Reforming the IMF? Lessons from Assistance to Post-Communist Countries

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The last year has seen a sharp turn in public opinion against Western assistance to former Communist countries, driven in large part by lurid scandals about the misuse of funds from the International Monetary Fund (IMF) and the World Bank in Russia and Ukraine. In the wake of embarrassing and expensive financial crashes in Moscow and Kiev in 1998--which in turn followed the even more embarrassing and expensive crashes in East Asia--many voices have suggested that the Washington consensus about which policies to promote in these countries was mistaken. The drama of a US presidential election makes the Fund and the Bank particularly vulnerable to criticism. International financial institutions are on the defensive, and even Stanley Fischer (Deputy Managing Director of the IMF) has publicly suggested that the Fund may have overextended itself by becoming involved in detailed, long-term structural adjustment programs.

Major public policy changes are often driven by considerations such as these, but it would be preferable if they were based upon data. The fact that a financial crisis occurred does not prove that the IMF and the World Bank were giving poor advice, and the fact that IMF conditions were violated does not prove that the IMF had no positive influence on a country's policies. In order to answer these questions, we need detailed studies of particular countries and broad, cross-national comparisons. What follows summarizes the conclusions of my forthcoming book, Lending Credibility, which is based upon detailed studies of Russia, Ukraine, Poland and Bulgaria, and statistical analysis on all 26 post-Communist countries (excluding Serbia, which received no IMF assistance).

- Control inflation. Controlling inflation is a necessary condition for political stability and economic growth. My analysis shows that inflation contributes to political instability, and political instability contributes to inflation. In addition, countries that failed to rapidly control inflation suffered steeper declines of output and took longer to recover. Some, like Ukraine, hope to see positive growth for the first time this year. Countries that suffered high levels of inflation also developed more inequality of income. Inflation generally hurts the poor in these countries, because wages and transfer payments do not keep up with the price level, while the rich can shelter their wealth abroad. In countries like Russia, extremely high levels of income inequality have led to widespread disillusionment with democracy and economic reform.

- The IMF is effective. Quantitative analysis shows that inflation is significantly lower and exchange rates are considerably more stable when countries' policies are subject to IMF monitoring. This analysis takes into account the fact that the IMF typically requires countries to improve their policies before beginning a program. It also takes into account the partisan (left-right) composition of governments, fragmentation of governing coalitions, parliamentary support for the government, and the timing of elections.

- The IMF is constrained. IMF officials cannot treat all countries equally, because the G-7 countries put pressure on the Fund to make exceptions for countries that are strategically important or politically favored. As a result, larger countries, and countries that receive larger amounts of US aid, are less likely to have their IMF credit lines cut if they violate the conditions attached to their programs. When tranches of loans are withheld, they are withheld for shorter periods. This analysis controls for the countries' economic policies as well as for the political factors described above.

- The IMF is more effective when it is less constrained. When the IMF cannot credibly enforce its programs, it is less able to influence government policies. As a result, its "seal of approval" is less valuable, because capital markets discount the effect of IMF monitoring of large, politically important countries. In order to measure this effect, I use data to estimate the probability that a country will be sanctioned by the Fund if it violates its conditions, and to estimate the length of time for which the sanctions will be in place. I then find that the less likely a country is to be sanctioned, and the shorter the duration of the sanctions, the more inflationary the government's policies. The government runs higher deficits, the central bank issues more credit, and inflation is higher. In addition, private agents expect higher inflation, so the currency depreciates and central bank reserves decline more rapidly. Again, these results take all of the political factors into account.

- The IMF can achieve something, even in Russia. Interviews with Russian officials make it clear that they believe the IMF has played an important role in Russian politics. They are very sophisticated about the ways in which IMF credibility has been compromised, and yet they believe that Russian economic policies would have been even more disastrous without IMF intervention. This judgment is supported by the cross-national data. The difference in inflation between a very large country, like Russia, and a very small country, like Slovakia, is larger than that between a very left-wing government (Gennady Zyuganov) and a very right-wing government (Leszek Balcerowicz). However, the IMF has net inflation benefits even in the biggest countries.

Policy Implications

Prudent reforms of the IMF are called for, but they should not reject the core mission of the institution, which is to stabilize financial markets; nor should they withdraw the IMF from its more recently-acquired role of fostering comprehensive structural adjustment. We have learned a great deal about the mechanics of economic transition in the last ten years, and mistakes have been made along the way. One important lesson of the transition in post-Communist countries, however, is that reform must be carried out simultaneously along numerous fronts, and that any sector that lags behind threatens to jeopardize the progress achieved in other areas. Consequently, it would be a serious mistake to compel the Fund to back away from the mission of fostering long-term structural adjustment.

A second key lesson of the transition is that the IMF's effectiveness is jeopardized by its dependence upon the G-7 countries. Modern economics teaches that only independent central banks are capable of restraining inflation and credibly committing to financial stability. However, the IMF--the world's central bank--is not independent. As a result, its credibility is severely strained when it deals with powerful countries that are able to exert influence over the major donors. The most important reform that could be undertaken--and the only reform that would substantially address the Fund's failures in the largest post-Communist countries--would be to strengthen the IMF's independence. Calls to subject the Fund to more democratic accountability are moving in precisely the wrong direction.