Issue Brief

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The Growing Case Against the International Monetary Fund

By: Stephen Moore

"Capitalism without risk is like religion without sin."
-Allan Meltzer, Carnegie Mellon University

As the economic crisis in East Asia and Russia deepens, the international foreign aid establishment is intensifying its pressure on the United States to replenish the coffers of the International Monetary Fund (IMF). The Clinton Administration—and in particular Treasury Department officials Robert Rubin and Lawrence Summers—have been tightening the screws on Congress, threatening to blame the Asian flu on Republicans if they refuse to fund the IMF. The Fund is requesting a $3.5 billion emergency aid package and an additional $15 billion in loan guarantees from the U.S. government to underwrite future IMF lending to economically troubled nations.

The good news is that many free-market oriented leaders in Congress have so far held up the IMF bail-out funds. House Majority Leader Dick Armey is leading the resistance to the bail-out, calling IMF activities a form of "foreign aid socialism." In the Senate, Lauch Faircloth (R-NC) has lambasted the IMF rescue plan. Faircloth writes that we have a new foreign policy in America dubbed "the Rubin doctrine," with the guiding principle that "international bailouts are good policy if Wall Street is not allowed to suffer any losses for its poor credit decisions."

"The IMF is ineffective, obsolete and unnecessary.... Once the Asian crisis is over, we should abolish it."

The economic chaos that now reigns in Russia has also added to skepticism of the IMF. From 1992 through 1996 the IMF provided nearly $20 billion in emergency credit to the Yeltsin government. But that money has had zero impact on economic conditions in Russia. It has not prevented a 9 percent decline in industrial production this year or the 70 percent Russian stock market drop. It did not prevent the August ruble devaluation. It has not compelled the Russians to fix their decrepit tax system. And it has not helped lay the foundations for the rule of law in Russia, which is a pre-condition for capitalism. Some reformers in Russia have even maintained that IMF funds have impeded progress, serving as "a drug helping to maintain an unfit government."[1]

1 See: James A. Dorn and Ian Vasquez, "Ending Russia's Chaos," *The Journal of Commerce*, Sept. 3, 1998.

This anti-IMF position has also been fortified by growing skepticism among economists and business leaders—some of whom formerly supported the IMF. The list of prominent IMF opponents includes Nobel-prize winning economists Milton Friedman and Gary Becker, former Treasury Secretary William Simon, former Secretary of State George Shultz, former Federal Reserve Board member Lawrence Lindsey, former Citicorp chairman Walter Wriston, and top Wall Street economic advisers Arthur Laffer and Lawrence Kudlow. A joint statement by Shultz, Simon and Wriston declared: "The IMF is ineffective, obsolete and unnecessary.… Once the Asian crisis is over, we should abolish it."

"The IMF's insurance scheme is very closely modeled after the FSLIC deposit insurance policies that created the savings and loan bail-out crisis in the United States in the late 1980s."

They are right. This paper summarizes the three major arguments against continued U.S. involvement in the IMF. They are:

❶ **The IMF has a dismal track record of promoting growth in the nations it supposedly aids**. One recent study found that of 137 mostly developing countries that have received IMF rescue funding from 1965-1995, only 44—or less than one-third—have graduated from needing assistance. Incredibly, 81 countries have actually seen their dependence on the IMF grow over time. Worse yet, there are 43 nations that have been receiving IMF aid for more than 20 years. The IMF is reminiscent of the "Hotel California:" you can check out any time you like, but you can never leave.

❷ **IMF policies contribute to a severe misallocation of investment capital by encouraging over-investment in politically risky and economically unstable nations**. Through its credit and insurance policies, the IMF essentially tells bankers and investors who put their money at risk in nations such as Mexico, Indonesia, and Thailand that their investments carry an implicit IMF guarantee of repayment. This establishes a conflict of interest that economists call a "moral hazard." Many economists believe that the Asian crisis was exacerbated by the IMF bail-out of the Mexican peso back in 1996, because investors now felt secure that risky business ventures in Indonesia and Malaysia carried IMF protection. The IMF's insurance scheme is very closely modeled after the FSLIC deposit insurance policies that created the savings and loan bail-out crisis in the United States in the late 1980s.

❸ **The IMF's bail-out mission is obsolete.** The mission of bringing stability to currency and capital markets is laudatory. It may have been necessary 30 years ago when nascent financial markets lacked the efficiency to gauge risk. Today's capital and currency markets are mature, sophisticated, and highly efficient. In 1996 private investors directed some $300 billion of private capital into developing nations. These funds are 3 to 5 times more than IMF capital and thus swamp the effects of IMF policies.

