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The Future of the IMF and World Bank: Panel Discussion

Stanley Fischer:[1] The International Monetary Fund performs several functions:

(i) It undertakes *surveillance* of the global economy and the economies of its members, reporting to its membership. Most of these reports are published.
(ii) It provides *technical assistance* to its members. The Fund staff draws on an unparalleled range of experience about what has worked in practice, and this assistance is generally regarded as highly valuable.
(iii) It serves, in the words of the Articles of Agreement, as "a permanent institution which provides the machinery for consultation and collaboration on international monetary problems." Virtually all international monetary problems end up for discussion, and often for implementation, in the IMF.
(iv) It *lends* to its member countries.

Among the many suggestions for reform of the Fund has been the proposal that countries prequalify for loans, to be provided virtually automatically when triggered by exogenous shocks. The Meltzer Commission recommended that, except in cases of systemic need, the Fund should lend only to prequalifying countries.[2] The Fund has long had a Compensatory and Contingent Financing Facility, which lends to countries adversely affected by changes in the terms of trade, but this facility is small.

More recently, the IMF developed the Contingent Credit Line (CCL) to lend to countries with good policies affected by external shocks. The Executive Board struggled to reach agreement on the CCL, mainly because many members of the Board were concerned that, by precommitting, the Fund would find itself lending to countries whose policies were not appropriate to their changed circumstances.

However, the CCL has had no takers. The main reason seems to be a Groucho Marx-type problem that no country that the IMF regards as good enough to receive the CCL has wanted to join the CCL club. Despite several attempts to solve that problem, the prospects for the CCL are unfortunately dimming.

Turning to Ricardo Caballero's (2003) paper, I read the suggestion that the Fund should have two departments, a Contingent-Markets Department and a Crisis Department, as an argument that the Fund should both lend in crises and promote the development of macroeconomic-shock-contingent markets. It would be a mistake to propose that these should be the Fund's only activities, for the valuable non-lending functions of the Fund described above should continue.

I am very sympathetic to the essential argument of the Caballero paper, that countries should use the capital markets to hedge exogenous country risks. With this insurance in hand, the government could run countercyclical fiscal policies; and as the markets develop, both individuals and firms could use them to hedge.

Caballero argues for very large hedging against macroeconomic disasters, rather than the hedging against "daily wiggles" provided by existing shorter-term commodity price hedges. In the Chilean case, he suggests the equivalent of a \$6–8 billion put, which would come into effect when the price of copper falls by more than two standard deviations for half a year. This is more than 3 percent of Chilean GDP.

The large hedging approach suffers from a disabling discontinuity: it would *add to* macroeconomic uncertainty, as it would for some time be uncertain whether a particular shock is large enough to activate the put. Thus "hedging against wiggles" may be a useful rather than a negative feature of the relevant derivative contracts. It is not obvious why Caballero confines the insurance to major disasters; nor do we get any sense of how frequent these would be. However, that is merely an argument about the design of the instrument. No doubt an instrument could be designed that would in principle remove much of the uncertainty produced by

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[2] The report of the Meltzer Commission (the International Financial Institution Advisory Committee) is available online at ⟨http://www.house.gov/jec/imf/ifiac.htm⟩.

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the external shocks confronting a developing country.

There remains the question of why long-term contingent contracts of this type so rarely exist. In the late 1980's, the World Bank tried to encourage the issue of commodity price-linked bonds by developing countries. Mexico has issued oil-price indexed bonds, but despite the increasing sophistication of the capital markets, and despite the incentives facing innovative investment bankers, there has been little use of such instruments. A few years later, Robert Shiller (1993) argued for the creation of a wide range of instruments to hedge against macroeconomic risks. Yet these innovations have not taken place.

Why? One reason is that there may be much more uncertainty about the stochastic behavior of shocks than regressions measure—given the uncertainty, there are very few people willing to bet on the price of copper ten years out. Add to that the Caballero proposal that the contracts be very large in aggregate. It is hard to envisage a risk-averse financial institution keeping such an obligation (which poses the risk of a large loss years ahead) on its balance sheet. The risks would have to be laid off. Whoever the ultimate holders of the contracts, they are unlikely to be willing to hold them at a low spread.

