The Future of the IMF and the World Bank[1]

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The growth of international private capital markets and the increasing access of developing countries to these markets has led some critics to argue that the IMF and the World Bank are no longer needed. This is clearly an extreme view. Despite the growth of private markets it can be argued that both institutions could have important roles to play as producers of global public goods, which cannot be left to markets, and also as instruments for countering various types of market failures.

The Future Role of the IMF

The IMF has the responsibility of overseeing the functioning of the international financial system with a view to ensuring its stability and efficiency. It also promotes sound macro-management in individual member countries which both contributes to stability and is a pre-condition for achieving sustainable growth. To achieve these objectives the Fund relies upon the twin instruments of surveillance and the provision of finance to countries in need. Both functions are likely to remain relevant in future.

Fund surveillance covers bilateral surveillance of individual countries and multilateral surveillance of the world economy. Both types of surveillance have become more important in some respects because globalisation has increased the vulnerability of individual developing countries, and to some extent the international financial system also, to crises.

Bilateral surveillance can, in principle, help reduce the possibility of crises by identifying potential problems at an early stage and encouraging countries to take pre-emptive action. The effectiveness of bilateral surveillance has been criticised in recent years because it failed to give advance warning in many cases, for example in Mexico and East Asia. In the case of Thailand advance warning was given but it was ignored, indicating that surveillance, even when it correctly identifies problems, may not be effective. Despite this experience there is agreement among

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both industrialised and developing countries that Fund surveillance is potentially useful and that it should be strengthened.

Bilateral surveillance will become more important in future because of the potential role of financial sector fragility as a cause of crisis in emerging markets and because Fund surveillance can play an important role in identifying such fragility. Much of the discussion of the new financial architecture has focused on the need to upgrade standards in various parts of the financial sector, for example banking, the securities market and insurance, and associated areas such as accounting, bankruptcy legislation and corporate governance. The Fund can play a major role in evolving a consensus on acceptable standards in these areas; it can also encourage emerging market countries to upgrade their standards to these levels.

Multilateral surveillance can also be said to have gained in importance in view of international financial integration because misalignments in industrialised country policies can have major destabilising impacts on international financial markets, imposing heavy costs on developing countries. Developing countries have therefore generally favoured strong multilateral surveillance aimed at achieving better co-ordination of industrialised country policy. One must, however, be realistic about what can be expected from multilateral surveillance in terms of actual impact on industrial country policies.

Experience shows that the multilateral forum is not the most important forum for policy consultation among industrialised countries. The relevant forum for this purpose is really the G-7, where the process of consultations has been institutionalised with an elaborate mechanism for meetings at the level of deputies and regular summit level meetings. Even so, instances of actual policy co-ordination are rare, for example the Plaza and Louvre Accords in the 1980s, and in those cases the Fund was only marginally involved.

Despite these limitations it can be argued that multilateral surveillance is useful because it produces inputs into the G-7 process. This provides a link between the outcome of discussions in multilateral forums, such as the Executive Board of the Fund and the International Monetary and Finance Committee on the one hand, and the more restrictive G-7 groups on the other. It is therefore important to increase the effectiveness of multilateral surveillance, while also ensuring increased participation on the part of developing countries. It is worth considering whether the Fund's input into the G-7 consultation process should be made public.

While the surveillance role of the Fund deals with crisis prevention, it is its financing role that is relevant for crisis resolution and this role is not performed by any other institution. However, there are important differences in perception between developing and industrialised countries on how this role should evolve in future. Developing countries typically argue that the rapid integration of international financial markets, with near instantaneous capital mobility and the ever present dangers of herding and contagion, has greatly increased their vulnerability to crises. The Fund should, therefore, be suitably empowered to help developing countries deal with crisis situations. Industrialised countries recognise that financial integration has increased the possibility of systemic crises and that the Fund has a special responsibility to deal with such crises, but they also worry that the Fund's financing activities have proliferated, often straying beyond the Fund's area of short-term stabilisation into areas that are much more akin to development financing. They also worry that easy access to Fund financing generates moral hazard, weakening the incentives to take preventive action and thus increasing the probability of crises occurring.

There is no doubt that Fund facilities have proliferated in response to the changing needs of its clientele at different points. Some of these have lapsed and some have been recently abolished, but it still has six major facilities.[1] These are the plain vanilla standby arrangements, the Compensatory Financing Facility (CFF), the Extended Fund Facility (EFF), the Poverty Reduction and Growth Facility (PRGF), the Supplemental Reserve Facility (SRF) and the Contingent Credit Line (CCL). These facilities provide very different types of financing, ranging from relatively long-term concessional finance from the PRGF (interest rate of 0.5 per cent and maturity of five and a half to ten years) to very short-term high-cost finance from the SRF (interest rate of 400 to 500 basis points above the standard rate and maturity of 18 months, extendable by one year).

