CHAPTER SIX

BAILING OUT THE POOR

The secret isn't counting the beans; it's growing more beans.

ROBERTO GOIZUETA (1931–1997)

I AM WALKING THROUGH one of the many slums in Addis Ababa. I pass residences made of mud walls and thatched roofs, some with holes in the roofs and walls, set off against more prosperous residences made from concrete blocks. Some residences feature neat flower gardens in front, as if defying demeaning poverty stereotypes that would rule out such touches. A smiling grandmother invites me into her modest dwelling of sticks and mud, offering coffee to the surprise guest, to the delight of a crowd of curious children. Poverty is here, as children in rags are playing in the red dirt beside a stream containing raw sewage. These slum dwellers are not among the 12 percent of Ethiopians with access to healthy sanitation facilities.[1] The children seem unusually thin and short for their age, as is to be expected in a country in which about half of all children are malnourished.[2] Food production in Ethiopia suffers from soil erosion and periodic drought. Some of the children could be AIDS orphans, as the AIDS crisis in Ethiopia is severe. Only 14 percent of children are immunize against childhood diseases, which no doubt has something to do with why 17 percent of them don't live to see their fifth birthday.[3]

Across town, the minister of finance and economic development of Ethiopia, Sufian Ahmed, is meeting with six men (and one female secretary) from the IMF to plan the future of Ethiopia's economy. They discuss the government's revenue and spending. The meeting is part of the IMF's "Fifth Review Under the Three Year Arrangement with the Poverty Reduction and Growth Facility." The economy is recovering from a major drought. Tax revenue has been lower than expected, as have external loans. To stay within the limits agreed with the IMF, Ahmed has cut government spending. The IMF staff approve of the spending cuts, although they urge Ahmed to protect "poverty-targeted expenditure." (It is unclear how they decided what was "poverty-targeted," since almost *any* spending that brings *any* results would lower poverty in such a poor society.) In reaction to the drought, the government is developing a "food security program." The IMF staff suggests that the government be careful that food security spending doesn't endanger "macroeconomic stability,.[4] although the report encouragingly indicates that otherwise "the staff welcomes the food security program."

The IMF specifies mandatory targets for Ethiopia for international foreign exchange reserves for the net domestic credit of the central bank, for domestic financing of the government deficit, for government arrears on paying its bills, and for government external borrowing. Other agreements of Ahmed with the IMF include reforming the tax system (including computerization of the taxpayer identification number and introduction of the value-added tax); limiting defense spending; limiting the government wage bill; consolidating regional and federal budgets and extrabudgetary accounts; reconciling fiscal and monetary account statistics; letting the market determine the exchange rate; provisioning by commercial banks for overdue loan repayments; privatizing the Commercial and Business Bank (CBB); restructuring the Development Bank of Ethiopia (DBE); restructuring th National Bank of Ethiopia (NBE); increasing the autonomy of the NBE; reforming the Commercia Bank of Ethiopia (CBE) based on an audit by the international firm KPMG and a detailed plan agree upon with the IMF that specifies numerical performance targets, limits any delinquent loan from CBE to two renewals, and transfers co-financed loans from the CBE to the DBE; liberalizing trade as a preliminary step in the Integrated Framework for Trade Development in the least-developed countries; rewriting the investment code to limit the role of government to electricity transmission, the postal service, and the national airline; tracking debt-relief resources so that they are used for poverty reduction; and improving the compilation of statistics on the balance of payments, monetary indicators, international reserves, and agricultural and industrial production. The government should do all this while consulting with the poor, civil society, nongovernmental organizations, private individuals, and the foreign donors on what it should do to reduce poverty, in the context of the Annual Progress Report (APR) on the PRSP. From January 2001 to November 2003, the minister of finance has benefited from twenty-one separate background papers prepared by the IMF to give him technical advice, on topics ranging from income tax legislation to the interbank foreign exchange market.

Has the International Monetary Fund been an effective agency to serve the poor in far-flung corners of the globe? The IMF is an interesting case study for testing the following hypotheses: (1) agencies work better with few goals rather than many goals; (2) unaccountable agencies are worse than accountable agencies; (3) top-down Planners suffer from information shortages about reality on the ground. And, indeed, as we will see, the IMF's effectiveness has benefited from its having fewer goals than other agencies of Western assistance (1), but its effectiveness has suffered a lot from lack of accountability (2) and from the lousy information available to top-down Planners (3).

The West first set up the IMF to prevent large trade imbalances and unstable currencies in the West. In this initial phase of the IMF's work, it was very successful. It then shifted toward bailing out countries in the rest of the world. On balance, the IMF has done useful short-term bailouts of poor countries experiencing financial crises, but it has done worse at promoting long-term development. Moreover, things have gotten worse over the past two decades, as the IMF's mission statement has grown more and more bloated, its conditions more and more numerous, and its interventions more and more intrusive. The IMF has no mechanism that holds it accountable to the poor for acting in their long-term interest or improving their welfare. It places excessive confidence in very shaky statistics on the countries' problems it seeks to correct. Although it has accomplished many good things, its performance today resembles more and more the coercive Planners' dreams of the White Man's Burden.

The World's Most Powerful Creditor

The International Monetary Fund, headquartered in Washington, D.C., is the West's most powerful agency for dealing with many poor countries. The IMF supervises poor-country finances. When the governments of poor countries can't pay their import bills or service their debts to Western creditors, the IMF arrives to straighten things out. The Fund arranges a new schedule of debt repayments that the country can manage. It lends the government short-term money (to be repaid within two to four years) to tide it over its cash squeeze.[5] The Fund also negotiates with the government a series of spending cuts or tax increases to enable the government to make the necessary repayments (including of its own loans).

The IMF has a lot of money. It has $157 billion in resources available to lend, of which $96 billion was actually out on loan in August 2004.[6] It gets its money from subscriptions by all of its members (most countries of the world) and then keeps the money rotating among borrowers.

