IS THERE A NEED FOR AN INTERNATIONAL LENDER OF LAST RESORT?

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In a luncheon speech at the AEA meeting on January 3, 1999, Stanley Fischer argued the case, in a reformed international financial system for "an agency that will act as lender of last resort for countries facing a crisis." He asserts that there is a need for such an agency and "that the IMF is increasingly playing that role, and that changes in the international system now under consideration will make it possible for it to exercise that function more effectively." One would never know that Fischer's remarks that the IMF has been subject to serious charges by critics of its performance not only with respect to its policy recommendations but also with respect to the basic loan agenda as creating moral hazard for country borrowers and foreign lenders. His lengthy discussion of moral hazard never implicates the IMF. He offered nothing more than a public relations effort to promote an expansive role for the IMF.

The speech raises at least three questions. First, is it true that the IMF possesses the attributes of a lender of last resort? Second, one should ask whether the countries that were recipients of IMF loans have benefited or been harmed by its operations. Would they have been worse off, had they had to manage without the IMF? Third, Fischer discusses the possibility of countries pre-qualifying for IMF loans. Is that a workable scheme?

Attributes of a Lender of Last Resort

A financial panic occurs in the money market. It can be quickly ended by a LOLR. A financial crisis occurs when asset prices plunge, whether of equity, real estate, or commodities, when the exchange value of a national currency experiences substantial depreciation, when a large non-financial firm, a large municipality, a financial industry, or a sovereign debtor defaults. A financial crisis is a prolonged disturbance that is resolved by government agencies other than the central bank, although at some stage it may provide liquidity to the market through the discount window or open market purchases. The collapse of the U.S. savings and loan industry is an example of a financial crisis that initially involved the deposit insurance agency and subsequently a new agency—the Resolution Trust Corporation—to deal with the problem. Resolving the savings and loan crisis was not a lender of last resort responsibility.

According to Fischer, the IMF now sees itself as a financial crisis manager and a financial panic lender, and seeks the status of an international lender of last resort. It is a confusion of two roles in a domestic setting, and betrays a faulty resetting of a domestic LLOR as an international lender of last resort.

Which attributes of a domestic LOLR must an international LOLR have? A domestic LOLR can create high-powered money without limit. Can the IMF create international reserves? Fischer's answer is that the IMF "has access to a pool of resources, which it can onlend to member countries." He notes that its resources, if they bore the same size relative to output, to the quota formula, to the volume of world trade, as in 1945, would be three, five, or more than nine times larger than it will be in 1999. Is there an implication that quota increases that have been sought every five years since the IMF founding will in the future be sought more often? Fischer also counts on the IMF's use of authorization to create SDRs as a supplement to its resources, and its ability to borrow. Therefore, according to Fischer, the IMF has the capacity to act as crisis lender to individual countries. One wonders, what happened to the idea that the IMF was a revolving fund of relatively small, short-term loans that countries repaid so others could borrow?

One major difference between a central bank LOLR and the IMF, to which Fischer does not allude, is that the IMF needs a vote of its Executive Board to take any action. It has no independent authority, such as a central bank has, even one subject to the consent of the minister of finance. Fischer refers to a complaint that the Fund is too slow in emergencies, but counters that the Emergency Financing Mechanism, introduced after the Mexican crisis, enables it to move very rapidly. Very rapidly means after weeks or months, while an agreement with the distressed country is produced. A central bank has the freedom to act with dispatch within days.

The IMF, it is clear, is only a simulacrum of a LOLR. It is not the real thing. What will its function be? There will be changes in the international financial system that Fischer describes—a shift to floating exchange rates, larger holdings of international reserves by emerging market countries, private sector involvement in financial crises, international standards—but he does not enumerate any changes in the way the IMF operates. The IMF will still provide loans to pay off a country's foreign debts, although since 1998 no longer at subsidized interest rates, and will impose fiscal and monetary conditions and micromanage institutional behavior. Are these IMF activities that should be perpetuated?

Emerging Market Countries Without the IMF

Every country that has a recipient of IMF loans has suffered a severe decline in output, punishing high interest rates, and accelerating inflation, despite the loans. The loans are massive, but the IMF has never revealed how it determines their magnitude, or how the recipient has expanded them. It may not even know how the money was spent. In the Mexican case, it seems that the money was given to local and foreign Tesobono investors. In the absence of the IMF loans, investors would have taken a hit but economic conditions in Mexico would have been no worse than they were with the loan, and Mexico would not have had the burden of repaying the loan.

