Preliminary

The Strategic Role of the IMF: Risks for Emerging Market Economies amid Increasingly Globalized Financial Markets

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I. Introduction

The basic objective of the IMF should be to enhance global financial stability and increase the flow of funds to developing countries. Financial stability is of critical importance because it is a prerequisite for economic stability and economic stability is essential for growth and poverty alleviation

However the goal of promoting economic stability must be sensitive to other economic concerns, particularly those facing developing countries. For instance, policies to promote stability are not sufficient to foster growth and development.[1] Moreover ill-conceived stabilization policies may actually impede growth and development and even reduce economic efficiency. For example, the attempt to stabilize exchange rates in times of crisis by enforcing large increases in the interest rate (as the IMF did during the East Asia crisis) makes firms more reluctant to use debt finance; in developing economies with limited equity markets[2], this implies a greater reliance on self-finance, with obvious adverse effects on growth and allocative efficiency of capital markets. In short, we cannot separate issues of stabilization policy from issues of growth and development.

In the last fifty years we have also learned that growth does not necessarily reduce poverty and 'trickle down' economics works no better for developing countries than it is for developed countries. Indeed some policies intended to promote growth may actually increase poverty. (This is, of course, especially true when policies designed to promote growth enhance instability.)

By the same token, some stabilization policies are *more* sensitive to the concerns of the poor. Fortunately, pro-poor stabilization policies are often more cost-effective than pro-rich stabilization policies, particularly in the context of an economic downturn (simply because the marginal propensity to consume of the poor is higher than that of the rich.)[3]

The implication of this is that we have to design not only pro-poor growth policies but also pro-poor stabilization policies, and just as issues of stabilization cannot be separated from issues of growth, neither can be separated from issues of distribution. Because even in advanced industrial

[1] See Rodrik (2000) and Hausmann and Gavin (1996)
[2] This is even true in developed countries, where there is effective equity rationing as a result of informational asymmetries.
[3] This was particularly evident in the fiscal policies adopted by the United States in 2001, where the "bang for the buck" was remarkably small, because these policies were so pro-rich.

countries safety nets are imperfect, pro-poor stabilization policies entail responding to crises in ways that minimize the depth and duration of downturns and ensure that adverse effects on the poor are minimized.

II. A framework for risk and stability analysis

For at least the last three quarters of a century, it has been recognized that markets do not automatically adjust to ensure full employment—or at least not quickly enough. At least in some circumstances, there is a role for government to facilitate the adjustment process. But while markets are imperfect, so too is government, and even the best run government macro-interventions result in extended periods in which the economy functions below its potential, with enormous waste of resources. The losses in output and welfare of these macro-failures are of an order magnitude greater than those associated with most of the micro-inefficiencies, e.g. associated with allocative distortions. At the same time, market imperfections, in particular the absence of insurance markets, means that the *welfare* costs of instability are substantially greater than the loss in output. And recent advances in economic theory, exploring the consequences of imperfect risk markets and incomplete and asymmetric information[4], have shown that markets by themselves do not result in efficient resource allocations. There is a role for government to improve on the market. Market failures are particularly pronounced in financial markets, the province of the IMF.

This has two very important implications. On the one hand, it means that there is no *theoretical* basis for the contention that financial and capital market liberalization will necessarily lead to greater economic efficiency and increased societal welfare.[5] To be sure, one can establish such results in models in which it is assumed that there are perfect markets, no information imperfections, or no information asymmetries, but such analyses are of no relevance to the *real* world, and provide a weak reed on which to rest policy. On the contrary, one can easily show that financial and capital market liberalization may lead to greater economic volatility and lower welfare.[6]

Secondly, it implies that governments need to be particularly attentive to the effect of any policy reform on the *risk properties* of the economic system, on the exposure to risk, on the ability of the economy to respond to shocks, and of individuals and firms within society to cope with shocks. Thus, capital market liberalization has been rightly criticized both because it exposes an economy to more shocks and because it reduces the ability of policy markers to respond to shocks, by circumscribing the ability to use monetary policy.

[4] See, e.g. Greenwald and Stiglitz [1986]
[5] See, e.g. Rodrik (1998)
[6] See, e.g. Stiglitz [2004].

Automatic stabilizers, like progressive income taxation and unemployment insurance, help the economy respond to shocks (and at the same time promote greater equality and reduce poverty.) Relying on the value added tax (a proportional tax) reduces the economy's ability to respond automatically to shocks.

Some regulatory policies—like excessive reliance on capital adequacy standards with little forbearance—may actually act as automatic destabilizers. Bankruptcy law too can affect how the economy responds to risk. (Chapter 11, which allows for a quick debtor-friendly reorganization, can be especially important in the context of an economic downturn; we have argued elsewhere for a Super-chapter 11, to be invoked in situations where there are large numbers of bankruptcies induced by a macro-economic shock.).[7]

In each of these cases, policymakers may have to trade off the stabilization properties with other purported advantages and disadvantages of the policy.