"The antidote is not to artificially prop up the currency of these nations.… To do so is to treat a symptom, not the disease."

The global financial marketplace is impervious to national borders and instantly mobil. When capital flees from a nation or when investors lose confidence in a nation's currency—as has been the case in Indonesia and to a lesser extent Japan, for example—the marketplace is emitting clear and powerful signals to these nations that their government policies have malfunctioned. The antidote is not to artificially prop up the currency of these nations—as the IMF and the Clinton Treasury Department have attempted to do in recent months, for example by making billions of dollars of purchases of Japanese Yen. To do so is to treat a symptom, not the disease.

IMF bail-out funds will not lure investors back to Indonesia, Thailand, Singapore, and Malaysia. The proper prescription for these nations is to cut tax rates, reduce trade barriers, privatize state-owned assets, reform their corrupt banking practices, end crony capitalism, better protect property rights, and adopt a currency board ideally with a fixed rate of exchange to the dollar. Japan finally recognizes this and has proposed lowering its confiscatory high 65 percent income tax rate down to a more reasonable—but still too high—50 percent. This correct policy prescription was not forced on Japan by the IMF, but by capitalists who were deserting the Yen and Japanese markets. Despite free-market lip-service from the IMF, the history of the Fund is replete with examples of its "advisors" opposing precisely these policy prescriptions.

In short, currency failures and capital flight in East Asia are not a result of private sector failure, but of government failure. It should be self-evident to policy makers that the solution to government failure is surely not more government—via the IMF.

If the U.S. does not fully fund the IMF, will the Asian flu spread, as Treasury Secretary Rubin has warned? The answer is that the IMF is irrelevant to the recovery process. The Fund has already dumped $120 billion into East Asian in the past eighteen months, yet there has been no discernible effect on economic conditions there. Indeed in many of these nations the crises have intensified. Ironically, the nations in East Asia that have steered clear of IMF interference are recovering more rapidly.

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So what should Congress's policy be with respect to the future of the IMF? Given current political conditions, the best course of action would be for Congress to approve the $3.5 billion emergency bail-out funds for East Asia that are already (unfortunately) committed, but to veto the IMF and Clinton Administration's request for $15 billion to finance future bail-outs. In the midst of the Asian crisis, the IMF is now poised to pump $22 billion into Russia. China may be next. Then Brazil. Congress needs to put an end to this bail-out madness. Denying the IMF $15 billion carte blanche authority to intervene in future crises will send an unambiguous message to American bankers, currency traders, and international investors that the IMF corporate welfare gambit is up; that in the future their international investments and loans will not carry a implicit guarantee of U.S. taxpayer insurance—whether those investments are in Mexico, Russia, or East Asia.

The goal should be to withdraw all U.S. support for the IMF—and it's even more corrupt sister agency the World Bank—within 5 years. If the Europeans choose to continue funding these international lending institutions, that is their business.

What is increasingly clear is that the global economy will be more stable and prosperous in the twenty-first century if the global marketplace is devoid of an IMF.

The IMF And Its Allies

Treasury Secretary Robert Rubin now has pending two separate IMF funding requests before Congress. The first and most urgent is the $3.5 billion in special bailout funds to fill the IMF's depleted coffers—depleted as a result of the nearly $120 billion in loans to Asian governments in the past year. The IMF has also requested an additional $15 - $16 billion in special drawing rights (SDRs). These SDR's are the equivalent of giving the IMF a direct line of credit to the U.S. Treasury. Rubin warns that "failure to

approve the IMF funding could cause a global financial crisis." He has sounded the sirens to investors that if the IMF runs out of funds, the Asian crisis will spread—thus threatening to wreck the bull market expansion that has created so much wealth and prosperity here in the U.S. (In recent weeks, however, congressional investigations have called into question whether the IMF is truly out of money.)

Supporters of the IMF include an impressive list of business heavyweights. The corporate community—and in particular U.S. banks who are direct beneficiaries of IMF bail-out funds—have rolled out the heavy P.R. artillery. Back in February a coalition of IMF corporate supporters took out full two-page ads in both the *New York Times* and the *Washington Post* (this costs roughly $200,000) calling for Congress to approve funding. The letter was signed by a veritable "Who's Who" of Fortune 500 CEOs. It was paid for by household names in corporate America: General Electric, General Motors, IBM, ITT, Chase Manhattan, BankAmerica, Time Warner, and Times Mirror.

