C = C_p + C_g$, $C_p = (1-s)(Y-tY)$ (private and government consumption functions) — t = tax rate on disposable income; R = reserves
7 $\Delta R = X - Z + A^*$ (Balance of payments identity, with reserves set at target level and foreign inflows autonomous) — A = foreign inflows (aid + non-concessional flows)
8 $\Delta Y = \Delta M_d v$ (Money demand) — M_d = demand for money
9 $\Delta M_s = \Delta R + \Delta DC$ (Money supply) — M_s = supply of money

Letting growth ΔY be the target and substituting for exports, imports and consumption into the national income identity (5), we have as the reduced form:

10 $$Y^* = \frac{1}{v-(s+m)(1-t)}(vY_{-1} + C_g + (a-z)e)$$

Assuming that the propensity to save s and the propensity to import m cannot be influenced by policy in the short term, this leaves as the main parameters able to be influenced by the Fund the marginal propensity to raise tax revenue out of income(t), and the responsiveness of exports and imports to the exchange rate (a and z). We

1950s, these coefficients are often, in countries with poor physical and financial infrastructure, too low to allow full adjustment to a balance-of-payments shock, whether internally or externally induced, within the currency of an orthodox IMF standby[14]. In consequence, other policy instruments - the family now known as 'supply-side measures', including foreign trade liberalisation, price decontrol, privatisation – have as previously discussed been brought in to raise the elasticity of export supply, and tax reform and user charges to raise the long-term responsiveness of the budget deficit to the standard Fund stabilisation package. But there are both economic and political limits on the speed with which this can be done. The economic limit is set by the fact that these measures have slower speeds of response than the standard expenditure and exchange-rate instruments, which is an important reason for extending the period of disbursement and repayment. The political limit is set by the fact that if the stabilisation-and-adjustment process imposes social strains with which government and society are unable to cope, this will reduce the elasticity of supply to the point where stabilisation and adjustment measures are completely ineffective. Hence an economically efficient, as well as a humane, stabilisation process will be one which minimises its social costs and increases the government's ability to cope with them: the Fund's gradually increasing interest in political processes and in poverty reduction, culminating in the rechristening of ESAF as a Poverty Reduction and Growth Facility and in M Camdessus' description of the Fund as 'the best friend of the poor' [15] need not be interpreted purely as compassion or empire-building on the part of the Fund, although it is indeed both of those, but as a mundane and entirely proper attempt by the Fund to push the elasticity of supply above the Marshall-Lerner threshold. And this attempt is not only needed in poor (ESAF) countries, but at least as much in Russia, Peru, South Africa and the former Yugoslavia: our case studies will illustrate.

---

argue here that these crucial parameters are heavily influenced by political structure and by the time period over which policy changes are exercised.

Alternatively, letting reserves ΔR be the target and substituting for imports and exports from (3), (4) and (7),
$\Delta R = (a-z)e - m(Mv) + A^*$
This 'more traditional' way of working back from a reserves target illustrates the standard old-style instruments of IMF conditionality – the money supply M and the exchange rate e – and once again the influence of the key response-parameters a,m and z.

[14] Bond (1983) estimates an average aggregate supply elasticity of agricultural production to price of between 0.2 and 0.5 over three years (the standard *repayment* period of an IMF standby) for a large sample of African countries (which constitute a high proportion of the poorer developing countries). Similar figures are found for a sample of eight African countries by Mosley(2000). Given that the elasticity of domestic import demand is also low in poor and war-damaged countries because of the difficulty of substituting for imports under the stimulus of devaluation from a weak production structure, it is unlikely that the Marshall-Lerner conditions can be met during the typical period of an IMF standby although, and the recent ESAF evaluation confirms this, they can eventually.

[15] At UNCTAD conference, Bangkok, 13 February 2000.

What form will 'a humane and politically effective stabilisation process' take? Research on this issue is not yet conclusive, not least because the quality of the database has so far precluded its being effectively conducted in low-income countries. Four groups of findings are particularly relevant: those emerging from OECD projects by Bourguignon and Morrisson(1992) and Morrisson et al. (1995) which establish a 'poverty-increasing hierarchy' of stabilisation instruments, leading to the conclusion that for minimum social damage exchange rate flexibility should be used as much as possible as an instrument of adjustment, and indirect tax increases as little as possible[16]; those focussing on the possibilities for 'poverty conscious restructuring of public expenditures' (Ferroni and Kanbur 1990; World Bank 2000) which emphasise the need for privileging certain pro-poor expenditures in times of crisis (typically, although the list is not yet robust, primary health and education, agricultural research and extension, rural infrastructure maintenance, and the social safety net); the civil order literature (e.g. Stewart et al 2000) which demonstrates a link between (change in) inequality and poverty, the likelihood of conflict, and productive capacity ; and finally the social capital literature (World Bank 2000: Ch.4) which not only shows that the fortunes of individuals and regions are determined by their ability to use social networks to their advantage, but also that the impact of extraneous shocks (such as IMF-sponsored adjustment) will be influenced by the extent to which they damage or strengthen such networks.

All of these literatures not only concur that the likelihood of social unrest and the government's capacity to cope with it are influenced by the pattern of budgetary and macro-economic adjustment, but also that the speed with which this is done influences the impact and sustainability of policy. Fast adjustment amidst low growth in fragile political systems – not only in poor, but also in middle-income countries - maximises the likelihood of such adjustment being forced into reverse for political reasons [17]– and fast adjustment is the type of adjustment towards which countries

---

[16] Bourguignon and Morrisson (1991: table 5,p.1643) quote the following impacts on the poverty gap, across an average of seven case-study countries, for the elimination of the balance of payments deficit entirely by means of the instrument stated:

cuts in current expenditure: +1.7%
cuts in investment expenditure: +1.9%
cuts in average public-sector wage: +4.5%
cuts in public-sector employment: + 4.7%
cuts in money supply:+1.7%
exchange-rate devaluation: +1.1%
increases in import duties: +5.6%
increases in existing indirect taxes: +9.5%

[17] The Fund has shown increasing awareness of the political limits to adjustment. It employs no political analysts as such; but the Fund's Executive Board is expected to appraise programmes for their political feasibility, and some of the Fund's recent analytical work, notably Mecagni (1999) explicitly examines the reasons, political as well as other, why Fund programmes have been interrupted in recent years.

supported by an IMF operating in the now favoured ‘emergency lender only’ mode would inevitably be forced.

We now illustrate further with five country case studies from the period of the 1990s: the first three from middle-income and the last two from low-income countries.

Thailand/Indonesia/Malaysia. All of these countries received large IMF stand-by loans to offset the massive drop in their external reserves in late 1997/early 1998. Malaysia, in addition, imposed controls on capital outflows from October 1997 to January 1999. The response of their economies to these defensive measures was very different, with Indonesia being forced into much larger devaluations, and experiencing a much sharper collapse in output, than the other

countries in order to plug a similar gap in their balance of payments[18]. In other words, the combined elasticities of supply of exports and imports were lower in Indonesia than in Malaysia and Thailand. During the crisis one cause of this became apparent, namely that in spite of relatively similar initial conditions (rapid, and reasonably equitable, export-based growth over the preceding twenty-five years) Indonesia suffered both from greater latent conflict and from lesser governmental capacity to manage that conflict. Unlike the other two countries, Indonesia was effectively a dictatorship at the start of the crisis, and popular resentment of this dictatorship conspired with ethnic tensions to magnify the perceived effect of the collapse in the real wage brought about by stabilisation measures. Indonesia had less 'social capital' to draw on, in other words, to buffer the effect of the precipitate withdrawal of financial capital from the economy; and it drew on it less, with threats, and in May 1998 shootings, replacing the consultations with unions and other affected groups which characterised Thailand and Malaysia (and also South Korea, see Rodrik(1999, ch.4) These political disturbances hampered economic recovery, and disbursement of the Indonesian standby had to be stretched out over a period of two years against the normal one, until June 1999. With democratisation, and a reasonably rapid recovery of the supply side through 1999, the IMF's patience in stretching out the initial standby was doubly rewarded.

The former Yugoslavia. Whereas the break-up and economic collapse of the former Yugoslavia are typically blamed on ethnic hatreds, a share of the blame also rests with the macro-economic management of the former Yugoslavia between 1989 and 1991, during which period the real money stock of the federation was reduced by 40% as an anti-inflationary measure during the currency of an IMF stand-by agreement. The real wage fell by a similar magnitude across the federation as a whole. Unemployment and inequality increased very sharply throughout the federation through the first half of the 1990s , and much of the social unrest leading to the break-up of the federation can be can be ascribed to this. Until 1995 Yugoslavia continued to receive credits from the Bank and Fund, but having suffered a collapse in export revenue and income, it fell into default on those, and for this reason is currently barred from receiving further finance from the Bretton Woods institutions. The key point is that a less rapid process of disinflation at the start might have averted the economic collapse to which much of the subsequent political collapse was due.