In addition, commodity prices are generally procyclical. This means that the payments to the developing countries would have to be made during global slowdowns, which again suggests that the spread on these instruments would have to be high.

Recognizing that private markets have been reluctant to innovate in this area, Caballero proposes that the IMF promote such contracts. In effect he would initially have the Fund sell the puts. But that is very close to the CCL, and the proposal would meet all the problems in the Board that the CCL did. In particular, the Board would fear being forced to make very large payments to a government with policies inappropriate to changed circumstances. Caballero argues that surveillance could ensure that policies stay on track. But surveillance is too weak a reed to provide sufficient reassurance.

Despite these comments, this is an interesting and useful proposal, which deserves to be promoted. It will only succeed if the private sector becomes involved. And if it does succeed, it will do so only by starting on a much smaller scale than recommended in Caballero's paper.

Allan H. Meltzer:[3] A principal implication of modern economic analysis is that governments or international organizations can improve allocative efficiency if there is evidence of an externality and the government agency or international organization can provide the public good or reduce the externality at a cost that is lower than the benefits obtained. In a dynamic context, these costs include the costs of bureaucracy—the impediments to change that arise in any bureaucracy, impediments that slow and even prevent socially beneficial changes.

What public goods can the International Monetary Fund and the World Bank provide at a social benefit greater than the social cost? After two decades of intermittent crises, questions arise about the net benefit that these institutions provide.

The IMF in principle could provide two benefits. First, it can reduce risk of international or global financial crises by serving as a quasi-lender-of-last-resort. Second, it can provide information, accounting, and financial standards that reduce costs of acquiring information. Better information improves market allocation by permitting market participants to make more-informed choices. One possible benefit would be less herd-like behavior by lenders. If lenders know only that a major lender is not renewing its loans, the probability that the country may be forced to devalue and default rises. Reducing exposure to the country becomes a more prudent strategy than before.

It is well established that markets respond to new information. The IMF has an advantage in obtaining information because of its working relationship with many developing countries and its mandatory Article 4 reports on country developments. The IMF was slow to develop standards to improve the quality of information and slower still to make the information public. There has been much improvement in recent years, but much remains to be done.

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The IMF's most important tasks are crisis prevention and amelioration, including service as a quasi-lender-of-last-resort. The IMF has interpreted its responsibility broadly, but its achievements have been limited, and its record is mixed. Neither its staff nor outsiders find evidence that countries in IMF programs, and subject to its conditional assistance, systematically suffer smaller losses of output than other countries.

The IMF should restate its principal mission. Instead of lending to all countries with problems, it should limit its role to preventing the spread of crises from troubled economies to their neighbors, trading partners, and others. Instead of lengthy negotiations to extract promises of reform, it should not lend to countries that have not adopted and maintained some specified reforms.

Instituting these changes would greatly change incentives for countries and lenders. Governments that wished to reform could explain to voters that the country would be less risky. It would, therefore, obtain more capital for development from abroad at lower cost. The IMF would be freed from the onerous burden of engaging in lengthy negotiations or reform agreements that countries often fail to implement or sustain. Lenders would know that if they lend to countries that have not reformed they should expect to take losses in a crisis. Market interest rates would reflect differences in risk, so market efficiency would improve.

This reform seeks to replace the present command-and-control system with an incentive-based system. One likely consequence would be less international lending in the form of loans or bonds with perhaps more foreign direct investment. This, too, would improve the relation of risk and return.

The World Bank poses a more difficult problem, because the nature of the public good that it provides is less clear. Originally a main purpose was to correct a possible market bias against developing countries. For the past 20 years, or longer, many of the problems in developing countries arose because the country or its residents attracted too much lending, especially too much short-term lending. The development banks and the IMF paid too little attention to the risky situations they helped to create, and lenders expected bailouts or support when problems developed.