"The very countries that are now ailing were until very recently held up as having model economic systems."

Perhaps the IMF's most influential support comes from the political elite of both parties. Among the prominent backers of the IMF within the GOP are James Baker, Henry Kissinger, Lynn Martin, Bob Dole, Nick Brady, Gerald Ford, and George Bush. Fed Chairman Alan Greenspan has also urged Congress to approve IMF funding, as has George Soros.

The elites have corralled one highly influential "yes" vote on Capitol Hill: Newt Gingrich's. The *Washington Times* reports that Speaker Gingrich is actively attempting to rally votes for the IMF among his skeptical colleagues.

The good news is that opposition to the IMF is still strong. Senator Lauch Faircloth of North Carolina has been a leading and influential critic of the IMF. Faircloth is a proponent of approving the $3.5 billion Asian bail-out funding, but to kill the Clinton administration's request for an additional $15 billion. This sensible outcome would allow IMF "aid" to continue to flow to the sick Asian tigers—Thailand, Indonesia, the Philippines, and Korea—but would severely curtail the IMF's cart blanche authority to intervene in capital and currency markets anywhere at anytime across the globe.

How the IMF Misdiagnosed the Asian Crisis

The sad irony of the Asian crisis is that the very countries that are now ailing were until very recently held up as having model economic systems by many American economists. Throughout the 1980s the liberal policy elite argued that the U.S. should be less hostile to governmental intervention and more like Japan, Korea, Singapore, etc. In an influential 1987 book *Trading Places*, economist Clyde Prestowitz wrote of the coming Japanese global domination thanks to its industrial policy framework. In his best seller, *Next American Frontier*, Robert Reich of Harvard and soon-to-be Clinton Labor Secretary, noted: "Japan's emphasis on community, consensus and long-term security for its workers appears to have driven its citizens to greater feats of production than has the rugged individualism of modern America." And finally, David Friedman of MIT effusively praised the Japanese economic system of government support of strategic industries and warned that "Japan's new financial empire threatens America."

Especially after the Berlin Wall fell and the illusion of socialism was shattered, the economic community shunned free market capitalism in favor of "the third way" of government-industry partnership, as perfected by

the Japanese and later the Koreans. Adam Smith-style laissez-faire capitalism was spurned as outmoded and noncompetitive. This new economic dogma was most concisely summarized by Robert Reich, who quipped that "the Cold War is over; Japan won." U.S. companies were said to be incapable of vying with the Koreans and Japanese and their massive government hand-outs to steel, auto, aeronautics, semiconductor, video, and computer industries.

"If there is anything positive that can come out of the terrible toll of the Asian economic crisis it is that the industrial policy/corporate welfare model of development can be labelled an expensive canard."

Today, many of these heavily-subsidized industries in Japan and the rest of East Asia are known to be technically financially insolvent. *The New York Times* reported in late July that the Japanese banks may be carrying a staggering $1 trillion of nonperforming business loans in portfolio. The once mighty Japanese auto industry is faltering with only Honda still recording strong profits. The situation is worse in the rest of East Asia. Up to half of bank loans in Indonesia are in delinquency or default. A 1996 report by the well-respected McKinsey Global Institute found that capital productivity in Japan was only 63 percent of the U.S. Only in automotives was Japanese industry competitive with America's. In short, years of Japanese industrial policy had led to a severe misallocation of capital in that nation.

If there is anything positive that can come out of the terrible toll of the Asian economic crisis it is that the industrial policy/corporate welfare model of development can be labelled an expensive canard. Government-industry partnerships erode competitiveness, misallocate resources, and foster corruption.

One reason to be highly skeptical of the IMF's ability to guide these nations out of their current economic turmoil is that the IMF has long trumpeted the East-Asian model that is now in collapse. In fact just one year before the Asian bubble burst, the IMF economists had given these nations a clean bill of health and forecast continued strong growth. Its reports gave glowing assessments of the Thai and Korean financial systems. A year before the currency crisis hit, the IMF officials never saw the storm approaching.

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After the Mexican bail-out the IMF had assured U.S. policy makers that it would develop an "early warning" system to avert such crises before they arose. That alarm system has quite clearly short-circuited.

But it gets worse. In early 1998 the IMF signalled to financial markets that the Asian crisis had bottomed out and that these nations were back on the right track. IMF Director Michel Camdessus announced in early February: "I don't want to sound over [sic] optimistic, but we are accumulating the bricks for the foundation of a more solid Asian economy." He announced that South Korea and Thailand had turned the corner.