Russia. An IMF Extended Facility of $12bn, at that time the largest to have been provided by the Fund but eventually increased to $22bn, was provided

---

[18]None of these output collapses was predicted by the Fund. The following data illustrate:

	Indonesia	*Malaysia*	*South Korea*	*Thailand*
1998 GDP growth (May 1997 forecast)	7.5		6.3	7.0
1998 GDP growth(actual)	-14		-6	-8.0

Source: IMF, *World Economic Outlook,* May 1997 and May 1999.

in August 1996, at a time when the national economy was still shrinking under the stress of the exposure of state industries to competition, in spite of a rapidly-growing world economy. The main conditionalities , over and above the usual performance criteria related to domestic credit creation and public expenditure growth, related to effectiveness of collection of tax payments (especially by state corporations) and regulatory measures for the financial sector. In spite of repeated overshoots of the performance criteria, successive tranches of this loan were disbursed until the shock of August 1998, when a moratorium was announced on repayments of the principal of Russia's overseas debt after a progressive loss of confidence by foreign banks in the short-term rouble bonds used to finance the government's widening budgetary deficit. After a period of macro-economic turbulence involving the collapse of a large part of the banking system and the stock market, a supplementary Fund standby, of value $4.5 billion, was agreed in August 1999 into the arrears of previous lending. At the time of writing (February 2000) the disbursement of the latest tranche of the loan was held up pending new bankruptcy legislation and progress in increasing the cash component of state enterprise revenues to reduce the level of barter in the economy. Positive growth returned to the economy in the third quarter of 1999, three years after the initial IMF rescue package, and has been sustained since then, which in many ways can be interpreted as a return on the Fund's patience.

As in Indonesia, the response of the real economy to financial corrective measures was delayed by latent social conflicts and limitations in the ability of the authorities to manage these. An indicator of the former is the fact that under the stress of erosion in the real wage and the social safety net poverty rates (even on the World Bank's standardised 'dollar-a-day' poverty line) have doubled between 1994 and 1997, and the Gini coefficient of inequality has gone in seven years from 26% to 48%, a higher level of inequality than that prevailing in the United States (Brainerd 1998). An indicator of the latter is the inability of the authorities to prevent the disappearance of much economic activity into the black economy, much of it controlled by criminal gangs. Again, the lack of social capital available to buttress the withdrawal of international financial capital (Rose 1999) is of significance. The key argument here is that a society's social capital is not exogenous to, but is determined by, the mix of corrective macro-economic policy actions taken by the recipient government consultation with the Fund; and that in Russia, both Fund and Bank have had to try to rebuild social capital massively eroded by the consequences of the transition process.

Bolivia. Bolivia in the mid-1980s experienced one of the more dramatic economic collapses of recent times, with annual inflation reaching 24,000 per cent in August 1985 followed by an IMF-coordinated stabilisation in which a majority of workers in tin mining, the main export industry, lost their jobs, and economic growth was negative form 1985 to 1991. Growth in the agricultural sector, and in agricultural exports, did not turn positive until 1995; in other words, it took ten years, much longer than

the period even of an IMF Extended Facility, for liberalisation in the exchange rate and other foreign trade instruments to feed through into growth in the key primary-producing sector. In the event Bolivia was acknowledged from the start as needing long-term therapy and has received a series of ESAF loans (four, as of end 1998). Since the 1985 emergency government has been, and continues to be, through a coalition of several parties. Perhaps because of the fragility of the political consensus, the role of the technical staff affiliated with the economic ministries –especially the finance ministry – has been more pronounced than in other countries, albeit consistently reformist. But for this consistency of policy, which eventually achieved credibility and a turn-round in the real economy, to continue, a major and sustained redistributive thrust was necessary, much of it –such as much social infrastructure and microfinance – emanating not directly from the state but rather from the NGO sector, underpinned by a range of bilateral and multilateral aid donors. In this case the relationship between the Fund and aid donors was harmonious and mutually supportive, notably in the negotiations which eventually led to debt write-offs through HIPC.

Mozambique. Our final example comes from the world's poorest country, ravaged like many African countries by civil war during the 1980s. The process of recovery from both war and underdevelopment required increases in especially the health and education components of recurrent expenditure to match the capital contributions being made by aid donors; and these implied the running of a budgetary deficit at a risky level of about 8% of GDP from 1994-96, which the Fund was at first not willing to tolerate. A key stage in the transition of the Fund to accepting a medium-term process of stabilisation came in 1996 during the negotiations surrounding Mozambique's second ESAF. The World Bank had to lean hard on the Fund in order to persuade it to accept transition to an 'acceptable' (less than 3%) level of budget deficit over a period of four years rather than two; but it eventually succeeded, and was rewarded for its advocacy. Attempts were also made to keep the adjustment process pro-poor by using relative price adjustments (especially exchange rate flexibility) and debt reduction (through HIPC) and keeping indirect tax increases, which would have hurt the poor, to a minimum. Since the Fund' s chance of heart Mozambique has been one of the fastest-growing countries in Africa,
with rates of growth of per capita GDP in excess of 5% each year from 1995 to 1999.

These case studies provide a preliminary justification for the following propositions:

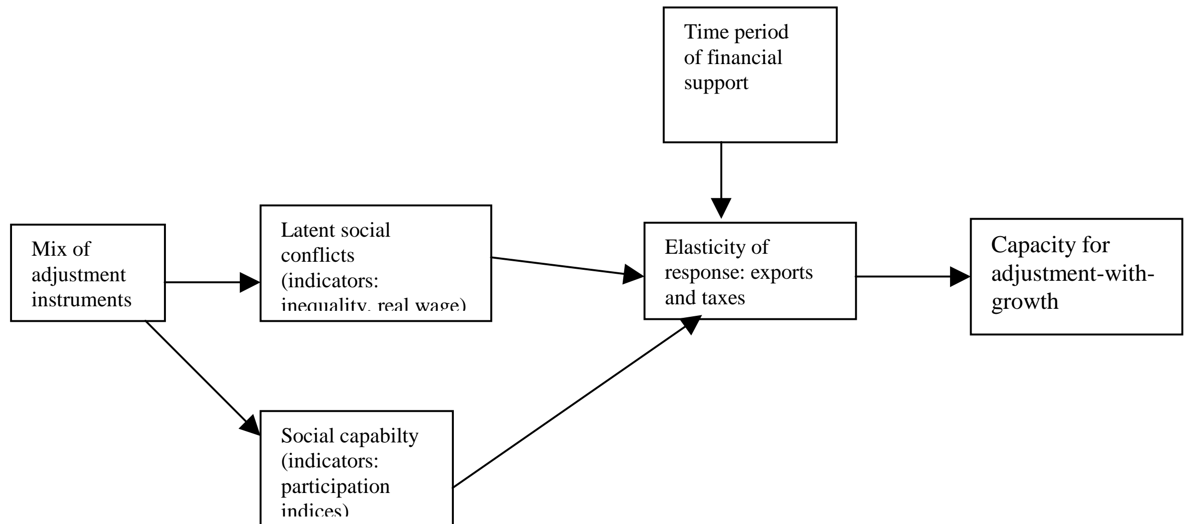
(1) a country's latent conflict potential *and* its ability to manage conflict, together with the time period over which financial support is given,

determine the ‘key IMF response-parameters’ of elasticity of export supply and its elasticity of tax revenue with respect to the tax base;
(2) conflict potential is influenced by the real wage and inequality, and ability to manage conflict is influenced by the level of social capital and the social safety-net arrangements which the government has put in place.
(3) elements of both of these can be influenced by the choice of stabilisation strategy. In particular, strategies which emphasise flexible exchange rates[19], de-emphasise indirect tax increases, and spare primary health and education are likely to be pro-poor and reduce conflict potential; and strategies which strengthen the social safety net, as well as democratisation itself, are likely to strengthen the government’s ability to manage conflict. Thus if the Fund is able to influence these intermediate variables through policy dialogue it will achieve a higher eventual response of exports and the budget deficit to measures of devaluation and tax reform; but this can probably not be achieved through short-term operations.

