

## **What Future for the IMF and the World Bank?**

**By**  
**Allan H. Meltzer**

The future value of the international financial institutions — the International Monetary Fund (IMF), World Bank, and others — depends on how they change. Designing a new financial “architecture” is a common way of discussing this issue. Architecture suggests some impressive new edifice to be added to the blocks of architecture clustered around 18<sup>th</sup> Street in Washington.

Architecture misdirects attention. The future of the IMF and the World Bank will depend on their ability to achieve three goals: (1) develop or enhance incentives within client countries for growth, (2) providing incentives for attainable public goods, and (3) improvements in quality of life and reduction in poverty. Increasingly success or failure must be judged by the ability of international institutions to encourage client countries to create the proper incentives for sustained growth and economic and social progress.

What public goods can the IMF and the World Bank provide at a social benefit greater than the social cost? After two decades of intermittent crises, questions arise about the net benefit that these institutions provide.

The IMF in principle could provide two benefits. First, it can reduce risk of international or global financial crises by serving as a quasi-lender-of-last-resort. Second, it can provide information, accounting, and financial standards that reduce costs of acquiring information. Better information improves market allocation by permitting market participants to make more informed choices. One possible benefit would be less herd-like behavior by lenders. If lenders know only that a major lender is not renewing its loans, the probability that a troubled country may be forced to devalue and default rises. Reducing exposure to the country becomes a more prudent strategy than before.

It is well established that markets respond quickly to new information. The IMF has an advantage in obtaining information because of its working relationship with many developing countries and its mandatory Article 4 reports on country developments. The IMF was slow to develop standards to improve the quality of information and slower still to make the information public. There has been much improvement in recent years, but much remains to be done.

The IMF’s most important tasks are crisis prevention and mitigation, including service as a quasi-lender-of-last-resort. The IMF has interpreted its responsibility broadly, but its achievements have been limited, and its record is mixed. Neither its staff nor outsiders find evidence that countries in IMF programs, and subject to its conditional assistance, systematically suffer smaller losses of output than other countries.

The IMF should restate its principal mission. Instead of lending to all countries with problems, it should limit its role to preventing the spread of crises from troubled economies to their neighbors, trading partners, and others. Instead of lengthy negotiations to extract promises of reform, it should not lend to countries that have not adopted and maintained some specified reforms.

Instituting these changes, allowing time for adjustment, would greatly change incentives for countries and lenders. Governments that wished to reform could explain to voters that the country would be less risky. It would, therefore, obtain more capital for development from abroad at lower cost. The IMF would be freed from the onerous burden of engaging in lengthy negotiations or reform agreements that countries often fail to implement or sustain. Lenders would know that if they lend to countries that have not reformed they should expect to take losses in a crisis. Market interest rates would reflect differences in risk, so market efficiency would improve.

This reform seeks to replace the present command and control system with an incentive based system. One likely consequence would be less international lending in the form of loans or bonds with perhaps more foreign direct investment. This, too, would improve the relation of risk to return.

The World Bank poses a more difficult problem, because the nature of the public good that it provides is less clear. Originally a main purpose was to correct a possible market bias against developing countries. For the past twenty years, or longer, many of the problems in developing countries arose because the country or its residents attracted too much lending, especially too much short-term lending. The development banks and the IMF paid too little attention to the risky situations they helped to create, and lenders expected bailouts or support when problems developed.

If the World Bank were less bureaucratic and bumbling, it might be possible to learn what it does more efficiently than the private sector. The Report of the International Financial Institution Advisory Commission conjectured that the World Bank might add value in four ways.

First, Bank staff are experts on many technical problems faced by developing countries. Developing countries should be able to rent this expertise, perhaps at a subsidized price.

Second, the development banks can support programs to raise the quality of life for people in impoverished countries with inefficient or corrupt governments. The Commission proposed monitored grants, in place of loans, with payments to vendors for performance. With commendable effort the Bush Treasury was able to get agreement from other donor countries and the Bank to shift part of its subsidized development lending to monitored grants.

Third, the Bank can finance global or regional public goods by getting countries to agree on environmental safeguards, disease eradication or reduction, and similar programs with large social benefits and low market returns.

Finally, the most difficult of all is to develop incentives for countries to introduce and sustain structural reforms. These reforms include rule of law, democratic accountability, protection of private property, economic stability, and openness to trade.