If the World Bank were less bureaucratic and bumbling, it might be possible to learn what it does more efficiently than the private sector. The Report of the International Financial Institution Advisory Commission conjectured that the World Bank might add value in four ways.

First, Bank staff are experts on many technical problems faced by developing countries. Developing countries should be able to rent this expertise, perhaps at a subsidized price.

Second, the development banks can support programs to raise the quality of life for people in impoverished countries with inefficient or corrupt governments. The Commission proposed monitored grants, in place of loans, with payments to vendors for performance. With commendable effort the Bush Treasury was able to get agreement from other donor countries and the Bank to shift part of its subsidized development lending to monitored grants.

Third, the Bank can finance global or regional public goods by getting countries to agree on environmental safeguards, disease eradication or reduction, and similar programs with large social benefits and low market returns.

Finally, the most difficult of all is to develop incentives for countries to introduce and sustain structural reforms. These reforms include rule of law, democratic accountability, protection of private property, economic stability, and openness to trade.

Jeffrey D. Sachs:[4] Some of the key controversies swirling around the IMF involve the Fund's role in the low-income countries. Many of the world's poorest countries have had prolonged loan-cum-conditionality arrangements with the International Monetary Fund, including 20 sub-Saharan African countries that had 10 years or more under IMF programs during the period 1971–2000 (International Monetary Fund, 2002 p. 37 [table 2]). A significant proportion of those countries failed to achieve sustained economic growth or to recover from debt crises that

[4] Earth Institute, Columbia University, 314 Low Library, 535 West 116th Street, MC 4327, New York, NY 10027.

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began in the 1970's and 1980's (Sachs, 2002). There is a strong case for a revised IMF approach.

One of the cruel ironies of international development is that high-income countries achieve economic growth with regularity while many of the poorest countries experience chronic stagnation or decline. Consider the data from Angus Maddison (2001) for countries with a population of at least 1 million persons, and excluding the fuel-exporting developing countries. All 19 countries with 1980 per capita incomes (in 1990 international dollars) above $10,000 experienced positive economic growth during the period 1980–1998. Of 57 countries with per capita incomes below $4,000 in 1980, 27 countries, or nearly half, experienced outright declines in per capita income. This highlights the fragility of economic growth in poor countries. Many of these countries are trapped in low and declining living standards.

There are many reasons for a poverty trap. Poor countries often lack the resources to address problems of poor governance, weak infrastructure, and disease. Very poor countries also tend to have very low saving rates, since current income is used for survival itself. These adverse conditions frustrate growth and keep the country stuck in poverty. Some poor countries are able to escape from poverty in part because they enjoy certain beneficial conditions, such as proximity to major markets, good natural ports, favorable conditions for disease control (e.g., low risk of malaria), while many other countries do not enjoy such supportive conditions. Geographically isolated countries (John Gallup et al., 1998) and those burdened by adverse disease ecology (World Health Organization, 2001), for example, are prone to a poverty trap. In such cases, international donor support through debt relief and development assistance can nudge a country out of a poverty trap and onto a path of self-sustaining growth.

IMF policies during the 1980's and 1990's in the low-income countries focused excessively on macroeconomic stabilization, trade liberalization, and privatization of government assets, while neglecting disease, geographical isolation, and the overhang of bad debt that all contributed to poverty traps. In recent years, IMF strategy has been getting more realistic, with a greater focus on debt reduction and the benefits of social spending (Sanjeev Gupta et al., 2001; Paulo Silva Lopes, 2002). Still, the changes have not yet been adequate (Sachs, 2002).