The design of stabilization policies involves other trade-offs to which policy makers have to be sensitive. In proposing policies for vulnerable countries, the IMF must recognize that policies which may have beneficial effects in reducing the likelihood of a crisis may have adverse effects on the consequences of a crisis if one occurs, posing complicated trade-offs which have to be carefully assessed.

In addition policies to cope with national economic problems may have consequences for the global economic system. Beggar-thy-neighbor trade policies are a case in point. These global impacts are particularly important in the new era of globalization.

The IMF was created, in part, in response to the recognition that maintaining global economic stability was a global public good requiring global collective action. There are important externalities in each country maintaining its economy at full employment; the IMF, in encouraging countries to have countercyclical fiscal policy to stabilize their economy and providing funds with which to do that (especially important given imperfections in capital markets), can help promote global stability. By contrast, when the IMF engages in pro-cyclical lending and does not encourage countercyclical fiscal and monetary policies, it contributes to global instability. Similarly, by pushing some of the "reforms" discussed earlier (like capital market liberalization), the IMF may have contributed to global instability.

As the IMF reaches sixty, it needs to refocus its attention on global financial stability, on the market failures and externalities which provide the key

[7] See Stiglitz [2000]

rationale for its existence. Each of the policies which it advocates needs to be assessed from this perspective. And in doing so, it must base its analysis not on models of the market economy assuming perfect information and perfect markets—models, which if true, would imply that there was, in fact, little rationale for very existence of the IMF.

In this paper, we will not go over these issues, many of which by now have been well-explored. Rather, in this brief paper we address two major global problems confronting the international financial system which we believe have not received enough attention, but which clearly fall within the purview of the IMF. We would go further: it is hard to see how the IMF can address its core responsibility of enhancing global financial stability without addressing these issues.

The first is that developing countries bear too much of the risk of interest rate and exchange rate fluctuations. The second is that the global reserve system is deeply flawed. Together these institutional weaknesses contribute to the magnitude of global volatility, which is felt particularly strongly by developing countries. The IMF should be trying to work for global financial stability through reforming the reserve system and shifting risk away from developing countries to those more able to handle it.

III. Risk, growth, and poverty

In well functioning capital markets, risk should be shifted from those less able to those more able to bear it. But developing countries still bear most of the risks of interest rate and exchange rate fluctuations. The consequences can be enormous, as evidenced by the debt crisis of the 80s which was precipitated by Latin American countries' exposure to the risks of interest rate increases. When the US raised interest rates to unprecedented levels, these countries were forced into default, leading to the lost decade of the 80s. Similarly interest rate increases of late 90s had much to do with the crises and poor performance of some developing countries during that period.

Similar problems are associated with exchange rate fluctuations.

The fact that developing countries have to bear so much risk has a number of consequences. Given the volatility of interest rates and exchange rates, it implies that developing country economies that borrow extensively abroad and/or have open capital markets are highly volatile. In effect, volatility is shifted from those economies with the best shock absorbers and best able to bear risk to those with the weakest shock absorbers and least ability to bear risk. As countries recognize this, prudence leads to lower levels of borrowing; and even at these lower levels of borrowing, there may still be high levels of volatility. Moreover, to mitigate the risks, developing countries

have to hold more money in reserves, earning low interests rates—at a high opportunity cost. With less capital, with more money set aside in reserves, and more volatility, growth is lowered and poverty is increased.

There is much that could be done to make markets work better. In particular, the IMF could do more to shift more of the risk burden to the advanced developed countries; and it is easy to show that this can be done in ways that do not create "moral hazard" (with exchange rate fluctuations).

At the very least, IFI's should absorb more of the risk in their own lending. This could be done by having repayments based on baskets of similar currencies.[8]

IV. The US dollar as the Global Reserve Currency

The global reserve system is a second (and in some ways, even more important) source of concern. Recent years have been marked by frequent crises and a high level of financial instability. One of the more important factors contributing to this instability is the global reserve system.

The reserve system is, of course, supposed to enhance global stability. Reserves act as a buffer against shocks, facilitating countries' abilities to withstand these shocks. That is why each country holds reserves. But the global reserve *system* results in a deflationary bias to the global economy, contributes to instability—and yet has a high cost, especially to developing countries.

The demise of the dollar reserve system

The essential requirement of a reserve currency is that it be a good store of value. This is why inflation has always been viewed so negatively by central bankers. But the credibility of a currency as a reserve currency depends also on exchange rates. For foreign holders of dollars, a weakening of the exchange rate is as bad as an increase in inflation. This is, in a sense, even true for domestic wealth holders; because of opportunity costs, even citizens of a country with a stable exchange rate may want to diversify out of holding assets denominated in that country's currency if there is high instability.