The basic linkages are illustrated by Figure 1.

[19] We thus have an additional argument for a movement, where feasible, to fully flexible exchange rates. The currently fashionable version of the argument is prudential: pegged rates, much more than flexible rates, attract runs on the currency (e.g. Eichengreen 1999: , Fischer 1999). Our argument, by contrast, is equity-based: stabilisation carried out mainly through devaluation is likely to increase poverty much less than an equivalent degree of stabilisation carried out through most alternative ‘technologies’, in particular indirect tax increases but also expenditure cuts, cuts in the money supply/ interest rate increases and public service redundancies (see table in footnote 16 above).

Figure 1. Capacity to adjust: a political-economic model



However, it would be useful to have more than an anecdotal test of these ideas. Table 3, in this spirit, compares performance between a sample of countries which received ESAF credits from the IMF and a control sample of adjusting countries selected to be as similar as possible to the IMF sample - except for the fact of not having received IMF loans during the specified period. Growth over the assessment period (the second half of the 1990s) is higher in the ESAF group than in the control group, and the difference between the sample means is significant at the 1% level. One interpretation of this would be that ESAFs enabled the Fund to buy out policies in recipient countries that were hostile to growth – inflation, overvalued exchange rates, and so on. However, we have argued that policy reform of this kind may not suffice to bring export elasticities to the required level, unless other conditions are satisfied, in particular that the reform process not inflame social stresses to the point where the government can no longer cope with them. As a preliminary test of this idea, we correlate response to adjustment with our measure of the distributional stance of macro policy (as an indicator of the extent to which economic reform has exacerbated social conflict) and the Observer Human Rights Index (as a measure of the government's ability, or otherwise, to manage social stresses). The results are displayed In Figure 2. Not only do the ESAF countries have a more 'pro-poor' mix of stabilisation instruments, and a higher measured level of social capacity indicators, than the non-ESAF countries –suggesting that IMF financial support may have helped to increase social capacity to manage crisis – but *within* the ESAF group, response to adjustment correlates with social capacity, and several of the negative outliers (e.g. Pakistan) are associated with lack of social capacity, indeed now with a return to military dictatorship. The inference which we draw – and which the IMF under

Camdessus has increasingly acknowledged - is that Fund support should be seen not purely as an exercise in the closing of fiscal gaps, but as an operation which will enable the building up of a governmental capacity to deal with crisis on a sustainable basis – and thereby close fiscal and balance of payments gaps more effectively in the long term. Statistically, we have argued this case in relation to ESAF (i.e. poorer) countries, but as earlier discussed, it is equally applicable to Russia and Indonesia.. We therefore wish to enter a plea against seeing the Fund's 'core mandate' as being purely short-term crisis operations: by the nature of its client base, the Fund, or more precisely the international financial system, often needs a medium-term perspective in order to make its short-term operations successful.

Table 3. ESAF countries and control group: Fund agreements, economic performance and indicators of 'social capacity', 1995-99

Country	***Date of most recent Fund agreement and type of agreement***	***Mix of stabilisation instruments (Note 1)***	***Social capability indicators: (Note 3) AM Obs***	***Growth 1995-9 (Note 2)***
ESAF countries (average per capita GDP= $426)				
Uganda	ESAF IV(1994)	6.4	-1.22 20.0	6.3
Malawi	ESAF IV(1994)	3.7	-1.57 13.7	6.0(a)
Tanzania	ESAF II(1993)	5.1	-1.22 22.4	1.7(a)
Mozambique	ESAF IV(1996)	7.1	.. 16.2	6.1(a)
Nicaragua	ESAF I(1994)	6.5	0.88 22.7	2.5(a)
Bolivia	ESAF IV(1994)	4.7	-0.35 21.2	2.4(a)
Albania	ESAF II(1995)	1.8	.. 38.6	5.5(a)
Vietnam	ESAF II(1994)	7.2	-0.49 29.7	5.7
Sri Lanka	ESAF III(1995)	1.4	0.35	3.6
Pakistan	ESAF I(1994)	1.3	56.5	2.2(a)
Zimbabwe		1.8	0.14 18.9	0.9
Ethiopia		3.2	-0.99 12.2	3.0
Bangladesh		2.7	30.5	
ESAF countries average		*3.8*	*24.7*	*3.1*
*Non-ESAF countries (average per capita GDP= $497)**				
Nepal		3.1	27.4	
Sierra Leone		1.9	14.4	
Uzbekistan		2.5	30.7	
Eritrea		0.6		2.1
Rwanda		2.3	26.3	..

Sudan		0.8	-0.64 46.2	2.5
Haiti		1.4	25.3	
Vanuatu		1.1		0.5
Tonga		0.9	9.1	-2.5(a)
Congo (Dem.Rep.)		0.4	42.5	-4.5
Congo(Rep.)		0.2	41.1	
Non-ESAF average		*1.3*	*31.7*	*-0.4*
t-stat (Note 4)		*4.23*****	*1.29*	*4.13*****

Notes: * The control group is selected to have similar income and other initial conditions to the ESAF group, except for the fact of not receiving ESAF support. For this purpose, the countries of the control sample are selected pairwise in relation to countries within the treatment sample (eg. Ethiopia is matched with Eritrea, Uzbekistan is matched with Albania, etc.)

1. This is defined as ratio of real devaluation to increase of indirect tax rates, 1994-9.
2. Start date of the 5 year period is 1995 or year after inception date of ESAF (if different) (a) denotes data for 1995-8 only.
3. AM = Adelman- Morris index of social capacity; Obs = Observer Human Rights Index.
4. T-statistic is defined for difference between sample means and is calculated

$$\frac{X_1 - X_2}{\sqrt{\left(\frac{s_1^2}{n_1} + \frac{s_2^2}{n_2}\right)}}$$

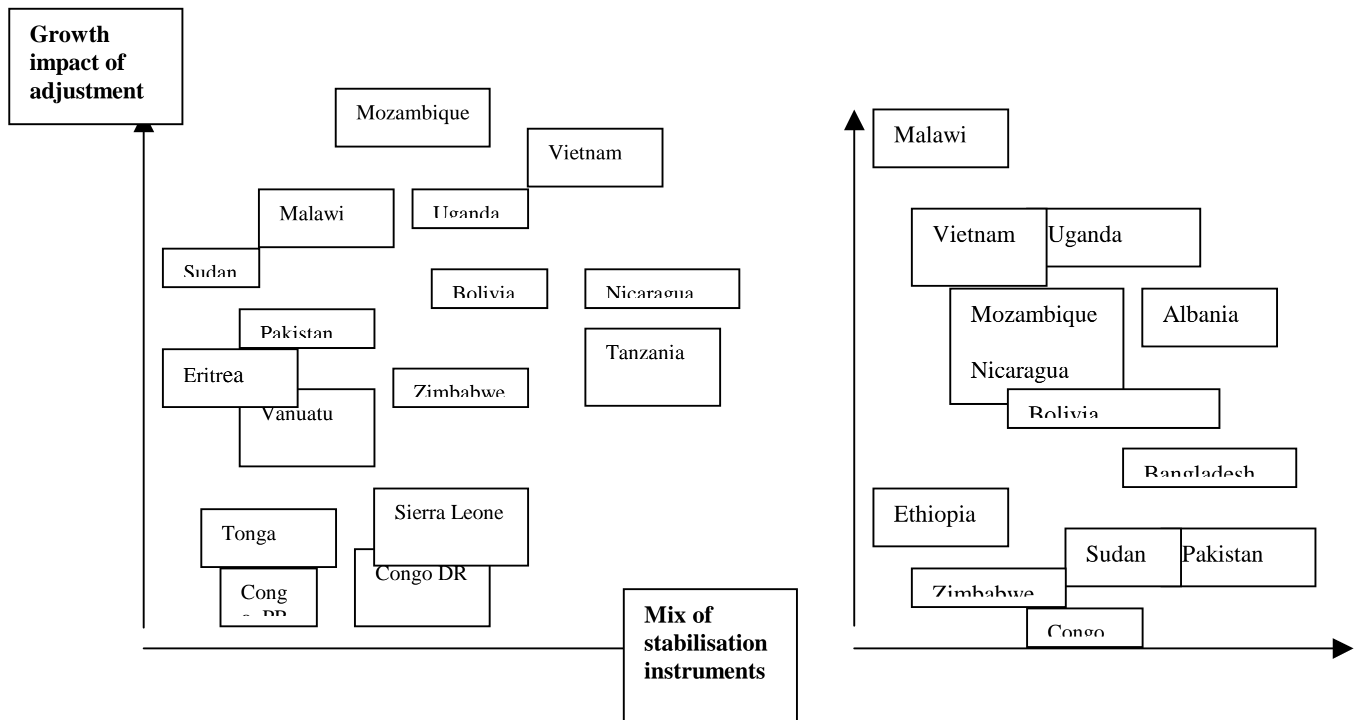


Figure 2(a) Growth impact of adjustment In relation to distributional orientation of adjustment (ESAF countries are circled)

Figure 2(b) Growth impact of adjustment in relation to measures of social capacity (ESAF countries are circled)

The question of why this medium-term perspective needs to be addressed by the *Fund,* as well as by the Bank and other institutions explicitly conceived as long-term operations, is germane: as we recall, the Summers/Collier/Wolf critique of the 'new' Fund explicitly accuses it of treading on the toes of the aid donors as well as the Bank. We now address the issue of division of labour between the Fund and other international financial institutions .

b)Coordination between Fund, Bank and aid donors (and the private sector) .