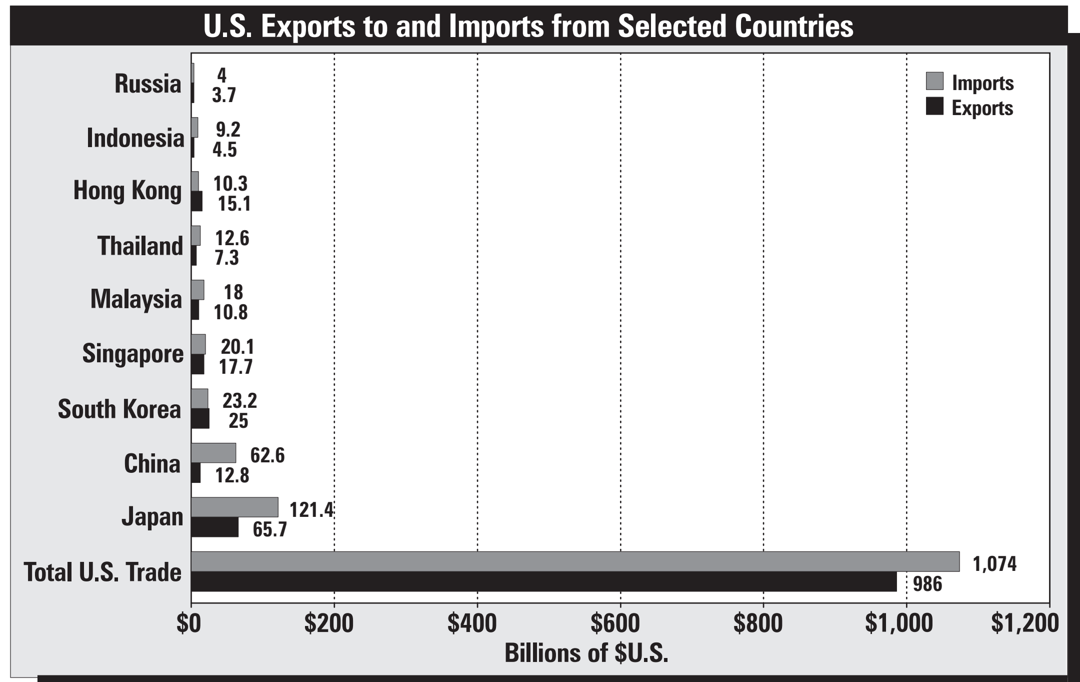
More than six months later the Asian crisis has worsened, not improved. Currency and stock markets have continued to sag. The contagion has shown indications of spreading. All of this despite an already massive infusion of IMF funds and technical assistance.

How the Asia Crisis Impacts America

Just how important are Asian markets to U.S. economic well-being? Are the East Asian nations vital export markets for the U.S.? The surprising answer is that Japan is the United States' only truly significant trading partner in this region of the world. As Figure 1 shows, the 5 most afflicted Asian nations—Indonesia, Malaysia, Thailand, Singapore, and Korea—are simply too economically inconsequential to matter significantly to the U.S.

Figure 1
The Asian and Russian Crises: What's at Stake? U.S. Exports to and Imports from Selected Countries

Source: Census Bureau; Economic Report of the President, 1998



"Russia…ranks behind Ireland, Israel, Colombia, and even the Dominican Republic in total exports and imports to the U.S."

Indonesia, the most ailing economy in Asia, accounts for less than 1 percent of U.S. imports and exports. In total, these five nations account for just 8 percent of U.S. imports and exports.

Meanwhile, Russia is only our 32nd largest trading partner. It ranks behind Ireland, Israel, Colombia, and even the Dominican Republic in total exports and imports to the U.S. In total, Russia accounts for less than 1 percent of the total U.S. export market

Japan is a different story. About 12 percent of our imports come from Japan; 7 percent of our exports go there. Japan has been in a sustained recession for the past six years. Since 1991 Japan's economic growth rate has averaged a sickly 1.5 percent, whereas the U.S. has averaged more than 3 percent growth. Over this time period, the Yen has lost roughly half its value to the dollar. Interestingly enough, so far the Japanese recession has not prevented the greatest four year high-growth bull market in American history. As Japan has faltered, the U.S. economy has thrived—thus calling into question the presumption that U.S. growth is dependent on Japan's.

This is not to say that Asia's fortunes are not important to the U.S. Clearly they are. But the fate of Japan matters most, and a mature developed nation like Japan does not need IMF support.

