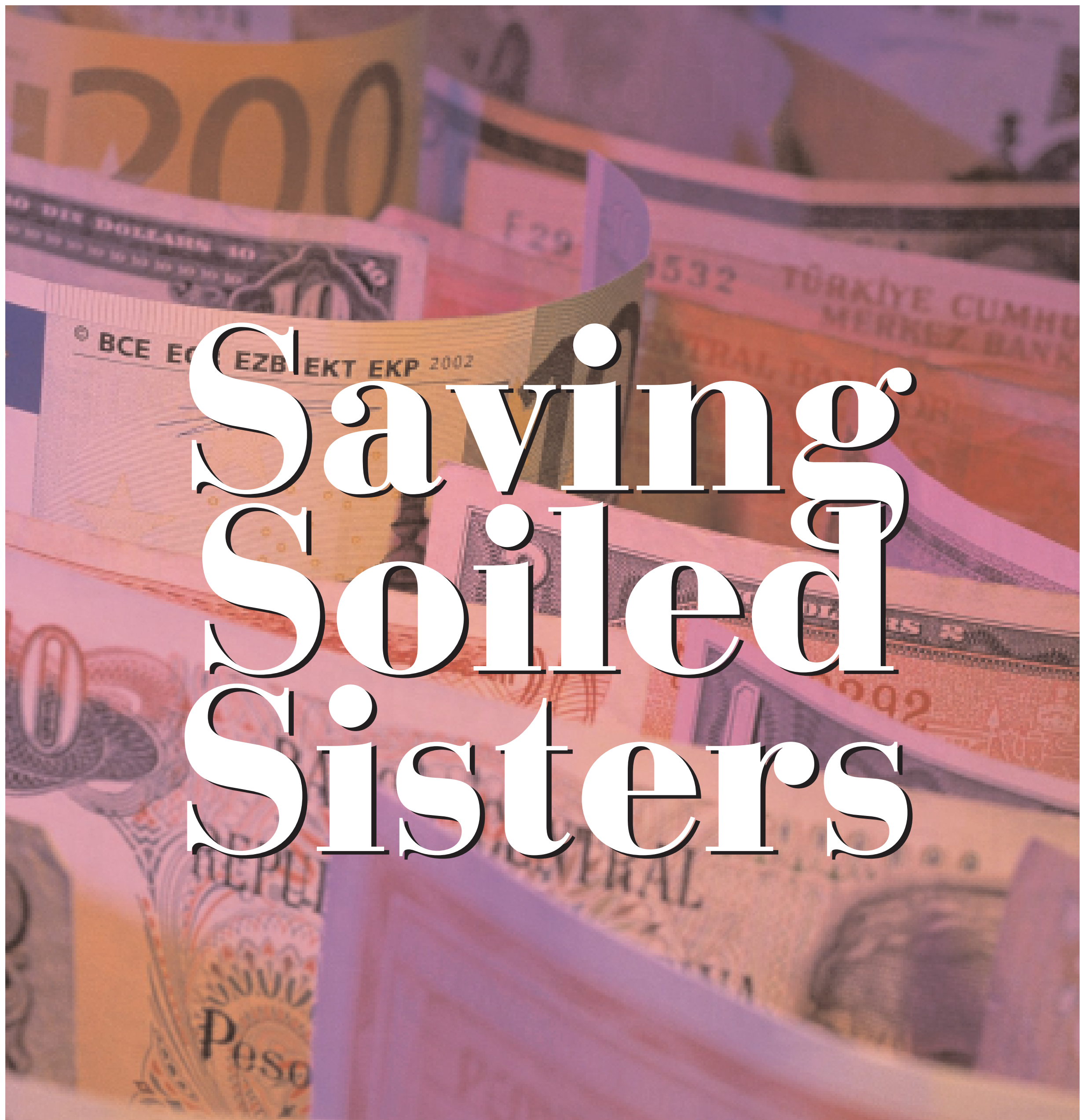

Saving Soiled Sisters

The IMF and the World Bank enjoy untouchable status without doing anyone but its pampered employees much good. For all that, there is a way to reform these institutions for the 21st century.

by Richard W. Rahn

SHOULD THE INTERNATIONAL MONETARY FUND (IMF) and the World Bank exist and, if so, what should they be doing? These questions are increasingly being debated by policy wonks and even by those affiliated with these institutions. A growing number of critics, from both the left and right, are coming to agree that the IMF and World Bank have tolerated too much corruption among their clients and many of their programs do not meet reasonable cost-benefit tests. The IMF says its "primary purpose is to ensure the stability of the international monetary system," and the World Bank says its mission is to "eliminate global poverty." These are laudable goals, even if unattainable, particularly by politically dominated multilateral institutions.