Even if the case so far made for medium-term financial intervention in crisis-hit countries as a public good is accepted, the question which still has to be answered is: why the Fund rather than the Bank, or for that matter aid donors[20]? Since the global depression of the 1980s, both the Bank and the Fund have been encouraging client countries to deploy micro-economic instruments of structural adjustment, as well as macro-economic instruments of stabilisation, to adjust deficits: the Bank alone through various policy-based operations and both institutions together through SAFs and ESAFs. In the process, as discussed earlier, the original Bretton Woods division of labour has become blurred, at some initial cost to Bank-Fund relations[21]. But one principle has continued to be observed: in the event of economic crisis, the Fund intervenes first, and with larger amounts of money[22]. This alone constitutes the main justification for continuing to involve the Fund in the process of helping to determine long as well-as short-term responses to crisis : by the time the Bank arrives on the scene, the long-term social and political consequences of a country's recovery strategy are largely predetermined by the nature of the short-term response (in particular, the inter-sectoral division of expenditure cuts and tax changes) contained in the agreement with the Fund, and the Bank can add little more than grace-notes; admittedly very important ones, such as the social sector projects discussed in the Russia case-study above. There are, however, other arguments. Firstly, the Fund has more credibility in the markets, and therefore is better able to induce a capital-account response to reform: the data of table 4, estimated across a sample of 86 countries which received adjustment credits from either the Bank or the Fund over the period 1980-97, suggest both a higher and a more significant response of foreign direct investment to IMF lending than to Bank lending, although there is plenty of scope for argument about the specification chosen[23]. Secondly, the Fund has had more relative success at enforcing its conditionality, having achieved, during the 80s and 90s, higher rates of compliance both in terms of proportion of policy conditions implemented

[20] According to a newspaper report (*Independent* March 24, 2000, p22), 'the Meltzer report recommends that the IMF should get out of long-term lending altogether, whereas the World Bank should focus on long-term development but switch from lending to aid grants'.
[21] For a discussion of these tensions, see Mosley, Harrigan and Toye(1995), chapter 2.

and in terms of proportion of loan agreements completed (as also shown in Table 4)[24]. All of the above asserts only a Fund comparative advantage in *adjustment lending* (long-term balance of payments lending with macro-conditions attached); not, of course, a Fund comparative advantage in *lending as a whole.* The Bank comparative advantage in long-term project lending, now of course extended into human and social capital building, survives as established at Bretton Woods in 1944. And the optimal division of labour between the two institutions has scarcely shifted from J.M.Keynes' desire, in that year, to see 'the Board of the Bank made up of ambitious expansionists, and the Board of the Fund made up of cautious bankers ' (Keynes 1945/1991:194). But caution, in an environment of poor, politically weak borrowers, now requires medium-term measures to build up the supply of both governance and physical output.

[24] It can be argued that this result should be expected, since Fund conditionality typically relates to monetary aggregates, fiscal balances and exchange rates which can be amended relatively quickly, whereas typical Bank conditions relating to privatisation, the tariff structure or civil service reform can take years to impement and require the compliance of thousands of people (Mosley 1986, section 2)

Table 4. Some Fund/Bank comparisons

	Impact on private capital inflows:		*Compliance with conditionality:*	
	Regression coefficient(1)		% agreements carried through to conclusion(3)	% policy conditions implemented(4)
IMF(1970-94)	0.65**(2.56)		83.7	(74.1)
World Bank (1980-92)	0.11(1.72)		72.2	51.2

Sources(1) Regression coefficient: coefficient b in the equation
Y = a +bX, where Y is FDI inflows (in millions of dollars) and X is capital flows from the World Bank or IMF (also in millions of dollars, lagged five years). Country samples for both IMF and World Bank operations: Bangladesh, Bolivia, Burundi, Ecuador, Ghana, Guinea, Guyana, Honduras, Indonesia, Jamaica, Kenya, Mali, Malawi, Mozambique, Nepal, Nicaragua, Pakistan, Philippines, Sri Lanka, Tanzania, Togo, Turkey, Uganda, Zambia, Zimbabwe (n=25).
(3) Compliance with IMF conditionality: rate of completion of IMF agreements, from Bird (1999:964)
(4) Compliance with World Bank conditions: from World Bank 1992. Sample: 64 deevloping countries borrowing from either IMF or World Bank.

We now consider the relationship between the Fund and other components of the international financial system. Collier and Gunning (1999), as we have seen, have accused the Fund –its ESAF specifically – of failing to bail in the aid donors in the right way, at a cost to poverty reduction, by squeezing them out as reform proceeds. However, we would argue that especially in the poorest countries the Fund has done a far better job than the donors of counteracting the moral hazard that is inherent in the transfer of concessional resources. Our main evidence in support of this statement is Table 5, which brings together, for poorer countries, inflows from the Fund and from aid donors in relation to various indicators of performance. As demonstrated by what is now a very large literature (for example Mosley et al. 1987, Boone 1996), aid flows have a poor record of effectiveness, on account of their inability to overcome the moral hazard problem : even the Bank's most recent attempt (1998) to demonstrate that aid can be effective where and only where policies are 'good' has recently been questioned on econometric grounds[25](Tarp and Hansen, 2000). One of the most dramatic demonstrations of this, highlighted in table 3, is that aid flows have an inverse correlation with tax effort: where poor recipient countries have a choice between financing a public expenditure from increases in taxes and user charges or from the politically less stressful source of obtaining additional aid, considerations of short-term rationality will always dictate the latter option, unless pressure is put on them to do otherwise. As a consequence, very poor countries easily become trapped in a vicious circle in which aid dependence is both the consequence and the

[25] Note that the key result of the Tarp and Hansen paper is to establish a link between aid effectiveness and, not the conventional index of 'good policy', but rather the Adelman-Morris index of social capacity. This buttresses our earlier argument (p. 20 above) that where social capacity is insufficient it must be built up over a period for financial flows to become effective.

continuing cause of inability to build up a democratic, accountable political system (Moore 1998)

The only effective source of pressure to exit from such a vicious circle is the IMF: which, exactly as described by Collier and Gunning, has sought to 'reduce the fiscal deficit…. defined so as to exclude both grants and the grant- equivalent of concessional lending' (1998:F 647). And, as shown in Table 5, it has had a measure of success, unlike the aid donors, with tax effort having *grown* on average across our sample of ESAF countries and *shrunk* on average across the control sample of non-ESAF countries. By successfully enforcing tax-based conditionalities across the ESAF sample the Fund has been able, against the trend of aid donors, to supplement rather than replacing domestic tax effort in those countries.

Another important criterion of the effectiveness of official financial flows is their effectiveness in attracting private foreign investment. As Summers argues, it is undesirable for the Fund to be 'a source of low-cost financing for countries with ready access to private capital', but in the poorer countries it has never been this. As shown by Table 5, the ratio of private investment to GNP is low across the whole range of poorer developing countries, to the point where it is not realistic to speak of private sector investment flows as an agency which could reasonably be expected to take over from the IMF as a financing source. However, within the group of poor countries, foreign investment levels (table 4) are better in ESAF countries than in non-ESAF countries and better in low-aid than in high-aid countries.[26] In middle-income countries there may be a risk of IMF clients failing to exit once they have regained the ability to access the commercial capital markets[27]; but this can be remedied by appropriate pricing of the IMF product, and the Appendix suggests a formula by which this might be done.

