Sick patients, warring doctors
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The International Monetary Fund is under attack, not least from its sister organisation, the World Bank, for prescribing the wrong medicine to bring economic health to poor and ex-communist countries.

The patients span the globe from Vietnam to Venezuela. The doctors face each other across 19th Street in Washington and dispense their medicine together. Their remedies, dubbed the Washington consensus, include tight fiscal and monetary policies, freer trade and capital flows, and privatisation. For much of the 1990s, these were accepted as the best ways to make the transition from poverty to prosperity and from communism to capitalism. The consensus’s sponsors, the International Monetary Fund (IMF) and the World Bank, stood unchallenged as the world’s top economic doctors.

No longer. After a series of financial crises from South Korea to Brazil, and an economic meltdown in Russia, the consensus has broken down. Many traditional prescriptions have been discredited and the doctors are at loggerheads with each other. Joseph Stiglitz, chief economist of the World Bank, who was vocal in his criticisms of IMF economic advice in Asia last year, is now equally vocally lambasting the Fund’s record in transition economies. Although he is not officially speaking for the World Bank, it is widely believed that the Bank’s boss, James Wolfensohn, shares his views.

Partly, the fracas is the inevitable result of apparent failure. But it also has a more subtle cause. In recent years the Fund and the Bank have been hijacked by their major shareholders for overtly political ends. Whether in Mexico in 1994, Asia in 1997 or Russia throughout the 1990s, the institutions have become a more explicit tool of western, and particularly American, foreign policy. Only this week the two bodies were using their economic muscle to pressure the Indonesian government into accepting an international peacekeeping force in East Timor. Such politicisation, many feel, threatens their credibility in handing out disinterested policy advice.

The focus of a lot of criticism is the IMF’s record in Russia. Almost a decade after reforms began, the place is a mess. Around 60m people, almost half the population, live below the poverty line. Income inequality has risen; life expectancy has plummeted. Corruption is massive and endemic.

Mr Stiglitz says much of this dismal performance stems from the intellectual inadequacies of the previous approach. There was, he argues, too much emphasis on macroeconomic stabilisation at the expense of institution-building. Privatisation was pushed too far too fast, and, without the right regulatory framework, was bound to fail. Western advisers wrongly thought that privatisation would create a demand for protection of property rights. Instead, new owners stripped the assets and transferred the money abroad, helped by a misguided liberalisation of capital flows. The result
was a country riddled with cronyism and corruption.

It would have been better, argues Mr Stiglitz, to have proceeded more slowly—building a regulatory framework before privatisation, and concentrating on strengthening the rule of law and on creating effective institutions, such as courts. He likens the misguided zeal with which Russian reformers and their western advisers set about changing a society overnight to that of the Jacobins and, yes, the Bolsheviks. It is as if many western advisers thought the Bolsheviks had the wrong textbooks but not the wrong approach, he writes.

These comments have caused a furore. Anders Aslund, of the Carnegie Endowment for International Peace, an early adviser to the Russian government, says mildly, “Stiglitz is a striking embarrassment to himself and the World Bank. Without knowing anything, he mouths any stupidity that comes to his head.” Officials at the Fund and the Treasury are more circumspect in public, but there is little doubt that they too are furious.

Mr Stiglitz is plain wrong, these critics claim, to argue that nobody emphasised the importance of building institutions. The World Bank itself sent dozens of teams to help with legal reform, training judges and so forth. But the process is complicated and slow. Reformers did not have the luxury of waiting until it was complete.

Most reform veterans also reject Mr Stiglitz’s policy prescriptions. Few accept that collapsing post-communist governments could have prevented the looting of assets. In a recent paper*, John Nellis, a privatisation expert at the Bank, argues that, globally, privatisation has been a success. Governments that botched it were equally likely to botch the management of state-owned firms. He points to Ukraine, which is in even worse straits than Russia, as evidence that the Stiglitz strategy of going more slowly would not have worked. The evidence from Eastern Europe is that the speed of “shock therapy” has delivered better results than gradual reform.

Third, nobody denies that reform in Russia and elsewhere has had to contend with political constraints. There were clear risks in rapid privatisation. And there were unsavoury aspects to Russia’s reforms, particularly the 1995 policy of handing over shares in lucrative state jewels to the financial oligarchs in return for short-term loans. But the political environment—the chance of a return to communism, a collapse into fascism or even the disintegration of a nuclear power—justified some risk-taking. The record of the Bretton Woods institutions should be considered against this background.

These arguments are not wholly convincing, however, not least because the Fund did offer mistaken policy advice to some transition economies. Among the most successful countries have been those which, although strongly reformist, ignored the IMF on important questions. Estonia, for instance, successfully reintroduced its pre-war currency, the kroon, in place of the rouble in 1992, when the IMF was still calling for a single currency from Tallinn to Tashkent.

And regardless of political constraints, the IMF, an overbearing organisation with a well-thumbed book of macroeconomic-policy nostrums, may have been unsuited as an institution to handle the murky, stricken economies of Eastern Europe in the first place. “Would you have wanted the IMF running the Marshall Plan in Western Europe after the war?”, asked Yegor Gaidar, Russia’s first radical reforming prime minister, at a recent conference in Stockholm.

Still, the political and strategic arguments help to explain why economic considerations often became secondary. That was why the Fund tolerated the loans-for-shares scheme; why it relaxed lending criteria before the Russian election in 1996; and why the Fund blew nearly $5 billion trying to prop up the rouble up in July 1998.

Political and strategic considerations have also played a role in the IMF’s recent reactions to financial crises elsewhere in the developing world. Starting with the massive bailout for Mexico in 1994, via the enormous support packages for Thailand, South Korea and Indonesia and ending with its failed attempt to prop up Brazil’s currency, the real, in 1998, the Fund’s programmes have
reflected its strategic as well as economic priorities—and those of its major shareholders.

There have been economic miscalculations too. Most people now agree, for instance, that defending fixed exchange rates for too long is a mistake. It is broadly accepted that private creditors should share the burden of unwinding economic crises; and that big public bailouts may create moral hazard, increasing the risk of future crises. This week, a task-force sponsored by the Council on Foreign Relations published a report that urged countries to avoid fixed exchange rates and to discourage short-term capital inflows, and called on the IMF to return to its old policy of smaller bailouts.

But if the political role the two institutions are being asked to play is part of the problem, that needs to be addressed too. Another recent study* argues that, just as independent central banks have proved better at fighting inflation, so a more independent IMF might be more effective at promoting international financial stability.

Such reforms, the authors say, would insulate the IMF from short-term political pressures, making its advice more credible and more effective. Pretending to be economic handmaidens while in fact being political social workers is a recipe for failure. On the other hand, the converse might also be awkward: officials would no longer be able to blame political constraints when their economic medicine doesn’t work.

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