The Meltzer Commission majority report recommended a drastic restructuring which would abolish the present multiple facilities and convert the Fund into a much smaller institution which would act as a quasi-lender of last resort, providing very short-term assistance (120 days with a maximum of one rollover) to solvent emerging economies which meet a set of pre-qualification criteria. The Commission recommended that once pre-

[1] Several facilities which used to exist have lapsed, such as the Trust Fund, the Oil Facility, the Structural Adjustment Facility and the Systemic Transformation Facility. More recently, the Buffer Stocking Facility and the Currency Stabilisation Reserve were abolished. The contingency element in the erstwhile Compensatory Contingency Financing Facility (CCFF), which was added at one stage, has also been abolished, converting the facility back into the Compensatory Financing Facility (CFF).

qualification criteria are met, there should be no post-crisis conditionality, except that Fund assistance should not support 'irresponsible budgetary policies'.

The drastic restructuring proposed by the Commission was not unanimous and the majority report has been strongly criticised by a dissenting minority of Commission members. The US Treasury has also indicated to the US Congress that it has fundamental reservations on practically all the main points. The main reasons why the Meltzer Commission's recommendations are unworkable are the following:

- Restricting Fund assistance to 'emerging economies' would limit it to around three dozen or so developing and transition countries. It would exclude the overwhelming majority of the membership from eligibility for Fund assistance;
- Even if the restrictive reference to 'emerging economies' is eliminated, the vast majority of the Fund's members would still not meet the pre-qualification requirements;
- The elimination of post-crisis conditionality puts far too much faith in the process of pre-qualification proposed by the Commission which is limited to the financial sector and the requirement that the government is not following 'irresponsible budgetary policies'. This ignores innumerable other areas of policy where policy imbalances could exist;
- The proposal that financing should be limited to 120 days, with a maximum of only one rollover, is far too restrictive even for pure liquidity crises. Crisis-hit countries provided with such short-term financing would be vulnerable to speculation about whether they would be able to meet their obligations at the end of the period.

For all these reasons, restricting the role of the Fund as drastically as proposed by the Meltzer Commission is too extreme a step and could be potentially dangerous. However, it is difficult to deny the need for some further rationalisation. The standby arrangements, the CFF and the EFF should continue. However, the interest rate structure of the EFF could be modified to create an incentive for early repayment. The PRGF, on the other hand, belongs more in the area of the Bank than the Fund and there is a case for shifting this facility to the Bank in a manner which guards against any reduction in the total volume of concessional flows.

The 1990s have seen the emergence of 'new generation' crises which pose new challenges. Unlike traditional crises which originated in a current account deterioration, these crises originate in the capital account. Management of these crises is a new role for the Fund, which is likely to become even more important in future. The financing requirement of such crises is much larger than in traditional episodes of balance of payments difficulties and this is especially so since several countries may experience crises simultaneously because of contagion. The Fund must be in a position to act as a 'lender of last resort' in such cases.

There are interesting differences of perception between industrialised countries and developing countries on this issue. There is general agreement that where a crisis is caused primarily by contagion and policy deficiencies are not involved, the Fund must aim at providing liquidity, with relatively limited emphasis on conditionality. The CCL was designed to deal with this situation. However, where policy deficiencies are involved, conditionality is unavoidable. The SRF was designed to deal with crises of this type. Experience thus far suggests that both facilities need to be refined in several respects.

The CCL is a potentially innovative instrument but it has not proved sufficiently attractive thus far and needs to be made more attractive if it is to be an effective defence against contagion. Since the CCL involves greater pre-crisis discipline, the facility should be made more attractive than the SRF to encourage countries to use it and accept the discipline involved. This could be done if it were made explicit that the scope for post-crisis conditionality in the case of the CCL will be restricted to a narrower area than for the SRF. The extent of automatic disbursement, without imposing new post-crisis conditionality, could be raised from 5 per cent of quota, as at present, to 50 per cent. The interest rate charged for the CCL should also be lower than for the SRF.

The SRF is the principal instrument for managing crises after the event and was used effectively in Korea and Brazil. The design of conditionality in such cases can become a potentially controversial issue as happened in East Asia. It is necessary to ensure that conditionality is sufficiently flexible to take account of the specific country situation and does not stray too far from what is needed to ensure stabilisation and restoration of confidence.

An important issue that remains unresolved is the amount of Fund financing that should be made available under the SRF in different circumstances. In principle, it can be argued that once a crisis-hit country has adopted the corrective policies needed to deal with policy deficiencies, it should be provided with the financing needed to deal with capital outflow, provided it can repay the resources borrowed. However, this means that foreign lenders escape scot-free. There is strong resistance to using public resources from the Fund to finance such outflows, since private creditors should be made to bear some of the costs of imprudent lending. The extent to which private creditors are made to bear part of the burden will obviously depend upon the amount of Fund financing that can be made available; this gives the Fund a critical role in triggering such negotiations.