The IMF's description of its function stresses the benefits of its activities to poor countries: "A main function of the IMF is to provide loans to countries experiencing balance-of-payments problems so that they can restore conditions for sustainable economic growth. The financial assistance provided by the IMF enables countries to rebuild their international reserves, stabilize their currencies, and continue paying for imports.[7]

Part of the IMF's role is to enforce "financial discipline," i.e., get countries to pay their bills and repay their creditors. Credit enforcers are always unpopular, but they do play a valuable role. If borrowers could default on their loans without fear of consequences, lenders would not make loans. Loans can finance productive investment that borrowers can't finance on their own. Loans can tide countries over bad times; countries can repay loans during good times. In the private market, collection agencies' combination of threats and negotiation facilitates borrowers' access to the benefits of future loans. The IMF client maintains its access to future Western loans by following IMF dictates, meanwhile getting an IMF loan to ease the pain (or more accurately, to postpone the pain to when it can repay the loan). Critics unfairly vilify the IMF because of the stereotype of the evil creditor squeezing the last drop of blood from the debtor. The international system including the IMF helped make a large market in lending to poor countries possible. The IMF *is* preferable to the earlier Western method for collecting debts—sending in gunboats to seize the poor country's customs revenues, or even invading the country to take over the government.

As for IMF conditions on its loans, you could understand them as a way to ensure that the loan is repaid. If your ne'er-do-well cousin asks for a loan, you may decide to give it only on condition that he change his behavior in a way that makes it likely that he will pay back the loan—that he stop drinking, that he get a job, etc.

The IMF has had some notable successes. It helped South Korea and Thailand with financial squeezes in the 1980s, after which they had rapid growth. The IMF bailout of Mexico in 1994–1995 although much criticized at the time, worked well. The Mexican government repaid the loans in advance, and economic growth resumed. Most recently, the IMF handled the 1997–1998 East Asian financial crisis with some success, especially, again, in South Korea.

The IMF recruits talented Ph.D.'s in economics, who observe strong norms of professional analysis. It has an outstanding research department, as well as other specialized departments that provide valuable technical advice to poor countries on their fiscal and financial systems. The IMF has been a good source of economic advice to countries on the wisdom of government solvency and the folly of excessive government debt and deficits. (One backward country is currently not heeding this advice, the one whose capital is the same city in which the IMF is located.)

But the IMF's more ambitious attempts to reform poor economies have had more mixed success Even the core function of enforcing financial discipline is flawed by an intrusive Planner's mentality that sets arbitrary numerical targets for key indicators of government behavior. Like all Planners, the IMF fits the complex reality of economic systems into a Procrustean bed of numerical targets tha have little to do with that complexity. The conditions on its loans often roil internal politics in a way that is much too intrusive. And in the end, it is not even clear that the conditions contribute to repayment of the loans.

The IMF does not force country governments to enter its agreements; they do so willingly. If IMI agreements are sometimes counterproductive, why do governments enter into such agreements? Usually it is because the government is myopic—a financial crisis makes it desperate for a loan righ away, no matter what the long-term consequences. The IMF is often the only way to get such a loan.

So Many Pesos, So Few Dollars

The standard IMF loan is a "standby arrangement." The IMF loan is conditional upon th government's getting its finances in order so it can pay the loan back quickly.

The IMF's approach is simple. A poor country runs out of money when its central bank runs ou of dollars. The central bank needs an adequate supply of dollars for two reasons. First, so tha residents of the poor country who want to buy foreign goods can change their domestic money (let's call it pesos) into dollars. Second, so those poor-country residents, firms, or governments who owe money to foreigners can change their pesos into dollars with which to make debt repayments to their foreign creditors.

What makes the central bank run out of dollars? The central bank not only holds the nation's official supply of dollars (foreign exchange reserves), it also makes loans to the government and supplies the domestic currency for the nation's economy. In accounting lingo, the central bank has two assets, foreign exchange reserves and credit to the government, and one liability, domestic currency.

In many poor nations, the government's main source of finance for any excess of spending over tax revenues is credit from the central bank (the other main source is foreign borrowing; more on that later). The central bank extends credit to the government and prints up a corresponding amount o currency to hand over to the government as the proceeds of the loan. The government spends the currency, and the pesos pass into the hands of people throughout the economy.

But are people willing to hold the currency? The printing of more currency drives down the value of currency if people spend it on the existing amount of goods—too much currency chasing too few goods. People don't hold pesos whose value is falling—this is like a savings account with a negative interest rate.

So they take the pesos back to the central bank to exchange them for dollars. Since they are unwilling to hold more pesos, they exchange pesos for dollars until the amount of pesos they hold is the same as it was before. At the end, the central bank holds more credit to the government and fewer dollar reserves, with the same amount of pesos outstanding. The effect of printing more currency tha people don't want is to run down the central bank's dollar holdings.

This was the insight of early IMF official Jacques Polak, the father of IMF financia programming. The central bank's holdings of dollars runs low because the central bank prints too many pesos, which people then want to exchange at the central bank for its dollars.[8]

There will often be a panic element to buying dollars from the central bank in this situation.

People's willingness to hold pesos is the key variable. When the public begins to suspect that the central bank is printing too much money for its existing holdings of dollars, it will rush to buy up its dollars before the supply runs out. Too few dollars for the outstanding stock of pesos is kind of like the *Titanic* with too few lifeboats. People will rush for the lifeboats (i.e., rush to buy dollars), and the stock of dollar reserves at the central bank will fall. People wanting to buy dollars for imports or to service foreign debts will then be out of luck. The country then calls on the IMF.

Excessive money printing also affects another important goal of IMF programs—controlling inflation. Too much money chasing too few goods will drive up the prices of those goods, causing inflation. Again, the key is how much money people are willing to hold relative to buying goods. If their desire to keep money in their wallet increases, that money won't be out on the town chasing goods.

The last insight of IMF financial programming is that excessive government deficits cause excessive printing of money. The government finances its deficit by borrowing from the central bank, which finances the loan by printing money. So the standard IMF prescription to build up reserves again is to force a contraction of central bank credit to the government, which requires a reduction in the government's budget deficit.