Almost all countries of the world are "members" of these sister institutions, and many members try to influence decision making, often in different directions—so when everyone is in charge, no one is in charge. The decisions made by these institutions greatly affect the well-being of the people in many countries, yet the decision makers are not democratically elected. Many of the staff members are hard-working and endure considerable personal hardship and risks, while others seem to spend too much time in Washington and European capitals, making sure that neither they nor the restaurants they favor are at financial risk.

The managers of the IMF and the World Bank have allowed their missions to overlap, too often defined success as money dispersed rather than service delivered, put too much stress on the limited pool of skilled administrators in poor countries, and failed to act on serious calls for reform (such as those recommended by the Meltzer Commission in 2000). They have also fostered expectations to exceed what realistically could be done—hence, the current widespread disillusionment.

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IN THE SUMMER OF 1944, many leading lights of world finance and economics, including John Maynard Keynes, met at a conference in Bretton Woods, New Hampshire, to plan the post-World War II global financial system. Many attendees distrusted the free market economic system, blaming it for the Great Depression and the rise of Nazism. As is all too typical of those from the academic and political classes, they misdiagnosed the causes of the Depression, and thus came up with unworkable "solutions" that created new problems. (The actual causes of the Great Depression were inappropriately tight monetary policies by the Fed and other central banks, excessive tariffs, and restrictive trade policies. A disaster caused by government was blamed on the free market and then used as an excuse to greatly enlarge government.) The prevailing wisdom was that socialism was the wave of the future and that only large governmental programs could solve economic problems and other ills of society. Thus, it logically followed that if certain economic problems were global, they could only be solved by powerful global institutions, transcending the nation-state.

From this cauldron of misplaced idealism and the desire for control by the "enlightened intellectual," were born the IMF and World Bank. One of the decisions made at Bretton Woods was to create a system of fixed exchange rates among countries. This required a mechanism to "manage" the fixed-rate system—hence the IMF. The IMF did that job quite well until 1971, when President Nixon "closed the gold window" (meaning the U.S. stopped the run on its gold supply by other countries, notably France, because gold had been under-priced), marking the effective end to the old fixed-rate exchange system.

With the end of the fixed-rate exchange system, the IMF should have been out of a job and disbanded. But as we know, in the real world government-created institutions have what Ronald Reagan called "the closest thing to perpetual life." The IMF had, after all, some big buildings in prime locations in downtown Washington, a cadre of highly paid and pampered employees, plus government bureaucrats from many countries who loved the international travel to IMF-sponsored conferences and other influential persons on the IMF teat. This left the IMF with no choice but to find a new mission and, ideally, one to make it even larger and more powerful, and that it did.

Those in charge of IMF mission development knew that leaders of most governments liked to spend other people's money, but directly taxing people was unpopular. Hence, governments tend to run deficits. If a government runs an unsustainable deficit, it normally bails itself out by inflating the currency (making the government debt increasingly worthless). This works fine as long as both debts and assets are in the country's own currency. But what if much of the debt is in someone else's currency, such as the U.S. dollar? At some point, foreigners will refuse to sell or lend dollars (or other hard currency) to an irresponsible government, and then there is no way for the government or its private sector to pay for necessary imports, thus resulting in economic meltdown.

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In the same way that drug abusers and alcoholics eventually need medical doctors, irresponsible governments eventually need economic doctors. And who better to be the doctor than the IMF? If the IMF was going to serve as the banker of last resort for governments, it would need a great expansion of capital and staff. The U.S. and other governments convinced themselves that this was necessary, so money was provided, more staff hired, and new buildings built. And, of course, there were plenty of governments in Africa, Asia, and Latin America most willing to run up the bills and then ask the IMF for a bailout.

The IMF did attach "conditions" for its loans, which most often included a plan for a balanced budget, consisting of some spending restraint, tax increases, and devaluation of the currency. The local leaders could blame the resulting hardship on the IMF, rather than their own mismanagement, and so the IMF programs were often unpopular. Many free market/supply-side American economists were also unhappy with the IMF programs that used static revenue analysis (assuming little or no change in people's willingness to work, save, or invest as a result of tax increases) to develop tax and spending programs for others. As expected, many of these "conditionality" programs did not work because of corruption and cheating by the recipient governments, and the disincentives for productive activity embodied in the program. Critics have also noted that the IMF adds to the systemic risk of the world financial system by making it too easy for governments to avoid the full effect of their irresponsible actions.