For most of the last part of the 20th century, US dollars have been used as the world's de facto reserve currency. But the current system is under threat from negative dynamics, as confidence in the dollar erodes, causing people move out of the currency; and as they do so, the currency is further weakened. While the huge fiscal and trade deficits of the Bush Administration have contributed to this weakening, the problem for the US

[8] In doing so, one can mitigate risk without leading to moral hazard.

dollar is partly inherent; the current Administration simply accelerated what would have eventually happened in any case. The reserve currency country naturally becomes increasingly indebted, because the ease of selling debt entices over-borrowing. Others want to hold T-bills; it is tempting to respond to the demand with an increase in supply. But eventually, debt levels get so high that credibility starts to be questioned.

This may well be happening today. Certainly there has been a major shift in thinking among central banks. Over the years, they have gone from thinking that a currency needs gold as backing to thinking that sterling is required to back their currency, to thinking that dollars should back their currency. But now, they realize what matters is *wealth*. They no longer rely solely on the dollar for their reserves, as they have realized that the dollar is not a good store of value, and are beginning to manage their reserves as a more diversified portfolio which is sensitive to risk and return. With multiple hard currencies to choose from, central banks may find it prudent to hold reserves in multiple currencies—or even in other assets. And as the US dollar appears more risky, they will naturally continue to shift out of dollar – a process which is already well under way.

But this shift out of the dollar reserve system is not necessarily a smooth one. Now, investors have to think not only about how other investors are thinking, but also about how central banks are changing their perceptions of risk and reserve policy. Changes in central bank holdings, or market perceptions of central bank holdings, may contribute to instability—and we have already evidenced several examples of this.

Deflationary bias

From a global perspective, there are other concerns both about the equity and stability of the reserve system. The system has an inbuilt deflationary bias, as every year, several hundred billion dollars of "purchasing power" are essentially buried in the ground. In the past, profligate governments and lose monetary policies made up for the deflationary bias. Today, it is the United States which partially sustains the global economy, in its role as "consumer of last resort". But it is surely a peculiar system in which it is only by enhancing the consumption of those who the world's richest and highest consumers that the global economy avoids a recession. And since this consumption is sustained by debt, it is questionable whether it is sustainable. And as doubts about the sustainability increase, the stability of the entire system brought into question.

Seen from a global perspective, the driving forces are clear: if America is to meet the demand for its debt as reserves, it must run a trade deficit. But with imports exceeds exports, there is a deflationary bias within the United States, which can normally be offset only by the government running a large

fiscal deficit. (The one exception was the 1990s, when irrational exuberance led to an unsustainable investment boom.)

The hot potato of global deficits

Persistent trade deficits have long been recognized as a source of instability. But the sum of trade deficits must equal the sum of trade surpluses, so surpluses are as much a part of the problem as deficits. As countries have learned the dangers of large trade deficits (including the effective loss of economic sovereignty associated with the IMF programs that follow the crises that so often result from persistent trade deficits) countries try to run surpluses. Some countries having learned the dangers of inadequate reserves have tried to build up their reserves, by running surpluses. Other countries have learned that a low exchange rate can help promote exports and growth, and have run persistent surpluses not so much because they want reserves or value surpluses in their own right, but these have followed from their exchange rate policy. For a variety of reasons, many of the well managed countries have succeeded in running surpluses over sustained periods.

But if there are some countries that persist in having a surplus, the rest of the world must have a deficit. If some country succeeds in eliminating its deficit, the deficit will appear somewhere else in the system (hence the term, deficits as 'hot potatoes'). The current system "works" because the US has been willing to be not just the consumer of last resort, but the "deficit of last resort". But even the United States has a problem in playing this role. With imports persistently exceeding exports, there is, as we have noted, a deflationary bias in the US which continues to require huge fiscal deficits to offset.

Moreover, it is not clear that even the United States can continue to mount such deficits and still sustain confidence in its currency. At least in some quarters, there will be fears of monetization, and of inflation; or fears that others will have such fears. And as such fears have become widespread, as even Central Banks start moving out of dollars and changing their mindset concerning reserves, there is a vicious circle.

A multiple reserve currency system?

It is *not* a solution for there to be a two-reserve currency system. Some in Europe had hoped that the Euro would take on this role as a reserve currency. This has happened, at least to some extent, but it has not been good for Europe, or the world.

As Europe becomes a reserve currency, Europe too then faces a deflationary bias. Given its institutional structure, a central bank focusing exclusively on inflation and a growth and stability pact restricting the use of expansionary

fiscal policy, there are doubts about whether Europe is able to respond effectively to the consequences. If it does not, Europe, and the world, face contractionary pressures.