This all sounds very technical and neutral, but the IMF then gets involved in how the government is spending the money (i.e., which items to cut). It often forces the government to do unpopular things, such as cut subsidies for bread or cooking oil. People in the country receiving the IMF loan often blame the IMF when the government does those things, and they take to the streets to protest IMF enforced austerity. One big trouble sign in IMF stabilization plans is their disturbance of domestic politics.

IMF Riots

Quito is a favorite destination of IMF staff, who gave Ecuador sixteen standby loans over 1960–2000. In the year 2000, the latest IMF loan's austerity measures induced reductions in teacher salaries and increases in fuel and electricity prices.

On January 22, 2000, three thousand protesters from Ecuador's indigenous groups occupied Congress, while more than ten thousand demonstrated outside. The government of democratically elected president Jamil Mahaud confronted them with more than thirty-five thousand soldiers and police. The leaders of the armed forces saw the handwriting on the wall, however, and deposed Mahaud on January 23, 2000, in favor of his vice-president, Gustavo Noboa. Noboa insisted he would continue with the IMF reforms.

In May 2000, teachers in Ecuador went on strike for five weeks to protest salary reductions. The government dispersed a demonstration of teachers in the capital with tear gas and riot police. On June 15, 2000, protest groups organized a general strike, which included teachers (again), government employees, doctors, oil workers, and unions. There was another tear gas confrontation between riot police and protesters in Quito. The army sent a unit under Colonel Lucio Gutiérrez to break up the protests. Colonel Gutiérrez instead sided with the indigenous protesters and attempted an unsuccessful coup. The army put down the coup and fired Gutiérrez.

Noboa temporarily managed to survive the protests, and the country wound up complying with the IMF conditions. The protesters got revenge at the next election, in November 2002, when the voters elected as president former coup leader and populist hero Lucio Gutiérrez.

By February 2004, the indigenous groups began protesting against Lucio Gutiérrez for once again cozying up to the IMF. On April 20, 2005, Gutiérrez, like his many predecessors, fled the presidential palace for good.[9]

Ecuador was not alone in protesting against the IMF. In the first nine months of 2000 alone, there were demonstrations against IMF programs in Argentina, Bolivia, Brazil, Colombia, Costa Rica Honduras, Kenya, Malawi, Nigeria, and Zambia.[10] We cannot always conclude that the protesters are representative of the majority, but at the very least, it is a sign of the impact of the IMF on domestic politics.

We still haven't exhausted the roll call of IMF involvement in domestic politics. There is an association between IMF involvement and the most extreme political event: total state collapse. Of course, prior to disappearing into the parallel universe of social collapse these governments were already very sick at the time they were getting IMF loans. It is unclear how much blame the IMF bears for subsequent collapse in these unfortunate countries, but financial indiscipline was the least of their problems. Liberia spent 77 percent of the period 1963–1985 in an IMF program, before finally collapsing into anarchy after 1985. Somalia spent 78 percent of the decade 1980–1989 in an IMF program, after which the warlords tore the country apart.

Table 4 shows that of all eight cases worldwide of state failure or collapse, seven of them had a high share of time under IMF programs in the ten years preceding their collapse. Statistically, spending a lot of time under an IMF program is associated with a higher risk of state collapse.

TABLE 4. ALL EIGHT CASES OF STATE FAILURE WORLDWIDE AS OF 1990S AND PRIOR IMF PROGRAMS

Country	*Approximate year of onset of state failure*	*Time under IMF programs in preceding 10 years (%)*
Afghanistan	1977	46
Angola	1981	0
Burundi	1995	62
Liberia	1986	70
Sierra Leone	1990	59
Somalia	1991	74
Sudan	1986	58
Zaire	1991	73
Average		*55*
Average for all developing countries 1970–90		*20*

Source for State Failure: Richard Rotberg, 2002

The IMF should have been more careful imposing its comprehensive reforms on such fragile political systems. At best, the IMF doing a program in these countries was like recommending heart-healthy calisthenics every morning for patients with broken limbs. The IMF feels its mandate requires it to help any and all countries in financial difficulty. However, the Planners' mentality in which the IMF applies the same type of program to all countries is ill matched to such ill societies. In retrospect, it would have been better if the IMF were not involved at all in these cases.

Sierra Leone had a horrific civil war after its state collapse in 1990, following years of heavy IMF involvement. Deranged rebels cut off thousands of civilians' hands to spread random terror. During a pause in the civil war, the IMF entered again to grant loans to Sierra Leone, which spent 83 percent of the period 1994–1998 under an IMF program. Civil war broke out again in 1998, not to be ended until the intervention of UN peacekeeping forces, including British troops, in 2001. The IMF quickly reentered, granting a new loan. Isn't there any society with an illness so advanced that the IMF will decline to prescribe its irrelevant medicine?

Here are some highlights of the IMF program begun in 2001:

- "The quantitative performance criterion for end-September 2001 relating to net domestic bank credit to the government was slightly exceeded, reflecting the difficulties we faced in limiting recourse to domestic financing in the context of substantial technical delays in the disbursement of budgetary assistance…. The structural benchmark relating to the passage of the bill to grant autonomy to the Central Statistical Office by end-September 2001 was however, missed due to the heavy legislative schedule."
- "Progress has also been made in implementing structural reforms and capacity building, although there were significant delays in implementing some key structural reform measures. In the area of economic management, work has continued in developing the medium-term expenditure framework (MTEF)."

The Economist Intelligence Unit summed up the Sierra Leone situation as of 2004:

- "The rank-and-file [former rebels], particularly in rural areas, remain largely unemployed…the government still cannot project fully its authority in the diamond mining areas in the east of the country."
- A couple million people internally or externally displaced out of 5 million are coming back to their old homes; meanwhile, traumatized amputees are getting less in benefits than the soldiers who committed the atrocities.
- "Indigenous institutions remain weak and, despite the outward appearance of peace and stability following the ending of the war, peace is being maintained by a large, albeit diminishing, contingent of UN peacekeeping troops. With most of the UN peacekeeping force due to be withdrawn by mid-2005 [recently postponed until end of 2005], it is not clear if the president will be able to hold the country together."