The conclusion which we draw is that 'bailing in the aid donors' is not the right criterion by which the IMF's ESAF should be judged: aid flows

are only a means and not an end to development, and given that they have paradoxically, on the available evidence, had less success, across a range of criteria, than an organisation which has never seen itself as a development institution, the inference which we draw is that it is the ESAF which is more successful at combating moral hazard, and has more need of being protected.

---

[26] Controlling for income level neutralises the argument that both low investment and high aid are induced by low levels of income, so that the negative correlation between aid and investment cannot be seen as causative.

[27] But the risk is overstated by Summers and by the other sources quoted at the beginning of this paper. The main culprits post-Asia have been the Philippines and Argentina, only.

Table 5. ESAF borrower countries and control group: IMF agreements, aid, taxation and private investment

Country	***Most recent IMF agreement: date and type***	***Aid flow/GNP: Ratio 1997***	***Change Since 1990***	***Tax revevue/GDP: Ratio***	***Change Since Latest IMF Agree-Ment***	***Private foreign investment/GNP: Ratio***	***Change Since 1990***
ESAF countries Uganda	ESAF IV(1994)	12.8	-3.4	11.2	+4.0	2.7	+2.4
Malawi	ESAF IV(1994)	13.7	-15.1			0.1	
Tanzania	ESAF II(1993)	13.9	-16.4	11.1	+0.6	2.1	+2.0
Bangladesh		2.3	-4.6			0.2	+0.1
Mozambique	ESAF IV(1996)	29.6	-16.0			1.0	+0.5
Nicaragua	ESAF I(1994)	22.7	-18.3	23.9	+3.8		
Bolivia	ESAF IV(1994)	9.2	-3	15.0	+3.2	10.2	+14.4
Albania	ESAF II(1995)	6.7	+6.1	16.6		1.7	+0.6
Vietnam	ESAF II(1994)	4.2	+0.1			7.7	+7.7
Sri Lanka	ESAF III(1995)	2.3	-7.0	18.5	0.0	3.7	+3.4
Pakistan	ESAF I(1994)	1.5	-0.5	12.9	-1.8	3.3	+3.0
Ethiopia		15.8	+4.7	11.9	+8.5	0.1	+0.4
ESAF countries, average		*11.2*	*-5.8*	*15.1*	*+2.6*	*3.0*	*+3.4*
Non-ESAF countries							
Sierra Leone		16.0	+7.9			0.2	-4.5
Eritrea			+14.8			0	0
Rwanda		11.6	+18.2			0.05	
Sudan				6.7	-0.8		
Congo (Dem.Rep.)				4.9	-0.3	0	
Burkina Faso		12.3	+3.3			0	
Congo (Rep)		9.9	+4.8			0.05	
Uzbekistan		0.5	+0.2			1.4	+1.8
Vanuatu							
W. Samoa							
Haiti		11.8	+6.0	8.1	+2.4	0.1	-0.6
Nepal		8.3	-3.5			0.6	+0.4

Average, non-ESAF countries		*10.0*	*+6.4*	*6.5*	*+0.6*	*0.3*	*-0.6*
t-statistic for difference between sample means*		*0.34*	*3.75***	*3.58***	*1.98**	*2.87***	*4.25***

Source: IMF, *World Economic Outlook* and (for tax data) *Government Finance Statistics Yearbook;* data on timing of IMF agreements are also from IMF *Annual Report* ; private investment data from World Bank, *World Development Report 1999/2000,* tables 1 and 21.

.

Table 6 Total net resource flows to developing countries, 1980-2000 (current $ billion)

	1981	1986	1990	1993	1996	1997	1998	1999	2000 forecast
Total **1. OFFICIAL DEVELOP-MENT FINANCE**	45.5	55.8	69.8	67.0	67.5	66.5	65.0	(66.0)	(67.0)
Aid (Official development assistance)	36.8	43.9	53.6	61.0	58.8	54.4	51.9		
Other	8.7	11.9	16.2	6.0	10.6	12.1	13.1		
2. EXPORT CREDITS	17.6	-0.7	4.6	6.5	23.7	22.1	8.5	(10.0)	(11.5)
3.PRIVATE CAPITAL FLOWS of which:	74.3	26.7	60.8	181.9	212.1	149.1	64.3	66.7	145.4
Net direct investment	17.2	11.3	26.5	56.8	95.9	72.7	25.0	36.7	73.3
Net bank lending	52.3	7.0	18.5	35.0	30.1	6.0	2.5	9.0	17.7
Net bond lending and portfolio equity	2.8	5.5	5.5	73.2	80.8	66.8	36.7	18.0	44.2
Other private	2.0	2.9	10.3	16.9	5.3	3.6	0.1	3.0	10.2
4. GRANTS BY NGOs	2.0	3.3	4.5	5.0	6.0	6.3	6.6	7.0	7.2
Total net resource flows	**139.4**	**85.1**	**139.7**	**260.4**	**309.3**	**244.0**	**144.4**	**149.7**	**231.1**
Africa Net private capital flows				8.7	7.6	16.3	10.3	11.9	16.8
Net direct Investment				1.9	5.5	7.6	6.8	8.0	8.3
Net portfolio Investment				1.0	-0.2	2.9	3.5	1.0	2.1
Bank lending and other portfolio investment									
Net official flows (IMF definition)				7.9	5.3	3.3	5.9	4.1	6.0

Sources: OECD *Development Cooperation* table VI-I various issues; World Bank *Global Development Finance* table 1; IMF *World Economic Outlook,* May 1999, table 2.5.

c)The effectiveness of conditionality. As we have seen Collier and Gunning (1999:F 645) accuse conditionality (in particular ESAF conditionality) of 'lack of effectiveness', and both Summers and Wolf use this contention as an argument in favour of a return to core responsibilities by the Fund. In passing we note that if the claim is true it implies trouble even for the Fund's ability to discharge these core responsibilities, since stand-bys and ordinary balance of payments support, no less than ESAFs and other extra-core operations, require compliance with a set of performance criteria laid down by the Fund. But, as we have seen (Table 3 above) there is little evidence, at the level of policy instruments, that the claim is true. At the level of policy targets – which is the one that matters – Table 5 has also illustrated that both in terms of standard macro-economic indicators *and* in terms of poverty reduction, ESAF countries have performed a good deal better, not only than other non-ESAF developing countries, but specifically than the group of countries which had received 'conventional', i.e. short-term, assistance from the IMF. Of course, we cannot prove that this is due to their having complied with conditions better – there are too many changing variables in the system. But we can show, first, that the IMF and other providers of finance have learned how to play the conditionality game more effectively[28]; second, that they appear to have played it more effectively

---

[28] The easiest way to see this is to visualise conditionality as a one-period game with the following structure of payoffs (where X= loan size, t= number of conditions, α= utility of conditions to donor, β=disutility to recipient of complying with conditions,p = percentage of conditions with which the recipient complies):

(Recipient) ***(Lender)***	***Complies With donor's conditions (p=1)***	***Fails to comply with donor's conditions (p<1)***
Repeat loan offered: ***Donor payoff*** ***Recipient payoff***	**(outcome 1)** $X + \alpha t$ $X - \beta t$	**(outcome 2)** $X + \alpha pt$ $X - \beta pt$
No repeat loan offered ***Donor payoff*** ***Recipient payoff***	**(outcome 3)** αt $-\beta t$	**(outcome 4)** αpt $-\beta pt$

This has a dominant strategy equilibrium in the top right-hand corner, where conditionality is always successfully evaded.

Now impose on these payoffs arbitrary numerical values such as $\alpha=\beta=p=0.5$, X=t=2. In this case the numerical value of the payoffs in the diagram above (donor's payoff written first) are:

Recipient Donor	Complete compliance with conditions	Incomplete compliance with conditions
Repeat loan	3,1	2.5,1.5
No repeat loan	1,-1	0.5,-0.5

In such a case all that is necessary if the donor wishes to move the equilibrium in the top right-hand corner up to the top left-hand corner where her conditions are met, is to work out a set of incentives that will increase the

in ESAF countries; and thirdly, that there are reasons why this may be the case, including greater attention to the political and the fiscal linkages mentioned above.

Table 7. Economic and social indicators in ESAF and other developing countries
(Per cent per annum, unless indicated otherwise)

	ESAF countries		*LDCs, not borrowers from the IMF*	
	1981-85	1991-99	1981-85	1991-99
Mean inflation	94.4	44.9	(23.5)	(139.9)
Budget balance	-9.1	-5.6	(-6.8)	(-4.8)
Infant mortality	111.9	87.5	(71.8)	(52.7)

Source: Schadler et al. (1997), table 1, p.6, and appendix .
Notes: ESAF countries are: Bangladesh, Bolivia, Burundi, Malawi, Tanzania, Nicaragua, Albania, Vietnam, Sri Lanka, Pakistan.
LDCs, not borrowers from the IMF are: Haiti, Sudan, Vanuatu, Congo DR, Congo PR, Eritrea, Burkina Faso, Uzbekistan, Nepal.

