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Managing Crisis: What Do International Organizations Contribute?

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It is ironic that, at a time of ever-growing recognition of "globalization" and rising interdependence of economies, the three key multilateral economic institutions—the International Monetary Fund (IMF), the World Bank, and the World Trade Organization (WTO)—seem to be under siege. One would think that the greater importance of the international economy to the United States would lead to rising support for these institutions, but this seems not to be the case.

For years, the World Bank was the premier institution fostering development of poor economies, primarily through project lending. More recently, it has diffused its energies over a multitude of issues, which may partly explain its apparent loss of support. There is much to be done in many countries where poverty remains a major concern and it is highly desirable for the Bank to refocus on alleviation of poverty.

As for the WTO, the increasing importance of trade demands that we agree on international rules. Were there not a WTO, a very similar organization would have to be invented. Actions that weaken the WTO weaken the international trading system, and thereby reduce the prospects for raising living standards throughout the world.

The Role of the International Monetary Fund

This brief examines the IMF, the international economic institution charged with oversight of the system of exchange rates between currencies. One of the Bretton Woods "twins" (the other being the World Bank), its original purpose was to prevent the "competitive devaluations" that plagued the world during the 1930s and clearly intensified the Great Depression. In its first quarter-century, the IMF was the linch-pin of the Bretton Woods system of "fixed, but adjustable" exchange rates. That system served the world well, as evidenced by the very rapid growth of real incomes and trade, especially in industrialized countries.

When the United States, Europe, and Japan abandoned the system of fixed exchange rates in 1973, the IMF's attention naturally turned to problems of exchange rate regimes in developing countries. Many of those countries maintained fixed exchange rates for extended periods despite having higher rates of inflation than their main trading partners. In consequence, after an exchange rate had become increasingly overvalued in real terms because of differential inflation, evidence would point to the inability of that country to meet its foreign currency obligations. At that point, speculators would attack the currency (by withholding exports in anticipation of devaluation, by speeding up import shipments, and by other legal and illegal means of shifting assets from local currency into foreign exchange), and the government would face a "foreign exchange crisis."

The crisis, of course, had its origins in high inflation, usually as a result of fiscal deficits. In those circumstances, countries' governments would approach the IMF for support and for loans to enable some imports to continue. Before agreeing to a loan, the IMF staff would want assurance of changes in policies so that the country would not quickly find itself in a new crisis. This generally meant negotiating reductions in fiscal deficits, a change in the exchange rate, and a rescheduling of debt-servicing obligations. When the IMF and the policy makers in the country agreed on a policy package that offered the promise of success, an IMF loan would be extended with "conditionality," stipulating measures for the government to correct the underlying imbalances that precipitated the crisis.

Until the 1990s, IMF-supported programs were generally for relatively poor countries, most of which had capital controls. By the 1990s, however, there were middle-income countries where rapid economic development resulted from changed economic policies, including opening the economies to foreign trade and relaxing capital account restrictions. Among those countries, Mexico, in 1994, and Korea, Thailand, and Indonesia, in 1997, had major balance-of-payments cum financial crises. These differed somewhat from earlier crises because the pre-crisis weakness of the domestic banking systems precipitated further non-performing loans and financial difficulties.

Resolving these crises with IMF support was more difficult than the traditional "balance-of-payments crisis" for two reasons: 1) relatively open capital accounts meant that speculative flows were large and allowed little time to agree on appropriate policy changes; and 2) the needed financial restructuring inevitably involved restructuring of the finances of large debtor companies along with those of banks.

When the IMF supported Thailand, Indonesia, and Korea in 1997-98, the "conditionality" imposed on the borrowing countries extended far beyond what had been typical of earlier agreements with other countries. This was because the impaired financial systems had to be restored to health for economic growth to resume. Immediately, loud criticisms of the IMF arose. Some of them had validity: some conditions, which would enhance the prospects for long-run economic growth, were not essential to resolve the crisis.

Other criticisms focused on the moral hazard presumably created by the IMF: allegations that banks lent to developing countries without proper scrutiny because they were sure the IMF would "bail out" the countries, and hence the banks too. Although private bank lending to developing countries certainly would be less if there were no international economic order, and measures are under-way to reduce moral hazard, most observers and analysts, with hindsight, have viewed this issue as being of secondary importance. This is especially true in light of the very rapid recovery of Korea and the emergence of the whole East Asian region from crisis much faster than many had thought possible. One observer questioned whether any criticism of the IMF was justified in light of the rapid resumption of growth in Korea, the country that most closely followed the IMF prescriptions! Indonesia has fared much less well, but its severe political difficulties have resulted in much slower implementation of its IMF programs.

Lessons for the Future

The big lessons that most analysts derive from the 1997-98 crisis focus on exchange rate regimes. There are very few instances of developing countries being able to fix (or target) their exchange rates for lengthy periods. The crisis-afflicted countries, including Mexico in 1994, all had attempted to fix their exchange rates. Allowing exchange rates to adjust to changes in market conditions with less "steering" by governments can reduce the risk of crisis. So, too, can the holding of larger foreign exchange reserves. And there can be more careful attention to early warning systems, appropriate conditionality, and a number of other fine-tuning changes in the IMF's programs and in countries' policies that will reduce the likelihood of future crises and make adjustments, when they are necessary, somewhat easier to manage.

Good economic policy can reduce the number and severity of crises; it cannot eliminate them all. But the crisis of 1997-98 in Korea seems a small price to pay for the four decades of very rapid economic growth that preceded it. Such "stable countries" as India may have avoided crisis but at the cost of excessively slow growth. The challenge—for policy makers, researchers, and the IMF—is to promote growth in ways that reduce the likelihood of crisis and the severity of its impact when it occurs.

About the author

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