IMF management, please phone home for a reality check. There may be some places that you can help, but Sierra Leone is not one of them.

Untidy Numbers

Although we can certainly blame the IMF for messing with fragile countries when it shouldn't, not all criticisms of the IMF are fair. People often blame the Fund for scarce government resources. Governments in poor countries have scarce resources because they are poor, not because of the IMF. Governments cannot live beyond their means on central bank credit, depleting a limited stock of international reserves.

What combination of government spending, budget deficit, and central bank credit makes the

books balance? The answer is more imprecise than the IMF acknowledges. The IMF financial programming model is the monetary Planners' equivalent of the Big Push model of the aid Planners. If the numbers are so unreliable, then it is not clear that the IMF conditions are actually increasing the likelihood of its loans being repaid.

Like doctors, the IMF officials cultivate the art of issuing confident pronouncements on the diagnosis and the cure of financial ills. They patiently explain that it's just arithmetic, little more than two plus two. Central bank credit to the government must be no more than the demand to hold currency minus the level of necessary dollar reserves (valued in domestic currency at the current exchange rate). For the banking system as a whole, the expansion of credit (including credit to the government) must not exceed the public's demand to hold currency and bank deposits minus the banking system's foreign exchange reserves. If credit is too high, the system will lose foreign exchange reserves as people turn in unwanted money at the central bank for dollars.

There are two problems here: (1) inadequate knowledge of what is really happening on the ground, and (2) complexities that are not captured by the financial programming model.

Planners everywhere like to manage by the numbers. The planning arithmetic is not as straightforward as it appears. Accurate information on all of the items in the central bank balance sheet are as hard to come by in many poor countries as an honest customs collector.

I can remember visiting the central bank of The Gambia in one of my first trips for the World Bank. The figures for currency outstanding, central bank credit, and international reserves were in a ledger book, which I saw with my own eyes. The figures were in pencil. The figures showed signs of having been erased and recalculated several times. The sum at the bottom was not equal to the sum of the entries in the column. My faith in central bank accounting suffered.

The IMF's standard training manual on financial programming gives the example of Turkey's central bank accounts. A mysterious item pops up, called "other items, net," which balances central bank assets (foreign exchange reserves plus domestic credit to the government) with central bank liabilities (currency and deposits by banks). Nobody knows what an "other items, net" is or where it will wake up tomorrow morning. The change in "other items, net" was one fourth of the change in domestic credit from one year to the next in the Turkey example from the IMF training manual.[11] This figure is about average for all of the data on central bank accounts in all countries over the last four decades.

The IMF's own numbers are not internally consistent. The IMF reports data in two ways: in its statistical publication, International Financial Statistics (IFS), and in the country reports that IMF staff prepare when they are designing a program for a country. The two sets of numbers measure the same concepts, such as the key variable net international reserves (local currency equivalent). Yet the numbers are often at odds.

I randomly assembled a sample of the most recent country reports that reflected active IMF programs, as shown on the IMF Web site in February 2004, and compared their data with that available in IFS at the same time. Table 5 shows very distinct estimates in some countries for net international reserves in the monetary survey.

TABLE 5. ESTIMATES OF LOCAL CURRENCY EQUIVALENT NET INTERNATIONAL RESERVES IN DECEMBER 2002 IN MONETARY SURVEY BY IMF INTERNATIONAL FINANCIAL STATISTICS (IFS) AND IMF COUNTRY DESK

Country	*Date of report*	*IFS*	*Country desk*	*Percentage difference*
Bulgaria	Feb. 2004	9,881	9,892	–0.1
Burundi	Feb. 2004	18,405	21,100	–12.8
Gabon	Feb. 2004	1.9	36.1	–94.8
Lesotho	Jan. 2004	3,770	3,201	17.8
Mali	Jan. 2004	324	285	13.7
Turkey	Oct. 2003	–6.6	–6.5	1.6
Uruguay	Aug. 2003	20,831	–31,044	–167.1

All these monetary uncertainties mean that the IMF staff set program targets for central bank credit, foreign exchange reserves, and money supply based on shaky numbers. The money supply number is very important because it determines how much credit expansion is safe without losing dollar reserves or increasing inflation.

GDP growth plays a big role in projecting how much money demand or other important variables will grow. In March 2003, IMF staff put Mali's GDP growth in 2001 at 1.5 percent. By August 2003, it had raised the 2001 number to 3.5 percent. Just five months later, in January 2004, IMF staff now put Malian growth in 2001 as 13.3 percent! This is not to say the IMF is incompetent at statistics; it is just that any statistics are very shaky in very poor countries.

Things get worse on the arithmetic that says the government budget deficit must equal its sources of financing. Government spending minus revenue yields one estimate of the budget deficit. Adding up all the sources of financing the deficit (central bank credit, foreign borrowing, etc.) yields another. The numbers do not agree. IMF programs will include an "adjustment" to reconcile the two. In the official statistics from the IMF's Government Finance Statistics, the "adjustment" is equal to 55 percent of domestic credit on average.[12] So we are not sure exactly how much the government deficit or domestic credit is now, and thus are not sure how much the government has to cut it.

Just as the IMF should not be blamed for all budgetary austerity, an IMF program also is not *necessary* for the budget to be balanced. If the IMF were not there, the government would still be constrained by its available revenues and whatever loans people were willing to give it. If it was an irresponsible spender, private lenders would not lend to it. The government could print money, but the revenues from doing so would be limited and come at the price of a high inflation rate, which is usually unpopular. The government on its own doesn't have the same dependence on shaky statistics that the IMF does because it will be constrained by real resources, even if it doesn't know how much it has. You may not know the balance in your checking account due to sloppy bookkeeping, but if you spend too much, your checks will bounce. Is the IMF's shaky accounting an improvement on what the government would do without the IMF?