We have found gaps, therefore, in the reasoning of each of the main arguments used to urge the Fund to ‘return to basics’, and the essence of our argument could be captured by the proposition that *especially in poorer developing countries, the IMF’s long-term role is itself basic, because preconditional to the short-term role.* We would like to present a concluding illustration of this idea. If the Fund is to take on the role of institutional lender of last resort, either with its own resources or by urging private banks to lend into a crisis, it needs a presence in the country where the crisis is occurring to be able to discharge that role effectively. A long-term lending operation based on a local country office gives it a perfect platform from which to do this. At present the Fund has only 43 of such offices, and in the other developing member countries – four-fifths of all members - is hampered in responding quickly by the need to send out a team from Washington. A stronger presence on the ground, and more extensive long-term operations, would appear to provide a better base than the cutbacks proposed by Summers *et al.* for the quick-response role which they have publicly espoused.

---

recipient’s payoff under complete compliance to more than 1.5 (or alternatively, a set of disincentives that will reduce his payoff under incomplete compliance to less than 1).
In a companion paper, Mosley and Hudson (1999) we have suggested four possible ways in which the structure of payoffs can be amended to make this possible in principle – two of them ‘carrots’ or positive incentives to the recipient (compensation payments to losers, and empirical demonstrations of the effects of compliance) and two of them ‘sticks’ or negative incentives (required ‘down payments’ of reform, and loss of reputation). What is possible in principle is not always possible in practice, but evidence is provided for example by Mosley (1996) for the practical effectiveness of the second of these approaches, and by Collier et al. (1999) for the effectiveness of the third.

4. Integration between the Fund's role and other initiatives

On the argument so far presented, therefore, there is a strong case for the Fund's wider role to be continued rather than cut back. But the Fund is only one component in a broader scheme of international economic governance, and before jumping to this conclusion, we first need to examine the relationship of the possible Fund's 'wider' and 'narrower' roles to the four initiatives mentioned on page 5. Of these, the interaction between IMF and aid disbursements has been examined in detail in the previous section, but the interrelationship of the IMF's role with HIPC, trade liberalisation and other architectural reforms remain to be discussed.

HIPC. The HIPC programme of debt cancellation is indeed intended to bring about a major change in the incentive-structure of poorer countries, by removing the disincentive to reform which follows from the absorption of additional earnings by debt repayments; and is cast in the role of logical successor to the IMF's 'wider role' by Wolf (1999). But this function, as currently constituted, it cannot fulfil: the total of resources available is too small, the conditions for entry too restrictive[29], and debt, in any case, not always the cause of the external disequilibria the IMF has been expected to counteract. The amount of money expected to be allocated to HIPC in 2000 is $1.5bn in relation to 'unsustainable' debt repayments in that year of about $250 bn., only five countries (Mozambique, Mali, Guyana, Uganda and Bolivia) have qualified for assistance under the programme so far, and the cancellation of multilateral debt is excluded. Given these limitations, the idea that HIPC can effectively take over the IMF's long-term functions (as suggested, for example, by Wolf[30]) is illusory.

WTO and trade liberalisation initiatives. An even trade liberalisation increases the elasticity of export supply for all countries and is thus beneficial for both the Fund's short-term and its long-term role.
It particularly benefits the governments of poorer developing countries unable to make bilateral trade deals with multinational companies and is thus strongly complementary with ESAF operations; and once the gains from liberalisation filter through they add to the political leverage of exporters. The latter benefits, however, materialise over the long run rather

---

[29] Countries are only considered for debt relief under HIPC once they have established a three –year track record of good macro-economic performance and their debt is judged unsustainable; bilateral donors have to agree to provide at least comparable levels of debt relief to that proposed by the IMF and World Bank.
[30] Wolf (*Financial Times,* 15 December 1999) writes:
In his speech to this year's annual meetings of the Bank and Fund (Michel Camdessus) hailed the rebranding of the ESAF as a 'poverty reduction and growth facility'. That is not the job of the Fund. It is also not particularly good at it. *Generous debt relief for countries with good performance should eliminate continuous IMF involvement* (emphasis added).

than the short, and to that extent it is the Fund's long-term role which experience more benefit from complementary liberalisation.

Other architectural reforms. An important asymmetry in the structure of international financial transfers is the dominance of debt over equity flows during boom periods[31] . During the period 1995-97 overseas debt stocks grew by four times the value of overseas equity holdings, depriving developing countries of a risk-sharing mechanism and leaving many debtors with little wealth to draw on to buffer them when overseas investors withdrew in 1997-8. That the Fund's main instrument for counteracting this situation should be the offer of yet more debt is not completely obvious, for all that none of the 'new financial architecture' proposals currently on the table propose an alternative. The obvious alternative coping strategy is that the Fund should work out a way of adapting repayments to repayment capacity, through a risk-sharing arrangement, or alternatively that, rather than simply acting as a *lender* of last resort, it should become an investor of last resort, and take up an equity position in the central bank, or possibly in the commercial banks, of client countries. This would enable it to exercise leverage on those banks to provide support to the private sector in times of financial crisis, up to the limit of their permitted liquidity ratios; in addition, panic withdrawals of external funds would now translate into declining local currency asset values, helping thereby to take some strain off a floating-rate regime. (Of course the World Bank already acts as a private-sector investor through IFC, but its *modus operandi,* even when the investee is a financial institution, does not enable it to respond quickly in times of financial crisis). This approach could complement the proposal for risk-sharing through the interest rate made in the Appendix.

---

[31] There are several sources of this bias towards debt financing, including the underdevelopment of developing-country stock markets (especially in Africa), the existence of insurance for holders of bank deposits and not equity , and (Rogoff 1999) the ability of the courts of creditor countries to protect debtholders up to a certain point, through the law of contract, but not suppliers of equity finance.

5. Proposals and conclusions

The financial crises of 1997-9 threw enormous strains on to the international financial system, which were the more traumatic for being unpredicted. One consequence of these traumas has been for commentators, in the aftermath of the crisis, to urge the Fund to concentrate on its 'core mandate' of short-term lending and crisis prevention, shedding in the process the entire baggage of longer-term financial responsibilities which has built up, in particular, over the last twenty years. This essay has asked whether the Fund should surrender to or confront those pressures.

Our conclusion is that it should confront them, and retain, with suitable reforms, its broader role. This conclusion is based on considerations of both political economy and the Fund's customer base. The Fund's customers have for many years been confined to the developing and transitional world. Such countries, especially at the lower end of the income spectrum, have lower elasticities of response of both exports and public revenue sources to measures of stabilisation designed to eliminate macro-deficits; and as a consequence they need more time than is provided by the conventional Fund stand-by if they are to do so on a sustainable basis in response to a Fund package. The apparatus of EFFs, SAFs, ESAFs, repeated stand-bys and so on which the Fund built up to deal with these problems was not adopted in a fit of absence of mind, but rather because of inadequacies in the performance of the narrower role itself. The same poor countries, in the 1970s and 80s, were visiting and revisiting the Fund again and again, because the old-style medicine was not working in any sustainable way; and this is why the new medicine was brought in. The 'disease' of slow response has not gone away, because it is rooted in the nature of underdevelopment, and it would therefore appear perverse to throw away the medicine.

We have found it necessary to emphasise the political roots of this slow response, because this in turn explains why it is the Fund and no other institution which can be expected to counter it. The slow response is not only due to poor infrastructure, but also to weaknesses in the capacity of many developing-country states to articulate and sustain a recovery strategy, which can be traced back to interlocking deficiencies in social equity and 'social capital'. These are not purely an exogenous variable, but are strongly influenced by the choice of stabilisation instrument, as much in Russia and the Far East as in the poorer developing countries; and this of course is a matter for choice by the recipient government in 'dialogue'

with the Fund. That the Fund no longer stands back from this decision, but actively seeks to influence the composition of public expenditure and the stabilisation package in a pro-poor direction, is an development very much to be welcomed, an advance in its policy capacity that it would be very unfortunate to reverse. Nor can the Bank or aid donors substitute for the Fund in this role: the Bank, for all its merits, only arrives on the scene when the direction of stabilisation policy has been determined, and aid donors, as we have seen, have exerted an influence which has often been unintentionally hostile and not supportive of the building up of fiscal and state capacity, and hence growth also. Conditionality is by no means dead, but the Fund's, for all its faults, has been much more effective than the donors'.