Equity

While the global reserve system has contributed to weaknesses in the global economy and to its instability, it is a system which is particularly unfair to developing countries. They suffer particularly from the instability—especially given the failure of international financial markets noted in the previous section in shifting risk to the rich. But while they pay a high cost from the failure of the system to produce stability, they also pay a high dollar cost directly in the way the system is run.

In effect, the system allows the US to have access to a ready supply of cheap credit. This has resulted in the most peculiar situation where the world's richest country is living well beyond its means, borrowing from countries far poorer. Just as risk *should* move from the poor to the rich, but is not; so too capital should flow from the rich to the poor—but in fact is moving in the opposite direction.

There is essentially a net transfer from developing countries to the richest country in the world, as the poor countries make low interest loans to the United States (often reborrowing some of the money at much higher interest rates.) Obviously, these net transfers—which exceed the value of the aid many of the poor countries receive from the U.S.-- have adverse consequences for their growth.

Why even the U.S. is adversely affected

While the United States would thus *seem* to benefit from the current set of arrangements, it too suffers. It suffers, of course, from the deflationary bias, and while for long periods it has overcome this by large deficits, the deficits themselves have a cost. But most importantly, the United States loses from the instability of the global economy, and the fact that it often operates at levels far below its potential.

An alternative

There is an alternative, which we shall describe briefly. There could be an annual issuance of global greenbacks (SDR's, Bancor) in amounts equal to amount of additions of reserves. (This "reserve" increase is essentially the same as the periodic issuance of SDR's under the IMF's current charter.)

This issuance would not be inflationary— it would just undo the existing deflationary bias of the current system.

With the annual issuance of these new reserves, the adverse consequences of the fact that the sum of deficits equals the sum of surpluses would be broken: any country could run a deficit equal to its receipts of new reserves without worrying about a crisis. The "hot potato" problem would be reduced, if not fully solved.

With the new reserve backed by the global community, the inherent instability of the reserve system—resulting from the fact that the reserve currency country *has* to become increasingly indebted—would be a thing of the past.

The new reserves could be allocated in ways which promote global equity, and help finance global public goods. This would enhance stability by eliminating the inherent instability from the reserve currency.

One could view the new reserve system as a form of cooperative mutual help. The international community would be providing entitlements to automatic "help" in times of crisis, allowing the country to spend beyond its means, beyond what international financial markets are willing to lend, as each country guarantees that the new reserve currency could be converted into their own currency.

In the limited space available here, we cannot discuss the political economy of the reform. Suffice it to say that since the gains to all—including the United States—are significant, there should be widespread support. But as an alternative, the reform could be implemented in a piecemeal manner, as a group of countries agreed to the new system, and agreed that those who join the system would hold gradually move to holding only the new reserve currency and the currencies of other members of the "club" as reserves. If enough countries joined the "club" there would be an incentive for any country that currently is a reserve currency (and believes that it gains from being a reserve currency) to join the club too.

Concluding remarks

It should be clear that the current global reserve system is not working well, that it is contributing to the current high level of exchange rate volatility, that this volatility has adverse effects on the global economic system. It is essential for the functioning of the global economic system that the global financial system functions well. The global financial system and the global reserve system are changing rapidly but are they changing in ways which will enhance global economic stability? This should be one of the key questions addressed by the IMF.

Certainly events of the last decades give us reason to pause and reflect on the weaknesses of the existing financial system. The developing countries

have experienced enormous instability which has come at great cost to the people in those regions. Some of that instability is a result of instabilities in the global financial system and of the failure of markets to shift risk to those in the developed countries who could bear it better.

The IMF needs to think carefully about the impact of each of its policies on the "risk" performance of national economies and the global economic system and about how to improve the risk performance of the system. The IMF needs too to think about how each of the policies it advocates affects the global distribution of welfare, and especially how policies affect poverty and the well being of those in the developing world. Modern economic theory has shown that when information is imperfect and markets incomplete, the economy is not in general Pareto efficient (or even constrained Pareto efficient). Modern theory has also shown that issues of distribution and efficiency cannot be separated, implying that one cannot ignore the distributional consequences of policy.

We have suggested that many of the reforms that the IMF has advocated in the past (such as capital market liberalization) have worsened the risk performance of the economy, increasing poverty and risk without increasing growth.

In this paper, we have discussed two issues that have not been on the agenda, which should be: transferring risk from the poor to the rich, and reforming the global reserve system. Reforms in both of these areas are central to the IMF achieving its central mission of enhancing global economic stability. Equally importantly, these are reforms which, if appropriately designed, can not only promote stability and growth, but also enhance global equity and reduce poverty. As the IMF turns sixty, it is time for it to turn to these fundamental issues in enhancing the performance of the global financial system.

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