Unstable Behavior

The second problem is that planning the macroeconomic program depends not just on accounting but also on the behavior of people inside and outside the economy. Remember, for example, that the effect of expanding central bank credit to the government and printing money would cause people to turn the extra money in to the central bank for dollars, depleting international reserves. But what if people decided they wanted to hold more currency, for whatever reason? The IMF estimates the desire to hold currency by assuming that the ratio of currency to gross domestic product will remain

stable. Un-fortunately, after examining data on all IMF borrowers for all available years, I found the historical path of this ratio to be more like that of a drunken unicyclist.

A supply of money greater than the demand to hold that money could also drive up prices. Again, it is uncertain how the actual supply of money compares with what people willingly hold. This may be why the IMF has had difficulty predicting inflation under its programs of financial discipline and restructuring. Post-program inflation under the IMF was higher than the program targets on average in the 1990s for a worldwide sample of countries.[13]

Conversely, what if people holding domestic currency suddenly panicked and wanted to turn it in for the central bank's dollars? It's not always clear why they panic, but it happens. International reserves would drop precipitously for reasons unrelated to government budget deficits. Many economists think that this is a good description of the East Asian financial crisis of 1997–1998. East Asian countries were not running large government deficits, yet they suffered currency panics and disappearing foreign exchange reserves all the same.

Another loophole in the relationship between budget deficits and foreign exchange reserves is that the government finances its deficit not only with central bank credit but also with foreign debt. The willingness of foreign investors and banks to buy government bonds is another unknown. This is not so relevant for the poorest countries, or with countries that just have a bad rep as politically unstable or as profligate spenders—they don't qualify as "emerging markets," to use Wall Street jargon. But other poor countries do qualify as emerging markets; private investors and banks help finance these countries' government deficits by buying government bonds. One Web site suggests that there were about forty-five emerging markets (countries), together accounting for 2.6 billion people.[14] A sudden surge in demand for government bonds by foreign investors could allow the governments of these countries to cut back their use of central bank credit, building up dollar reserves without any need for fiscal austerity. Conversely, a flight out of government bonds in emerging markets—as happened after the Mexico crisis in 1994, the East Asian crisis in 1997–98, the Russia crisis in 1998, and the Argentina crisis in 2001—could suddenly force governments to use central bank credit again, running down foreign exchange reserves.

How much do you need to cut central bank credit when the desire to hold domestic currency jumps around like my dog, Millie, after swallowing a jalapeño? How much do you need to cut deficits when the willingness of foreigners to hold government bonds is oscillating? The desire to hold currency or government debt may itself depend on the government's policy on cutting central bank credit or budget deficits. It is circular—if the government is willing to cut the deficit and cut central bank borrowing, then people will be willing to hold more currency and hold more government debt, which lessens the need to cut deficits and central bank borrowing. Finding out where this complex process reaches equilibrium is more complicated than jet-lagged IMF staff can capture by adding up numbers on a spreadsheet.

The moral of the story is that IMF prescriptions about how much to cut central bank credit and government deficits are often based on shaky foundations. The IMF should give up its pretensions that it understands the whole complicated system of financial equilibrium—this is another strain of the disease of utopian social engineering.

Is the IMF a Wimp?

The real test of the IMF's approach is whether it gets results on stabilizing macroeconomic disorder.

On average, one of the big surprises is that the IMF has been weak in enforcing its conditions or macroeconomic misbehavior.

Let's analyze the IMF and the World Bank adjustment loans together because they play the same role of promoting "structural adjustment" (i.e., the reforms to straighten out finances and promote free markets) and because World Bank adjustment loans often support financing for IMF programs. The key number is what happens to the budget deficit. Remarkably, budget deficits did not improve from one adjustment loan to the next over 1980–99.[15]

Next, let's broaden the definition of bad government policy to include a variety of indicators: (1) whether the inflation rate is above 40 percent; (2) whether the dollar is trading on the black market for foreign exchange at more than a 40 percent premium over the official rate; (3) whether the official exchange rate is more than 40 percent out of line with the competitive rate that facilitates exports; and (4) whether interest rates are controlled at more than 5 percent below the rate of inflation. If any of these conditions is met, economic policy is classified as bad. These are exactly the kind of bad economic policies targeted by the IMF and the World Bank. That is, the IMF and the World Bank give "structural adjustment loans" on the condition that all of these problems be corrected. Yet the fraction of structural adjustment loan recipients violating one or more of these conditions did not decrease from one structural adjustment loan to the next (see figure 24).

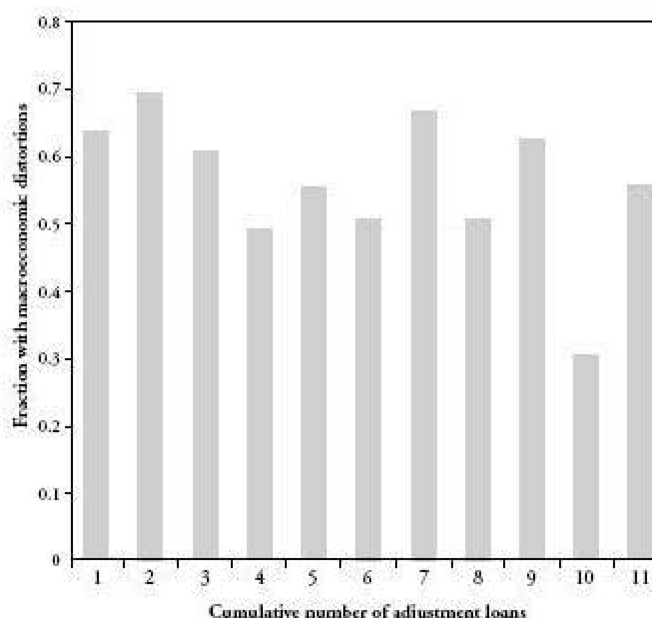

Fig. 24. Fraction of Countries with Macroeconomic Distortions by Cumulative Number of Adjustment Loans

What explains this surprise? One possible explanation is the IMF's tendency to wipe the slate clean with each new loan, especially if new officials are in power in the recipient country. Even though an IMF loan is supposed to be a short-term or medium-term bailout, the countries often don't seem to stay bailed out. Other countries fail to fulfill the conditions on old loans and yet get new loans anyway. Countries such as Ecuador and Pakistan went for more than two decades receiving one IMF loan after another, even though they had never completed any previous IMF program (meaning they didn't fulfill the conditions to get a second or later installment of a loan commitment).[16] A slew of examples in Africa had the same problem, which was to contribute to the African debt crisis.