In the wake of the Asian crisis it is perfectly reasonable to ask whether the Fund can still afford its extended role. We believe that the answer is yes, and not only because allowing the poorer developing countries to borrow long- rather than short-term is unlikely to significantly influence the Fund's exposure. It is also because a failed short-term operation almost automatically turns into a long-term operation, as in Russia, and the costs of acknowledging it as long-term in the first place are much less than the costs of aiming for the infeasible and acknowledging it as such only under duress.

It remains the case that some reforms in the international financial architecture, over and above those already implemented, might be capable of enabling the Fund to discharge its extended role at lower risk. The most important ones concern the relationship between the Fund and the private sector of the recipient country. In the poorer countries, the Fund has never been a source of 'low-cost financing for countries with ready access to private capital', since private capital stayed away even through the boom of the mid-90s. But what makes them vulnerable in a crisis is still their high ratio of debt to equity, which the Fund as currently constituted can only attempt to ease by imposing on them yet more debt. Could it only offer equity (by analogy with the World Bank's existing International Finance Corporation), either in the form of actual shares in the commercial banks of recipient countries or in the 'quasi-equity' form of pressure on liquid commercial banks to lend to illiquid private-sector firms, that might take a good deal of pressure off beleaguered recipient governments, the more so where, as in East Asia, the private sector's financial problems are at the root of the crisis. A formal statement of how this might be done is provided in the Appendix.

It is important, finally, to emphasise the limitations as well as the merits of the 'long-term development partner' role which we have sought in this paper to defend. In the short term, the retention of a medium-term Fund lending capacity does reduce the amounts available for short-term lending to large crisis-hit middle income countries. It is leading to 'turf disputes' with the Bank, and is also causing some strain with bilateral aid donors. But we believe, for the reasons mentioned, that implemented

alongside the contingency reserve and various improvements in prudential supervision over recent years, it reduces the medium-term risks of a global financial crash, and also contributes to the cause of global poverty reduction. The Fund has made major gains in recent years, in understanding of response-mechanisms within developing countries and in ability to meet the financial needs of a wider range of countries and constituencies. It is only recently that it has earned the right to call itself 'the best friend of the poor'; but it has earned that right justly, and existing bureaucratic imperatives will not allow it to shed that role easily. It is natural that the Asian crisis has made risk-averse all those concerned with the protection and development of the international financial system, but it would be more than a pity if that risk aversion should go so far as to wipe out the gains that the Fund has made in understanding the economic and political structure of its main constituents and in empathising with their predicament. As we have attempted to show, those gains do not need to be sacrificed, and should not be.

Bibliography

Bird, Graham, 1999, ‘Crisis averter, crisis lender, crisis manager: the IMF in search of a systemic role’,*The World Economy,* vol.22(September 1999), 955-975.

Botchwey, Kwesi, Paul Collier, Jan Willem Gunning, and Koichi Hamada, 1998,*External Evaluation of the E(nhanced) S(tructural) A(djustment) F(acility),* Washington DC: IMF.

Bredenkamp, Hugh, and Susan Schadler, eds. 1999, *Economic adjustment and reform in low-income countries: studies by the staff of the IMF.* Washington DC: International Monetary Fund.

Collier, Paul, and Jan Willem Gunning,1999, ‘The IMF’s role in structural adjustment’, *Economic Journal,* vol.109 (November), F634-F652.

Burnside, Craig, and David Dollar, 1997, ‘Aid, policies and growth’, Policy Research Working Paper 1777 (Washington DC: World Bank)

Collier, Paul, and others, 1997, ‘Redesigning conditionality’, *World Development,* vol. 25 (September), 1399-1407.

Eichengreen, Barry, 1999, *Toward a new international financial architecture: a practical post-Asia agenda,* Washington DC: Institute for International Economics.

Finch, David, 1989, *The IMF: the record and the prospect,* Princeton N.J.: Princeton Papers in International Finance 175.

Fischer, Stanley, 1999, ‘Reforming the international financial system’, *Economic Journal,* vol.109, F557-F577.

FitzGerald, Valpy, 1999a, ‘Global capital market volatility and the developing countries: lessons from the East Asian crisis’, *IDS Bulletin,* vol.30(January),

FitzGerald, Valpy, 1999b, ‘The development dimension of the new international financial architecture’, unpublished lecture notes.

Giannini, Curzio, 1999, '*Enemy of none but a common friend of all'? An international perspective on the lender-of-last-resort function,* Princeton N.J.: Princeton Papers in International Finance 214.

Gilbert, Christopher, Andrew Powell and David Vines,1999, 'Positioning the World Bank', *Economic Journal,* vol.109, vol.F598-F634.

Hansen, Henrik, and Finn Tarp, 1999, 'Aid effectiveness disputed', unpublished paper, University of Copenhagen, forthcoming *Journal of International Development.*

Helleiner, Gerald, 1983a, *The IMF and Africa in the 1980s,* Princeton N.J.: Princeton Papers in International Finance 152.

Helleiner, Gerald, 1983b, 'Lender of Early Resort: The IMF and the Poorest', *American Economic Review,* vol.73, pp.349-353.

International Monetary Fund (IMF), 1998, *External evaluation of the ESAF (Enhanced Structural Adjustment Facility),* Washington DC.

International Monetary Fund(IMF), 2000, *The rationale for IMF financing,* Pamphlet Series No 50, 5 February. Available at http://www.imf.org/external/pubs/ft/pam/pam50/pam5002.htm.

Keynes, John Maynard, 1945/1991, *The collected writings of John Maynard Keynes:* vol.XXVI, *Activities 1941-46: Shaping the post-war world: Bretton Woods and Reparations.* London: Macmillan.

Khan, Mohsin, Peter Montiel and Haque, 'A Fusion of the World Bank and IMF models', *IMF Staff Papers,* 1990.

Mecagni, Mauro, 1999, 'The causes of programme interruptions', chapter 9 in Bredenkamp and Schadler (1999).

Moore, Mick, 1998, 'Death without taxes: democracy, state capacity and aid dependence in the fourth world' in Mark Robinson and Gordon White(eds.) *The democratic developmental state: politics and institutional design,* Oxford: Oxford University Press.

Morrisson, Christian, 1996, *The political feasibility of adjustment,* Paris: OECD Development Centre.

Mosley, Paul, 1987, *Conditionality as bargaining process: structural-adjustment lending,*1980-86. Princeton Essays in International Finance 168.

Mosley, Paul, Jane Harrigan, and John Toye, 1995, *Aid and power: the World Bank and policy-based lending,* second edition, New York and London: Routledge.

Mosley, Paul, 2000, *A painful ascent: the green revolution in Africa,* forthcoming, Cambridge University Press.

Polak, Jacques, 1991, *The changing nature of IMF conditionality,* Princeton N.J.: Princeton Papers in International Finance 184.

Rose, Richard, 1999, *What does social capital add to individual welfare? An empirical analysis of Russia,* World Bank Social Capital Initiative Working Paper 15.

Sahn, David, (editor),1996, *Economic Reform and the Poor in Africa,* Oxford: Clarendon Press.

Schadler, Susan, 1993, *Economic Adjustment in Low Income Countries:Experience under the Enhanced Structural Adjustment Facility,* IMF Occasional Paper 106, Washington: International Monetary Fund.

Spraos, John, 1986, *IMF conditionality: ineffectual, inefficient, mistargeted,* Princeton N.J.: Princeton Papers in International Finance 166.

World Bank, 2000, *World Development Report 2000/01: Attacking Poverty.* Discussion draft (17 February 2000)

Appendix: A proposal for risk-sharing arrangements as a reinforcement to the Bank's long-term lending operations

When an international organisation lends, it is unable to protect itself by the expedient typically used by a lending organisation within a country, namely that of taking collateral. It is both more exposed (given the large amounts of money involved) and less well protected. In consequence it must devise *substitutes for collateral.* Historically, with both the Fund and the Bank, conditionality has been one of the most important of these: compliance by the borrower with specified undertakings related to policy and institutional reform is designed to maximise the probability of a return to sustainable growth by a crisis-hit country, and thus the probability of repayment of the loan. Outside the Fund (but within the Bank Group, in the shape of the International Finance Corporation) another option is the taking of an *equity stake in the borrower,* which gives the lender a role in the management of the borrower entity. Typically (certainly in IFC) this approach has mainly been applied to investments in private-sector corporations in developing countries. But it does not have to be thus restricted: and a number of recent diagnoses of the Far Eastern crisis (for example Rogoff 1999,) have suggested that an increase in the equity-to-debt balance among sovereign creditors would be a good idea. This appendix takes the general approach a step further by suggesting *risk-sharing contracts* as a supplement to the Fund's portfolio, particularly on the long-term operations which form the focus of the current article. These introduce an element of insurance for the borrower, and an element of 'profit-sharing' and therefore performance-related pay, for the lender.