The IMF pays its staff and operating expenses from interest earned on the money it lends to governments (even though its capital funds were directly or indirectly supplied by taxpayers from wealthy nations). In recent years, as the world economy has been growing at record rates, there have been fewer and fewer borrowers from the IMF, and some loan recipients have repaid their debts early. This global success (for which the IMF can take some credit) has ironically resulted in insufficient funds to pay the IMF's salary and operating expenses, unless it downsizes.

An area where the IMF can legitimately claim success is in its technical assistance work. Central banks, financial systems, and currency boards have been established in the former Communist countries of Eastern and Central Europe. Senior IMF experts have experienced real hardship—at considerable personal risk—working in Afghanistan and Iraq.

The world bank is far less defensible than the IMF. The bank was formed on the false assumption that if rich countries lent money to poor countries, the poor countries would become rich and poverty would largely disappear. In fact, rich countries became rich because they created the institutions and policies that allowed profit-seeking individuals to create goods and services for their fellow man. Rich countries are characterized by having the rule of law, protection of private property, and relatively little government interference with free markets. Most poor countries lack these attributes and tolerate, if not outright engage in, massive corruption.

As the late, highly regarded development economist Lord Peter Bauer famously noted: "The argument that aid is indispensable for development runs into an inescapable dilemma. If the conditions for development other than capital are present, the capital required will either be generated locally or be available commercially from abroad to governments or to businesses. If the required conditions are not present, then aid will be ineffective and wasted."

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The World Bank had an impossible task. It was required to provide most of its funds to governments, but the governments that could not attract the necessary private capital were too corrupt or incompetent to properly manage monies they received. The World Bank has dispensed approximately $370 billion, coerced from taxpayers in wealthy countries, and has precious little to show for it. (The World Bank is proof that the old line that "foreign aid is the process of taking money from poor people in rich countries and giving it to rich people in poor countries" is not far from the mark.) Many Third World dictators and thugs have become rich from World Bank programs—the late Congo dictator Mobuto being a prime example. Because the World Bank was making loans to government agencies in sovereign states, it only had limited control over the funded projects. Both recipient and donor countries pressure World Bank managers to make loans, and since everyone involved is spending someone else's money, many incentives to ensure the money is well spent are missing.

So what can be done with them? The best solution is to privatize them.

When I served as co-chairman of the Bulgarian Economic Transition Task Force in 1990, I witnessed World Bank staff undermining needed reforms. In one case, we were trying to privatize and de-monopolize the state-owned telephone company, "BulTel." International private carriers were ready to provide state-of-the-art telephone services to Bulgaria. However, the World Bank provided a loan to BulTel with the express condition that the government not allow private competition. When I confronted the World Bank officer in-charge, his response was, "We have to make sure our loan is paid back." As a result, the Bulgarian people suffered from inferior telephone service far longer than necessary, and the corruption and inefficiency in the state-owned company continued.

Even though the World Bank and IMF have become more market friendly in recent years, they still funnel too much money to incompetent or corrupt governments. The World Bank has developed a number of private sector and direct assistance programs, which have worked somewhat better than its major government project loan programs. But these small improvements are insufficient to overcome the fatal flaws in the concept and design of the institution.

Given that there are so many people of influence with a vested interest in the IMF and World Bank, these organizations will not be abolished. So what can be done with them? The best solution is to privatize them. They generate interest income from their lending and receive some fees for their advisory work, and they each have major financial and real estate assets that are presently "owned" by the governments that provided the capital. The "government owners" could be given shares of stock equal to their contributions to each organization, and then each government could choose to either hold or sell the stock to private parties.

The current unwieldy management and board structure should be changed to that of a normal corporation where stockholders elect a few directors to oversee the company. In addition to their interest and fee income, both organizations could become contractors for governments or groups of governments to provide special services, such as grants administration, data collection and dissemination, or even government bailouts.

By becoming normal profit-seeking corporations, they would likely do a much better job in resource allocation and cost control. A privatized IMF and World Bank would, over time, modify their missions and activities. Incentives for laggard countries to adopt the high-growth policies and institutions of successful developing nations would grow once the crutch of the IMF/World Bank was removed. (The proper analogy is U.S welfare reform, which worked far better than predicted.) The regional development banks, which already duplicate many of the development activities of the World Bank, would still exist. The IMF might well develop a major line of currency risk insurance for both governments and private investors—which could be very profitable if properly priced—and would serve as a strong incentive for fiscal prudence.

Privatization might also enable the taxpayers who footed the bills to get at least a partial return on their investment. Governments—including the U.S. government—have created many institutions that have been successfully privatized to everyone's benefit. So why not the IMF and World Bank?

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