The IMF's relationship with its clients is capricious. First, the IMF is tough on cutting budge

deficits and causes riots. Then a new government comes in and again runs a high deficit, which the IMF then tries to bring down again (the deficit, not the government).

Debt and Consequences

The IMF also monitors government debt because it knows that a heavier debt load will increase future government deficits by increasing interest costs on the debt. Too high a debt will also make the creditors unwilling to continue lending.

The IMF has its own self-interest in this—if the country owes too much, it can't pay back the IMF. The IMF protects itself against this with a stipulation in its loan agreements that the governmen always pays it *first,* before other creditors. Still the IMF fails in its mission if a country becomes insolvent. Part of the IMF's role is to head off this denouement by persuading the government to borrow no more than a reasonable amount. But what is a reasonable amount? The IMF has a difficul time finding the answer to this question.

Then there is the problem of repaying the IMF loans themselves. The capricious relationship jus described between the IMF and some of its clients means that first installments of IMF loans are made, but true macro-economic adjustment does not happen. This does not augur well for countries being able to repay the IMF loans.

Bailing Yourself Out

One way the IMF has adjusted to this situation is to keep making new loans to repay the old loans Once a country is in deep to the IMF, with the country owing the Fund due to previous bailou packages, it is hard to get out.

Although the IMF bailing out Wall Street investors is controversial, the real problem is that it is bailing itself out. If the IMF did not make a new loan, the country might not repay the previous IMI loan. The IMF often drags in its sidekick, the World Bank, just across Nineteenth Street in Washington from the IMF, which makes an "adjustment loan" to the country as part of the bailout package.

One sign of this self-repayment is the high loan repetition rate for the Sisters of Nineteenth Street. The probability of getting a new loan does not go down with the number of IMF and World Bank adjustment loans already received. (See figure 25.)

The IMF's Independent Evaluation Office highlighted this problem of "prolonged use" of IMI money.[17] It defined a "prolonged user" as a country that was under an IMF program for seven years out of any ten-year period. Forty-four countries met this definition of IMF addiction over the period 1971–2000. Prolonged use has become more common in recent years. In 2001, loans to prolonged users accounted for half of all IMF lending.

As usually happens with addiction, the IMF habit of repeat lending includes some self-deception. The IMF made overly optimistic projections of the prolonged users' GDP and/or expor growth. It granted waivers of its conditions on its loans to repeat offenders. As the Independent Evaluation Office describes this process of fooling yourself into lending: "Internal incentives in the IMF encourage overpromising in programs. This results from both the relatively short time frame of programs, forcing optimistic assumptions about the pace of adjustment.… This led to a tendency to downplayrisks. Even when, as was often the case, they were well identified during the internal

review process, the assessment of risks was not candidly presented to the Executive Board." The Evaluation Office noted that repeat lending by the IMF tended to weaken the leverage the Fund hac over countries to enforce its conditions.

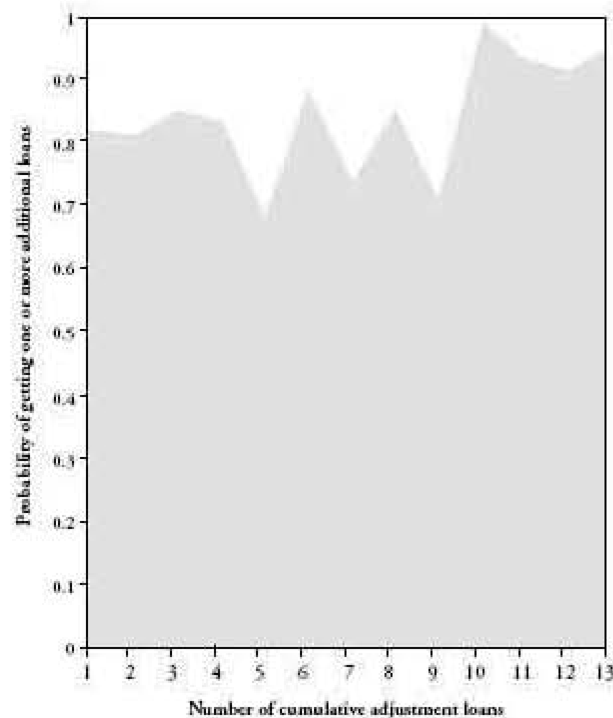

Fig. 25. Repetition Rates of Structural Adjustment Lending After Given Number of Loans, 1980–1999 Number of cumulative adjustment loans

The IMF displays one of the classic symptoms of Planner's disease: in many countries, it keeps doing the same thing over and over again to reach a never-reached objective. The repetition itself shows the failure of previous attempts at "short-term stabilization."

Heavily Indebted Poor Country Crisis

Repeated lending also does nothing to make the debt repayable, as debt keeps mounting without countries becoming more able to service the loans. One embarrassment happened with the poorest countries, which received many IMF loans as well as World Bank "structural adjustment loans," alsc meant to restore financial discipline. The poorest countries also received loans from Western governments and export credit agencies. Their debt load became so extreme that after 1996, the IMF and the World Bank, for the first time in their history, forgave part of their own loans. The IMF anc the World Bank called these impoverished borrowers the Heavily Indebted Poor Countries (HIPCs). Among poor countries receiving above-average amounts of IMF and World Bank structura adjustment loans, seventeen of the eighteen became HIPCs, whose debt the IMF and the World Ban partly forgave. Among poor countries who had less than the average IMF and World Bank borrowing (measured by number of loans), only eight of seventeen became HIPCs. This could reflect the maddening selection problem again—that sick economies were both more likely to pile up debt and to turn to the World Bank and the IMF for help. However, this does not reflect wise lending by the IFIs, since a good part of the HIPC debt that had to be forgiven was directly from the IMF and th

World Bank—even in such "successful" cases as Ghana and Uganda. Far from helping the poor countries achieve a reasonable debt load, the IMF and the World Bank were themselves contributing to the excessive debt of the HIPCs.