The essence of the proposal is that the Fund would charge interest on its loans in two parts: a 'basic rate' (r) which would cover its share (c) of the costs of borrowing and administration (but no more) and a 'surcharge' (r^*) which would be proportionate to the change in the economy's growth rate since the loan was taken out ($g - g(0)$), if this change were positive. Thus for each loan,

$$R = r + r^* , \; r = c, \; r^* = \alpha(g - g(o)) \text{ if and only if } g < g(0). \qquad (1)$$

The surcharge r^* is to be seen as a form of quasi-equity, a dividend which is paid only if and when the IMF's loan achieves its intended result. This would have the following benefits:

(1) for the borrower, some matching of payments to ability-to-pay, with modest relief on repayments during the hard initial year or so of a loan agreement when change in living standards is often negative as a result of expenditure cuts and import price increases from devaluation, without the benefits of stabilisation having been received;

(2) for the borrower, a political dividend from being able to adapt out-payments (and hence the budget) more effectively to cash-flow;

(3) for the borrower, an incentive to graduate to the international financial capital markets as soon as feasible, given that the premium α is set at a level to maximise the IMF's monopoly profit and therefore will be higher than the free-market interest rate.

(4) for the lender, a performance incentive, with profits being made contingent on ability to deliver growth; but the potential for quite substantial profits, in what is often a quasi-monopoly lending situation, if the premium α is set correctly (see below), which would help to pay for some of the costs of lending long-term.

(5) for the global economy as a whole, it would help to offset the procyclical tendency of Fund lending as a whole (Snowden 1997: figure 2), thereby helping to stabilise international capital movements.

Determination of the 'profit markup' α. By the argument made under (3) this should be set at the profit-maximising level (1+1/e) where e is the interest-elasticity of demand for international borrowing. For many countries e will be well below one, and the markup proporionately high, reflecting the difficulty which countries will experience, during a crisis and if their past repayment reputation is poor, in obtaining loans from any other source.

The merits of adopting a package of this sort. The essential argument for moving to a two-part loan tariff of this sort is that it increases the likelihood of compliance with IMF policy conditions, which, if the conditions are properly designed, increases the likelihood that the loan will be repaid and the recipient country return to growth. In extension of the argument in footnote 28, let X=loan size, t=number of conditions, α= utility of conditions to donor, β= disutility to recipient of complying with conditions, p= percentage of conditions with which the recipient complies. The payoff matrix is:

(Recipient) ***(Lender)***	***Complies With donor's conditions (p=1)***	***Fails to comply with donor's conditions (p<1)***
Repeat loan offered: ***Donor payoff*** ***Recipient payoff***	**(outcome 1)** $X + \alpha t$ $X - \beta t$	**(outcome 2)** $X + \alpha pt$ $X - \beta pt$
No repeat loan offered ***Donor payoff*** ***Recipient payoff***	**(outcome 3)** αt $-\beta t$	**(outcome 4)** αpt $-\beta pt$

This has a dominant strategy equilibrium in the top right-hand corner, where conditionality is always successfully evaded.

Now impose on these payoffs arbitrary numerical values such as α=β=p=0.5, X=t=2. In this case the numerical value of the payoffs in the diagram above (donor's payoff written first) are:

Recipient Donor	Complete compliance with conditions	Incomplete compliance with conditions
Repeat loan	3,1	2.5,1.5
No repeat loan	1,-1	0.5,-0.5

The lender's task is therefore to increase the recipient's payoff under complete compliance to more than the 1.5 which it assumes in the top right-hand corner under complete compliance. A contract such as the one proposed increases the payoff to compliance by:

(i) reducing its political costs, by reducing the debt service burden when times are hard (i.e.before benefits from complying with the conditionality have been perceived); and in this way reducing the political costs of compliance;

(ii) increasing the correspondence between costs and benefits of compliance, and indicating the lender's confidence that such benefits will be forthcoming.

Finance and Development
Working Papers Series (as at 26.6.00)

No 1 *Impact Assessment Methodologies for Microfinance: Theory, Experience and Better Practice*
David Hulme, IDPM, University of Manchester
February 1999
Published as:
Hulme, D (2000) 'Impact Assessment Methodologies for Microfinance: Theory, Experience and Better Practice', *World Development* 28(1), 79-98

No 2 *Financial Sector Regulation: the Lessons of the Asian Crisis*
Martin Brownbridge and Colin Kirkpatrick, IDPM, University of Manchester
February 1999
Published as:
Brownbridge, M and Kirkpatrick, C (1999) 'Financial Sector Regulation: Lessons of the Asian Crisis', *Development Policy Review* 17(3), pp243-266

No 3 *The Poor and Their Money*
Stuart Rutherford, SafeSave, Bangladesh
February 1999
Published as:
Rutherford, S (1999) *The Poor and Their Money*, DFID, New Delhi, India

No 4 *Micro-Macro Linkages in Financial Markets: the Impact of Financial Liberalisation on Access to Rural Credit in Four African Countries*
Paul Mosley, Reading University
March 1999
Published as:
Mosley, P (1999) 'Micro-Macro Linkages in Financial Markets: the Impact of Financial Liberalisation on Access to Rural Credit in Four African Countries', *Journal for International Development*, July-August

No 5 *Flow of Funds: Implications for Research on Financial Sector Development and the Real Economy*
Christopher Green, Loughborough University and Victor Murinde, Birmingham University
April 1999

No 6 *Capital Surges, Investment Instability and Income Distribution After Financial Liberalisation*
E V K Fitzgerald, Oxford University
May 1999

No 7 *Progress, Constraints and Limitations of Financial Sector Reforms in the Least Developed Countries*
Martin Brownbridge, IDPM, University of Manchester and Samuel Gayi, UNCTAD Secretariat, Geneva
June 1999

No 8 *Policy Issues in Market-Based and Non Market-Based Measures to Control the Volatility of Portfolio Investment*
E V K Fitzgerald, Oxford University
September 1999

No 9 *Financial Services for the Poor and Poorest: Deepening Understanding to Improve Provision*
Imran Matin, David Hulme and Stuart Rutherford, IDPM, University of Manchester
October 1999

No 10 *Financial Sector Development and Savings Mobilisation: an Assessment*
George Mavrotas, School of Economic Studies and Roger Kelly, IDPM, University of Manchester
November 1999

No 11 *Some Lessons for Regulation from Recent Bank Crises*
David Llewellyn, Loughborough University
December 1999

No 12 *Financial Regulation in Developing Countries*
Martin Brownbridge and Colin Kirkpatrick, IDPM, University of Manchester
January 2000
Published as:
Brownbridge, M and Kirkpatrick, C (2000) 'Financial Regulation in Developing Countries: a Critical Survey', *Journal of Development Studies*, August

No 13 *The Prediction and Diagnosis of Banking Failures in Zambia*
Samuel Maimbo, IDPM, University of Manchester
February 2000

No 14 *Finance and Small and Medium-Sized Enterprise Development*
Paul Cook, IDPM and Frederick Nixson, School of Economic Studies, University of Manchester
April 2000

No 15 *The Policy Environment for Promoting Small and Medium-Sized Enterprises in Ghana and Malawi*
Dalitso Kayanula and Peter Quartey, IDPM, University of Manchester
May 2000

No 16 *Key Microstructure and Policy Issues for Emerging Stock Markets: What Have We Learned?*
Christopher Green, Loughborough University, Victor Murinde and Rose Ngugi, Birmingham University
May 2000

No 17 *The IMF after the Asian Crisis: Merits and Limitations of the 'Long-Term Development Partner' Role*
Paul Mosley, Sheffield University
June 2000

All papers are available from the IDPM website (http://www.man.ac.uk/idpm) and the Finance and Development websites (http://www.devinit.org/findev)

For further information on other IDPM Discussion and Working Papers, please contact:
Maggie Baldwin, Marketing and Publicity Administrator, Email:maggie.baldwin@man.ac.uk