It is not clear at present how much Fund financing can be made available without forcing some renegotiation with private creditors. One way of introducing transparency would be to establish objective norms for the amount of financing, as a multiple of quota that would be available to support adjustment without insisting on debt restructuring. Countries that are able to manage within this limit without restructuring would be allowed to do so. However, if financing was needed beyond this amount, it would only be provided if parallel action was taken by the country to negotiate with private creditors. This approach has the advantage of transparency, but it may not be the best approach. The financing need in a crisis varies greatly for reasons beyond a country's control and a more flexible approach, determining the limits of financing on the basis of individual cases, may be better. The issue of the degree of transparency to be adopted is difficult to resolve.

Managing new generation crises also raises the issue of the resources that must be put at the Fund's disposal. In many crises the Fund has had to supplement its own resources with resources from other bilateral donors, the World Bank and the regional development banks. The need to tap other sources inevitably introduces uncertainty and non-uniformity in the extent of financial support that can be provided in different situations. The Fund's credibility as a multilateral crisis manager requires that it should have sufficient access to resources under its own control to manage crises when they arise. This suggests the need to consider establishing a special mechanism, based on the creation of SDRs, which could provide the Fund with adequate resources for use in emergency situations, subject to majority decision of the Fund Board.

The Role of the World Bank

The Bank performs three different types of functions, each of which will remain relevant in the future: it serves as a conduit for long-term concessional assistance, through the International Development Association (IDA), to low-income countries; it acts as an intermediary providing non-concessional loans to creditworthy developing countries; and it engages in research and provides advice on development policy. Assessment of its future role must depend upon assessment of the role of each of these functions.

The role of the Bank as a conduit for IDA flows to the poorest countries remains essential for the task of reducing global poverty, an objective which is regarded as a global public good. This role is particularly important in the low-income countries of sub-Saharan Africa, where growth rates have been very low in the 1980s and 1990s and where a significant improvement in growth or acceleration of poverty reduction is not possible without additional concessional assistance.

The role of the Bank as an intermediary for non-concessional flows is more open to question in view of the development of capital markets. However, there are strong arguments in favour of a continuing role for Bank lending.

- A large number of developing countries do not have significant access to capital markets and depend almost exclusively on the International Bank for Reconstruction and Development (IBRD) lending for non-concessional loans.
- Many countries that do have substantial access would not find it possible to completely replace borrowing from the Bank by private financing without a significant deterioration in their credit rating. Private markets will not provide finance on long maturities as is available from the Bank, and a shift to private financing will therefore imply a deterioration in the debt structure with a reduction in borrowing capacity.
- Private capital markets are highly volatile and developing countries are poorly placed to handle such volatility. The active involvement of the Bank provides an element of stability in capital flows, and possibly also the possibility of counter-cyclical action.
- Continued access to Bank lending for countries which could otherwise obtain resources from private markets can be justified on the grounds that it can influence the allocation of resources in a desirable direction. For example, Bank lending directed at sectors such as health, education or environmental protection can ensure a larger flow of resources to these sectors than would occur if the government borrowed from private markets because the latter would generate funds that are much more fungible.
- Finally, Bank lending can be used for leverage in policy reforms in many infrastructure sector areas which in many developing countries have traditionally been dominated by the public sector, but which could attract large volumes of private sector investment if the necessary reforms are implemented. This is a potentially important role for Bank lending which private lenders will not play. This is, in fact,

> a very useful development role which the Bank can play in countries which have market access. Far from substituting for private lending, Bank lending in such cases can actually lay the framework for future growth of private investment and reliance on private capital.

In recent years the Bank has also emphasised its new role, based on its research activities and the experience gained from its economic and sector work in many countries, of providing 'knowledge inputs' into development. This is undoubtedly an important activity, especially since development objectives have become much more multi-dimensional (growth, poverty alleviation, access to basic social services, gender imbalance removal, participation, sustainability, etc.) and the range of policies considered relevant for development has also widened considerably. However, it is relevant to ask whether the activity of disseminating knowledge should be unconnected with Bank lending. In practice, however, effectiveness of transmission depends critically upon its being combined with a substantial volume of lending from the Bank. The decline in the volume of IBRD lending in recent years, after adjusting for lending in support of IMF crisis management packages, is a disturbing development from this point of view, and needs to be reversed.

A related issue is that the accumulation of knowledge as the multifaceted nature of development objectives and policies should not lead to over-crowing of conditionality. The Bank's ability to perform the role of leveraging policy in desired directions depends upon its ability to limit excessive conditionality which burdens each loan or programme with multiple concerns. Bank financing has the advantages of low interest rates and long maturity. But an excessive load of conditionality can add to the hassle factor associated with Bank lending; this will have the effect of reducing the willingness of developing countries to absorb Bank funding, and thus limit the Bank's ability to leverage policy reform.