IMF Policies: Myth And Reality

Why do we need an IMF? Some of the arguments in favor of the agency range from the sublime to the ridiculous. Senator Chuck Hagel of Nebraska, who heads the Foreign Affairs Subcommittee overseeing the IMF, recently defended the agency by stating that "without the IMF funds to Britain in the 1970s there would not have been a Margaret Thatcher." He even argued that IMF funds and sound advice 20 years ago had helped steer the U.S. out of the crisis of the high inflation in the late 1970s. But since the U.S. is the principal funder of the IMF, any IMF bail-out of the U.S. economy can only be financed with our own money.

In recent months, one of the most common justifications made for the IMF has been that failure to approve IMF funding will hurt American farmers because of eroding foreign markets in Asia. The American Farm Bureau

and the U.S Chamber of Commerce warn that the Asian crisis is a major threat to U.S. agriculture export markets. According to Bruce Hosten, Vice President of the Chamber, "Our concern is that the Asian contagion is growing. Exports are slowing. Unemployment is rising."

The argument that the IMF bail-out will help American farmers serves the purpose of broadening political support in the U.S., particularly in mid-western farm states, for foreign aid. It is quite true that the Asian flu and the dramatic real income declines in these nations have negatively effected U.S. agriculture exports to this region. But if the goal is to aid U.S. farmers, foreign aid is a circuitous means of getting that aid to them. The strategy is designed to route a multi-billion dollar aid package through the bureaucracy of the IMF, which then sends the funds to inept and often corrupt governments in Asia, who will then trickle some of those funds down to the workers and consumers in these countries, who will then send the funds back across the Pacific Ocean where theoretically the dollars will find their way into the pockets of U.S. farmers.

"If we must provide aid to midwestern farmers, then Congress should cut out all these middlemen and send them a check directly."

If we must provide aid to midwestern farmers, then Congress should cut out all these middlemen and send them a check directly, not fund a 2,000 person foreign aid bureaucracy.

Another unconvincing argument in favor of the IMF is that it is free to taxpayers. In a speech on August 4th before the National Governors Association, Deputy Treasury Secretary Robert Rubin insisted that IMF bail-out funding "will not cost American taxpayers a single penny." These loans, he assured the governors, "will be repaid in full with little risk of default."

This argument, which has become a staple of IMF allies, is a non sequitur. If it were true that IMF loans and insurance carry little risk and will be fully repaid with interest, then this would be prima facie evidence against the necessity of a U.S. taxpayer bail-out. The IMF could go to Citicorp, BankAmerica, Prudential, or any other bank or investment house and receive private funding for its operations. A profitable IMF could and should be a privatized IMF. The truth is that no private bank or brokerage is likely to provide the IMF with funds precisely because these are extraordinarily high-risk bail-outs. There have been dozens of examples in the past two decades where IMF bail-outs have led to hundreds of millions of dollars of losses and defaults.

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Perhaps the most insidious IMF myth of all is that its policies steer nations in a free market direction. The truth is that, throughout its history, the IMF has very often offered donor nations a panoply of wrong-headed policy advice. IMF policies often encourage donor nations to:

- raise taxes and/or spurn tax rate reductions;
- devalue the currency and raise interest rates;
- balance the budget at all costs;
- delay market-based regulatory and banking reforms;
- prevent firms and banks from going bankrupt as they should; and
- prop up corrupt regimes and the systems of "crony capitalism" that often create the crises in the first place.

India is a prime example. Between 1951 and 1989 the IMF poured more than $20 billion of aid into India. But according to Indian economist Shyam Kamath, most of that money went to support public projects, not private sector development. Mexico is another example of IMF failure.

IMF proponents hold up the 1995 Mexican bailout by the IMF as an example of the agency's success now that inflation is under control there. Alan Meltzer, economist at Carnegie Mellon University, has shown that "the IMF has been 'helping' Mexico since the 1930s." But Meltzer has found that between "1973 and 1996 Mexican debt increased 14 times faster than per capita income of Mexican citizens." IMF policies go a long way in explaining "why Mexican policy has been so erratic and undisciplined for so long," concludes Meltzer. That is some IMF success story.

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Here is an even more contemporary example of the IMF's "free market" advice. In 1996 the IMF published a report advising the U.S. against a reduction in the capital gains tax and other forms of tax relief on the grounds that the money would be better spent on government "investment" and deficit reduction. This report was seized upon by the Clinton administration and the media to help try to torpedo GOP capital gains and family tax reductions. Here we had a U.S. taxpayer funded international agency using those tax dollars to lobby Congress not to cut taxes. Fortunately, U.S. policy makers can and did ignore the IMF. The tragedy is that for thirty years the agency has been peddling this misguided advice to third world nations across the globe who are seduced by "free" IMF funds and thus impelled to follow economically destructive monetary and fiscal policies.