HIPCs qualified for debt relief by meeting some of the same conditions that they had failed to meet (or first met and then backtracked on) when getting the original loans. As of March 2005, debt-reduction packages have been approved for twenty-seven nations, providing fifty-four billion dollars' worth of debt relief—a reduction by about two thirds of their outstanding debt.[18]

HIPC debt forgiveness was supposed to be a once-and-for-all solution that would solve the debt problem. The IMF and the World Bank often had optimistic forecasts for GDP growth in the HIPCs. This hoped-for growth would have allowed the HIPCs to keep the ratio of debt to GDP from surging again. But the debt relief did not spur growth.

Bolivia is an example. The country had been an IMF ward ever since the first HIPC relief in 1998. The IMF and the World Bank projected rapid growth in Bolivia in per capita income over 1999–2003; instead living standards declined (see figure 26).

The failure of debt relief to spur growth was a problem because the failure of the original loans to spur growth was what had caused the debt problem in the first place. We have already seen that Africa, a favorite destination of repeated IMF and World Bank lending, also failed to have the growth that would have enabled it to service its debt. This is a general pattern: the growth in program countries fell short of the IMF's own targets. On average for IMF programs in the 1990s, the target GDP growth was 4 percent, but actual growth was only 2 percent.[19] Since population growth was also about 2 percent, this meant that the actual growth of income per person was close to zero.

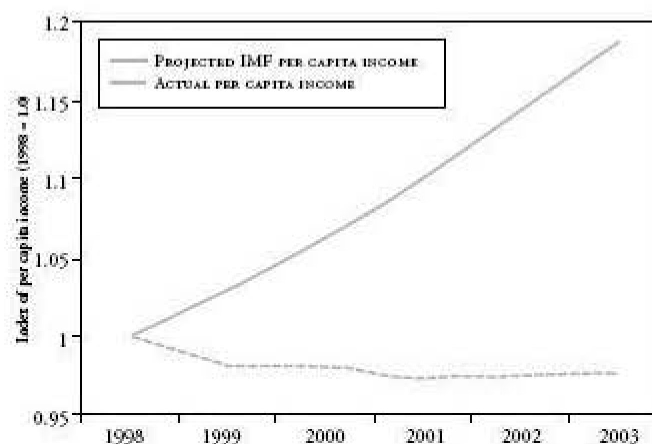

Fig. 26. Bolivia: Index of Per Capita Income Projected by IMF and Actuals

The supposed once-and-for-all debt relief in 1996 was superseded by Enhanced HIPC in 1999, which gave deeper debt relief to more nations. However, even Enhanced HIPC was not enough. The G8 Summit in July 2005 decided to give 100 percent debt cancellation (worth forty billion dollars) to eighteen low-income countries that had already qualified for HIPC debt relief, including Bolivia and fourteen African countries.

Low-income countries have had debt problems since the 1960s, yet still the IMF and the World Bank have insisted on making repeated loans to very shaky borrowers.[20] This is yet another of our numerous examples of the aid community pouring in resources at a fixed objective—financing "development" with aid loans. The IMF and the World Bank kept making new loans to repay old loans, even though countries were having ever-increasing difficulties at repayment.

At this point, the ever-escalating degree of debt forgiveness has destroyed low-income debt as a believable instrument to finance anything. The borrowers have little incentive to repay when they see the debts periodically forgiven (what economists call "moral hazard"). Calling a loan to the poorest countries a "loan" has become ever more fictional. The World Bank, which is an aid agency, should just give the poorest countries grants, not loans (this was one of the better ideas of the Bush administration on foreign aid). The IMF, which is not supposed to be an aid agency, should get out of the business of loaning money to the poorest, least creditworthy countries altogether. Is there any reason to keep bailing out countries that chronically fail to stay bailed out?

Cry, Argentina

Another of the IMF's recent embarrassments was Argentina's default on its government debt in December 2001. The IMF was deeply involved in the elusive quest for Argentine financial stability with fifteen standbys from 1958 to 1999. After unhappy decades of financial chaos, Argentina had a decade of financial stability after 1991. It was the star pupil of the IMF, even as other IMF clients such as Mexico, Russia, Brazil, and the East Asian countries experienced crises. But Argentina began to get into trouble in 1999. President Carlos Menem, who presided over Argentina's near decade of financial stability, increased public spending in his quest to get a third term in office. When this quest failed, electoral politics among other contenders took over. In the understated language of a former top IMF official, Michael Mussa, "election-year concerns further depressed the normally low level of interest Argentine politicians…attached to measures of fiscal prudence.[21] Argentina borrowed heavily from emerging-market investors in 1999 and 2000. By this point, the game was up—Argentina would not honor its commitments to private foreign lenders. In the quaint language of emerging markets, private lenders would "take a haircut." At this point, the IMF should have pulled the plug. Instead, it put together a forty-billion-dollar rescue package that included fourteen billion dollars from the IMF itself, five billion dollars from the Inter-American Development Bank and World Bank, one billion dollars from Spain, and a projected twenty billion dollars from private lenders—announced on January 12, 2001.

In 2001, lenders demanded interest rates on Argentine government debt that were ten percentage points higher than comparable loans elsewhere. If our team was behind by late 2000, the game was a rout in the first half of 2001. Deposits in the banks and international reserves collapsed. By August 2001, as Mussa put it, "prospects for a favorable outcome were pure fantasy." The IMF should have curtailed its scheduled payouts under the January 2001 package.

Instead, in August 2001, the IMF increased its payout to Argentina by more than five billion dollars and offered three billion dollars more to support Argentina's rescheduling payments to its private creditors. As Mussa put it, there was "a failure of moral courage, to decline substantial additional support for policies that no longer had any reasonable chance of success."