The IMF is a paternalistic institution whose staff assumes that it possesses wisdom superior to that of the officialdom of the countries to whom it is lending. It acknowledges mistakes ex post. An emerging market country that gets into trouble does not need the ministrations of the IMF to overcome its difficulties.

The problems may be a financial panic or financial crises or both. If the banking system is short of liquidity, the domestic central bank, not the IMF, must create high-powered money to calm depositor fears. If the monetary and fiscal situations indicate lax policies, if the current account deficit is growing as a percent of GDP, foreign investors will be seized by doubts about the economy's viability. A government or the private sector that has borrowed abroad will be faced with sudden investor flight. Asset markets in which the investments were made will plunge, and the exchange rate of the domestic currency will depreciate. Correction of the conditions that produced this setback must fall on the troubled country, not the IMF. If it cannot service and amortize its foreign borrowings, the country, not the IMF has to negotiate a workout with the foreign lenders.

If individual banks or other financial institutions are insolvent, domestic agencies either exist or must be established to recapitalize or shut them down. The same solutions apply to corporate and in non-financial businesses that are in trouble. Financial crises unlike panics, are not quickly ended. They may require fiscal infusions and the resolution may not be attained for months or years. Compensating for the loss of wealth that a financial crisis imposes may exact a reduction in personal consumption and increased national saving over an extended period. This is what troubled countries have to endure. The presence of the IMF does not spare them from these bleak consequences.

It is hard to see why Fischer proposes lending freely by the IMF on Bagehot's rules through the Supplementary Reserve Facility. Given global capital markets that will be ready to lend to countries that are willing to pay a penalty rate of interest and to offer good collateral, why is the IMF needed?

Fischer parses lending freely as meaning "ready to lend early and in sufficient amounts to other countries that might be affected by contagion from the crisis." He nowhere defines contagion or justifies the assumption that it occurs.

Contagion, if the term is used accurately, occurs only in circumstances in which other countries are free of the problems of the country that first experienced trouble and yet suffered unwarranted investor disaffection. It has become a dogma since the 1995 Mexican bailout that there was a tequila effect. The evidence of contagion that has been offered since then is that the currencies and stock markets of countries (other than the original one to surface with problems) have declined. What is overlooked or deliberately omitted is that the countries said to be victims of contagion had the same problems as were present in the country that was supposedly the source of contagion. Proponents of the contagion dogma do not explain the absence of contagion from the New York stock market crash of 1987 or from the 1990 crash of the Tokyo stock market and property bubbles.

A final point is that a country that cannot meet the conditions for borrowing that the private market sets may require financial aid. Outright gifts from an international agency may be the right solution for such a country.

Is Prequalification for a Loan a Workable Scheme?

President Clinton would give the IMF the right to arrange precautionary credit lines for member countries on which they could draw to supplement their reserves before they are engulfed in a financial crisis. If substantial members of 182 member countries would prequalify, the IMF would clearly require a big increase in its supply of funds. Fischer believes this is a proposal worthy of consideration. Secretary of the Treasury Rubin has, however, questioned its practicality on grounds that lenders would assume that they would be bailed out if countries were assured of IMF assistance in the event of a crisis because they prequalified. What if a country that prequalified because it met certain criteria subsequently did not live up to the criteria? Brazil might have been such a prequalifier, yet once it had access to IMF funds could not satisfy any of the conditions on which the loan had been granted. The loan furthermore did not restore investor confidence. The proposal also assumes that the IMF can know in advance when a crisis will occur, when there is no record that it has acted on early warning signs. True, it has claimed that it warned East Asian countries in advance of the crises that befell them but its warnings were disregarded. This is an additional reason to doubt that the world will be the worse if the IMF is stripped of its illusions that it is an international lender of last resort.

Concluding Comments

Countries need a central bank to fill the limited role of a LLOR in a financial panic. Central banks have no special function when a financial crisis occurs. Other agencies must then take charge. The IMF has neither attribute of a LLOR—power to create unlimited amounts of high-powered money and independent authority to exercise that power. It is not needed if many countries experience a financial panic—each of them has a central bank. If many countries face financial crises, each of them has to reconstruct the broken elements of its financial system, whether domestic institutions or negotiations with foreign lenders. If they need to borrow abroad, they will find private sector lenders in international capital market if they will pay a penalty rate and offer good collateral. These are the terms of the IMF now says on which it will end. The IMF may then be a lender in competition with private capital markets, but that does not make it an ILLOR. The IMF was established in 1944 to serve as a lender to countries when private international capital markets were limited and repressed. In the 1990s private international capital markets are deregulated and flush with funds. Is the existence of the IMF in this decade a statement that the market is a failure?