A World Without an IMF

There are three arguments against continued financing of the IMF.

First, and most importantly, the IMF is a dinosaur. The IMF was founded in 1944 as part of the Bretton Woods Agreement. Its original purpose was to provide short term loans to nations that had balance-of-payments problems under the newly-created Bretton Woods exchange rate system. But as Johns Hopkins economist Steven Hanke recently noted: "In 1971 Richard Nixon closed the gold window, signalling the collapse of the Bretton Woods Agreement. With that collapse, the purpose of the IMF passed into history. The IMF should have, but did not."

How has the IMF sustained itself and its 2,000 person bureaucracy with its original mission null and void? By creating new missions. In the five years after the collapse of Bretton Woods, the IMF vastly expanded its international lending function. In the five years 1970-75, for example, the IMF doubled the size of its loan portfolio. In the 1970s it lent to Latin American nations. In the 1980s it lent to Africa. In the early 1990s it lent to Eastern Europe and Russia. In 1995 it lent to Mexico. And now, it is pouring at least $100 billion into East Asia. Next it wants to move back into Russia with a $22.6 billion bail-out package.

"The IMF is perpetually inventing new missions, despite the fact that it has a poor record of succeeding wherever it has intervened in the past."

Like any classic bureaucratic institution with a pipeline to government funds, the IMF is perpetually inventing new missions, despite the fact that it has a poor record of succeeding wherever it has intervened in the past.

Second, the IMF has a dreadful track record at promoting free markets and economic growth. The table below consolidates this dismal track record. As Johns Hopkins economist Steven Hanke recently noted, "Few nations graduate from IMF emergency loans. Most stay on the IMF dole for years on end." Ian Vasquez, an economist at the Cato Institute and an expert on foreign aid believes that the Fund has "not helped countries move to the free market, but rather has created a network of loan addicts." Examples of nations that have suffered this addiction to IMF funding include: Egypt, Ghana, Bangladesh, Uganda, and Zaire. One recent Heritage Foundation

study found that of 137 mostly developing countries that have received IMF rescue funding from 1965-1995, only 44—or less than one-third—have graduated from needing assistance. Incredibly, 81 countries have actually seen their dependence on the IMF grow over time. Worse, yet there are 43 nations that have been receiving IMF aid for more than 20 years. So much for the "temporary" nature of the bailouts.

IMF Welfare Addiction	
Number of Countries that received IMF support 1965-95	137
Percent of IMF-supported nations that have reduced need for IMF aid	32%
Percent of IMF-supported nations whose need for aid has increasedby at least 50 percent	52%
Percent of IMF supported nations that are worse off today	31%

Table 1
IMF Welfare Addiction
Source: Heritage Foundation, 1987.

Finally, the IMF intensifies international currency crises through the moral hazard problem of its lending policies. The IMF essentially privatizes the return on risky investments abroad, but socializes the risk by offering a safety net to investors that get burned. These bail-out policies cause a maldistribution of capital flows, by over-rewarding high risk investments. The Asian debt crisis, the Hoover Institute's Alvin Rabushka has stated: "was in large part a result of the IMF's catalyst role." The IMF's resources are sufficient to "induce private banks to provide huge loans to the governments of developing countries by removing the risk of default."

Former Fed Governor Lawrence Lindsey believes the Asian currency crisis was worsened by the IMF Mexican bailout. "Mexico set up Asia," he says. It sent signals to international investors who loaned money in Asia, that their investments carried a de facto U.S. government guarantee. Lindsey maintains, "Outside of Washington, no one takes seriously the story that the Mexico bailout was a success." Investment bankers on Wall Street talk about how they actively promoted loans to Asia once the Mexican rescue was in place." This is a textbook case of moral hazard.

"Outside of Washington, no one takes seriously the story that the Mexico bailout was a success."

The situation is entirely analogous to the savings and loan crisis in the U.S. in the late 1980s. Depositors pumped funds into financially shaky thrifts in the '80s, especially those that were offering interest rates above those of commercial banks. As a result of federal deposit insurance, these depositors could earn these high interest rates without worrying about the financial solvency of the thrift. Meanwhile, S&L operators had a financial incentive to invest the funds in these insured deposits in highly speculative real estate ventures with a high potential pay-off, but also a high probability of default. Like the S&L situation, with the IMF we have established a "heads I win, tails you lose" situation for U.S. banks and multinationals.