The only effect of the August 2001 package was to postpone by a few months the Argentine default on eighty-one billion dollars owed to foreign bondholders. Argentina defaulted on its debt in stages in November–December 2001. Riots in late 2001 spread from the provinces to Buenos Aires. Rioters smashed store windows and looted. The president resigned. Political farce ensued, as three interim presidents took office and resigned in the space of ten days.

After much bluster on both sides in the wake of the default, Argentina put out a take-it-or-leave-it offer to pay bondholders thirty-five cents on the dollar in February 2005, a loss for creditors of

unprecedented scale in recent experience. The majority of bondholders took the offer. The IMF in past debt crises has often played the role of referee between creditors and borrowing governments. Perhaps scarred by its own Argentine miscalculations, this time it stayed on the sidelines.[22]

International Monetary Paradise

The IMF sometimes plays a useful role in the world's financial system—it helps countries facing a temporary shortage of cash get off their backs. The world needs some kind of an international financial crisis manager like the IMF.

But the IMF fudged its mission beyond short-term crisis bailouts to be a repeat lender to deadbeat governments, with the idea that it was promoting "structural adjustment." Even worse, it became a long-run lender to the poorest countries through its loans with the Orwellian name "Poverty Reduction and Growth Facility" (PRGF)—the new name for structural adjustment loans. The IMF is now getting involved in programs to broaden "country ownership" of its adjustment loans, to strengthen "popular participation," and to put a "more explicit focus on poverty reduction.[23] No amount of rhetoric can paper over the contradiction between the IMF dictating conditions and "popular participation." We will tell you what to do, as well as promise you that you are doing it of your own free will.

The participation fad indicates that the disease of bureaucratic babble is spreading to the IMF. The Fund is even concerning itself with environmental policy, which is about as far from its central mission as you can get.[24]

The extremely long list of conditions the IMF attaches to its PRGF loans, as exemplified by the Ethiopia example at the beginning of this chapter, makes each loan an attempt to engineer paradise rather than do piecemeal reforms. The IMF seems more and more to be trying to do everything, a lot like the aid bureaucracies we looked at in the previous chapter.

Conclusions

Although the IMF has benefited from having a narrower mandate than other development agencies, it too, suffers from lack of accountability to its intended poor beneficiaries as it seeks to reform the economy from the top down. The simplicity of its mandate is outweighed by the heavy-handed way it is applied. The IMF's confident pronouncements about what governments should do has some patronizing echoes of the White Man's Burden, in which (in the words of William Pfaff) "the native peoples of Asia, Africa, and the Americas were expected to acknowledge Western truth against native error.[25]

The IMF needs to find a way to drastically simplify its dealings with poor countries in ways that reduce its intrusion. First, there are some poor countries that are so politically and institutionally dysfunctional that the IMF should not be involved with them at all. The fiasco of low-income debt has shown how ineffective the IMF conditions were at ensuring repayment of loans in the poorest countries. The IMF's natural niche seems to be the emerging markets, not the poorest countries. The latter includes most countries in Africa, where the IMF should just head for the exit and let traditional aid agencies operate.

Second, the IMF needs to find a way to get rid of its intrusive and complex conditionality. We

have seen that its conditions are not effective in making sure the loans are repaid anyway, so it's hard to argue that they are essential for the functioning of the IMF. One possibility is that the IMF could just make bailout loans when it judges—as any lender does—that the loan is likely to be repaid. How the borrower manages to repay the loan is up to it, just as how I spend my money is of no interest to my Visa company. The IMF has an enforcement mechanism in that it can refuse to lend in the future to a country that fails to pay it back. Also, the IMF has the leverage that it is the creditor that is paid first, and so private creditors will not lend if a country is not serious about repaying the IMF. (This didn't work to prevent the HIPC debacle, but that was because the poorest countries—which I have argued the IMF should not lend to anyway—did not have access to private creditors.) Suppliers' credits are the lifeblood of trade, and having these cut off is a very effective threat. This is a lot like the multilateral punishment strategy for networks of merchants that chapter 3 discusses. This is the same as the enforcement mechanism in the private market—if you fail to repay your creditors and declare bankruptcy, you won't be able to get new loans for a long while. If all this is not enough, the IMF may need to sup-plement the refusal-of-new-lending sanction with some other market-based device, such as requring that some kind of collateral be put up by the government. The movement away from intrusive conditionality and toward simple credit payment enforcement would prevent the IMF from getting involved in poor-country politics, which has been so disastrous, as shown by the IMF riot phenomenon.

The IMF needs to shed its excessive self-confidence that it knows in detail what is best for the poor, based on an analysis of the whole economy that shares the presumptions of utopian planning. It should go back to its narrow mandate of financial stabilization. The talented professionals at the IMF *could* play the simplified role of bailout creditor effectively, making a useful contribution to the well-being of emerging-market countries.

SNAPSHOT: WATER PIPE

IN THE GREAT RIFT VALLEY of Ethiopia, I visited a village far from the big dreams and Big Plans the West has for the Rest. A British nongovernmental aid organization called Water Aid, which receives funds from official aid agencies, had inaugurated a new project in this village. This agency seemed to be acting more like an explorer and less like a foreign aid planner. Water Aid had discovered a way to get clean water to some very poor villages in the Great Rift Valley. They built a water pipe to carry clean water from springs on top of the mountains bordering the Great Rift Valley to villages down in the valley. The project was run entirely by Ethiopians, with representatives from the villages sitting on the board of the agency.

At a bustling water tap in one village, the villagers watered their cattle and collected drinking water for a nominal fee paid to Water Aid, to be used for maintenance of the system. Previously the villagers had walked two miles every other day to collect water from a polluted river. Villagers, especially children, had been getting sick from the contaminated water—with some of them dying. Children had been kept out of school, farmers away from farming, all to pursue the all-consuming and backbreaking task of fetching water.

Now life was better. Some of the money of the rich *had* reached the desperate poor.