The greatest continuing weakness of current IMF programs in the poorest countries is the absence of systematic analysis of the overall financing requirements that need be to overcome in order to restore growth. What is needed is an arrangement whereby the IMF would work with each country to calculate the external assistance that would be necessary to enable the country to escape the poverty trap, mainly by ensuring an adequate flow of public services in health, education, basic infrastructure, policing and public administration, after which the IMF would turn back to the donors and creditors to help arrange the needed financing package. In essence, the IMF would calculate a "development financing gap" to be filled by donors according to a systematic assessment of budgetary needs in response to prevailing conditions of disease, isolation, illiteracy, high fertility, and other constraints to economic growth. Since increased development financing will be successful only when adequate governance is in place, conditionality will also be required to link the increased donor support with good governance. Happily the needed domestic governance is already in place in many long-suffering impoverished countries.

Nicholas Stern:[5] The paper by Abhijit V. Banerjee and Ruimin He (2003) makes a number of sensible points about the comparative advantage of the World Bank. In particular, it argues that (i) the Bank should be a leader in terms of establishing and promoting what works and what does not—that is, it should be an agent of change; (ii) to do this effectively requires careful analytical selection and evaluation of projects and programs; and (iii) it also requires a careful combination of instruments (concessional loans, grants, studies, research) that will vary according to country circumstances.

In assessing the past and considering the future, the paper does not, however, take adequate account of how much the world, our thinking about development, and the World Bank all

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have changed over the last 2–3 decades and, particularly, the last 10 years. There has been unprecedented poverty reduction, concentrated mostly in Asia. There have also been impressive gains in developing countries in life expectancy (20 years since 1960) and infant mortality that are more broadly spread. But some locations in the developing world (e.g., East Asia) have performed far better than others (e.g., sub-Saharan Africa). In terms of development thinking, there is now widespread appreciation that countries are poor primarily because of weak underlying institutions and policies. Furthermore, it is clear that an outside agency such as the Bank is not, and should not be, in the driver's seat when it comes to bringing about change. Fundamental reform depends on countries' own actions. The locations where we have seen large-scale poverty reduction are the ones in which we have seen sustained domestic reform movements: China, Vietnam, Uganda, and India (particularly in some states).

In my view, to assess the effectiveness of the Bank in supporting institutional change would require detailed country case studies. If one took the four relatively successful cases above and added in Bangladesh, Nigeria, Indonesia, Russia, and Brazil, that would cover 60 percent of the population of the developing world. Case studies of these countries, including asking policymakers, would help us answer whether or not the Bank has helped them with their reforms at both the macro- and microeconomic level. This would be a much more useful exercise than the casual cross-country regressions that Banerjee and He present. There is already a great deal of material to help us. Aside from the general problems with Banerjee and He's approach, a number of their regressions are impossible to interpret. The Bank explicitly has two different financial product lines with different allocation criteria (IDA [concessionary credits] and IBRD [loans]). The authors add these together, but the two product lines are designed to have different relationships with right-hand-side variables, so there is no meaningful interpretation to the resulting coefficients.

The third thing missing from the Banerjee-He paper is any appreciation for how the Bank is changing in response to developments in the world and in development thinking. My own vision of the future World Bank involves strengthening some important trends that are already underway. Let me highlight three. First, the World Bank has decentralized and placed large numbers of staff in the field. This shift reflects a whole new model of supporting change. If the same blueprint works in each country, then some specialists sitting in Washington can take the blueprint to the field. If, alternatively, each country and community has to find its own way, drawing on lessons of what has worked elsewhere, then it is important to have staff working shoulder-to-shoulder with clients.

Second, in the last few years the Bank has moved away from conditionality toward selectivity in its support. For IDA credits (designed for poorer countries), we look at a variety of institutional and policy indicators and allocate more IDA overall to countries with sound institutions and policies. In recent years, for example, Uganda has received more IDA financing than nearby Kenya, which would not have been the case 15 years ago.

The third change in the Bank, which serves both as a safeguard and a learning tool, is that we now build more scientific evaluation into projects. There are many examples of projects that have the kind of careful evaluation that Banerjee and He propose. As chief economist, naturally I would like to see even more expansion of careful evaluation and more of our research built around evaluations of microeconomic interventions. But I see this as strengthening a trend underway, not as a sea change in how the Bank operates.

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