How Global Markets Will Solve the Asian Crisis

We now live in an age of "quicksilver capital." This means that every moment of every day capital investors and currency traders are holding de facto elections on the economic policies of the nations across the globe. The capital markets are demanding free enterprise, unfettered capitalism. Policy makers are effectively precluded from confiscating wealth or socializing their economies. If governments attempt to erect trade barriers, raise tax rates, build-up unfunded social welfare programs, inflate their currencies, nationalize or heavily-regulate industries, capital markets will instantly punish these dysfunctional political decisions by fleeing. Hence the instant mobility of capital today has a very healthy disciplining effect on

governments. These markets reward wealth-enhancing policy and punish wealth destructive policy.

This quicksilver capital phenomenon explains why, for example, for the past twenty years, tax rates across the globe have been falling. A report I authored last year for Laffer and Associates found that personal income tax rates have fallen by an average of 15 percentage points in a survey of 100 nations. Capital mobility also explains the general reduction in trade barriers. The logical fallacy of the IMF model of economic development is the idea that global bureaucrats can provide this discipline more effectively than the democratic decision making process arrived at by the millions of currency traders and capital investors around the world.

"The instant mobility of capital today has a very healthy disciplining effect on governments."

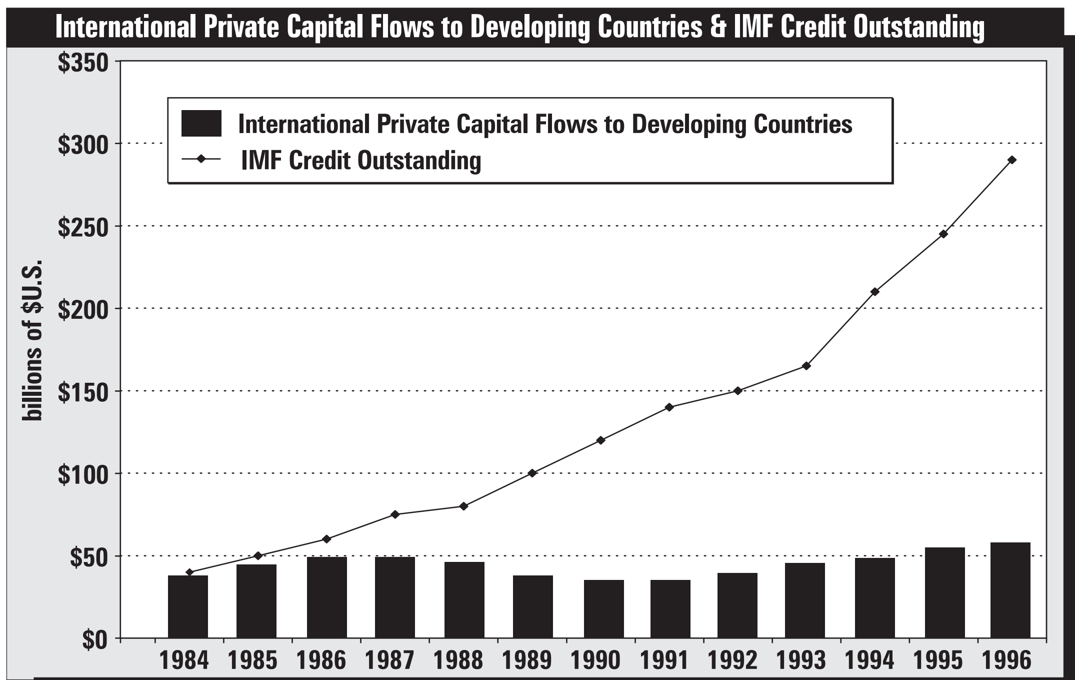
Macro-economist Rudiger Dornbusch of MIT has asked this unanswered question of the IMF's mission: "If the capital market is perfectly capable of identifying worthy projects and readily finances private investment and public budgets around the world, who needs these remnants of foreign aid and statism?"

In this information-age global economy, international capital markets swamp the effects of an IMF bailout. The data confirm the primacy of capital markets in solving international currency crises. Ten years ago the total amount of capital flows into the third world was less than $40 billion. As Figure 2 shows, last year, more than $250 billion flowed into these nations, and this year will eclipse that amount. Meanwhile, every month hundreds of billions of dollars in currencies exchange hands, as the traders equilibrate demand and supply for rubles, deutchmarks, Thai bahts, Indonesian rupiahs, pesos and so on, based in part on governmental policies. In this environment of quicksilver capital, the IMF is at best a spit in the ocean. Political leaders can and should dispense with the advice of IMF officials on issues related to the advisability of monetary, trade, or tax policy changes; the capital markets will inform them instantly of success and failure.

Many in the foreign aid establishment have precisely the wrong world view of the impact of capital mobility. C. Richard Neu of the IMF recently wrote this of the inefficiency of markets: "For all the advances in

Figure 2
Who Needs the IMF? International Private Capital Flows to Developing Countries & IMF Credit Outstanding

Source: *Investor's Business Daily*; International Monetary Fund; Cato Institute



information technology, information about and sound analysis of economic conditions in particular countries remain scarce." He continued: "Investors show a tendency to follow the herd, crowding enthusiastically into this or that market and then fleeing en masse at the first disappointing news." (Of course, to the extent that this is at all true, it is in part a result of the IMF moral hazard problem). Finally, the IMF economist concludes: "Market mechanisms cannot be counted on to provide the discipline necessary to encourage countries to adopt sound macroeconomic policies. When markets do administer discipline, it is draconian and sudden, leaving national governments little time to adjust." The implication here is that only international government bureaucrats can be counted on to provide the necessary discipline. This is bureaucratic arrogance run amok.

"The truth is that the capital markets have operated precisely as they should have"

It is also alleged by IMF supporters that private capital markets are economically destabilizing if left to their own devices. Many believe that the Asian crisis was a result of capital market failure. Currency traders like George Soros have even been blamed as the "villains" in the Asian crisis. The truth is that the capital markets have operated precisely as they should have. The failure was not in the capital and currency markets, but rather in the governmental policies of these nations. The only impact of the IMF and its bail-out funds has been to contribute to the crisis by spurring overinvestment in East Asia and delaying market reforms.

The only genuinely appropriate response to the Asian crisis is to allow the currency and capital investment markets to fulfill their function of "voting on" Asian reforms—yes, even in a draconian fashion, if need be. If Thailand, Indonesia, and Korea begin to privatize, cut tax rates, end crony capitalism, and adopt other market based reforms, the currency will stabilize and the crisis will subside as capital flows reverse their exodus. It is true that some of the "conditions" that the IMF is imposing on Asia in exchange for bailout funds are sound. For example, the IMF is requiring the sale of government owned monopoly enterprises. But as Larry Lindsey has noted, "All of the conditions negotiated by the IMF would be forced on Korea by the market." Meanwhile, Japan's supply-side tax cut plan came not from the impetus of the IMF, but global investors who were repelled by a 65 percent tax rate.

"A world without an IMF would not imperil U.S. financial or export markets."

U.S. policymakers cannot change the economically dysfunctional economic policies of sovereign nations—nor should we bribe them to do so through the IMF or other forms of foreign aid. But U.S. policy makers can change economic policies at home. The optimal U.S. response to the Asian crisis is for America to aggressively pursue pro-growth policies here: including a reduction in business taxes and the capital gains tax, lower federal spending (especially by ending funding of programs like the World Bank and the IMF), and less onerous regulation on business. This is the most promising cure for the Asian crisis: it is called leading by example.

Conclusion

When Bill Clinton traveled to Africa earlier this year he adopted a very sensible economic development strategy for the U.S. to best help these poor nations. He called it "trade, not aid." The irony of the IMF aid package before Congress is that many of the supporters, such as House Minority Leader Dick Gephardt (D, MO), also oppose free trade agreements. Their position for the U.S. is evidently "aid, not trade."

Of course, Africa is the starkest example of the economic irrelevance of IMF funding and technical assistance. For 40 years the IMF and the World Bank have pipelined billions of dollars into Africa and have populated these nations with thousands of high-priced economic advisers, but to virtually no avail.

"More likely, curtailing the IMF would have a stabilizing influence and preclude such disasters in the future."

Republicans and some Democrats in Congress are now asking the right questions of the IMF: In the next century, what is the mission of this fifty year-old multi-lateral lending agency that has so little success to show for itself? Finally, many in Congress are examining its pitiful record, and demanding accountability from IMF officials. We even now see political leaders in developing nations beginning to openly rebel against the IMF's often unwise advice, as occurred earlier this year in Indonesia. A world without an IMF would not imperil U.S. financial or export markets. Indeed, more likely, curtailing the IMF would have a stabilizing influence and preclude such disasters in the future.

About The Author

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