STRAIGHT TALK

More Cheerleading or More Whistle-Blowing?

A little more IMF whistle-blowing would be a welcome sound

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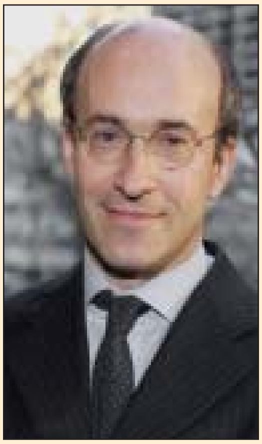

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IN TRYING to prevent global financial crises, the IMF faces a constant tension between being a "whistle-blower" and a "cheerleader." To forestall problems from building to crisis proportions, the IMF needs to speak out clearly, forcefully, and publicly at an early stage. Yet confidence is often fragile, and governments undertaking tough reforms deserve words of public encouragement. What should the balance be between these two roles?

Why not more cheerleading?

Isn't the golden rule for any doctor "first, do no harm"? Wouldn't it be better for the IMF never to say *anything* negative at all than to even once undermine confidence and possibly set off even a minicrisis? The problem with this view is that it's predicated on the assumption that international financial markets are stable—and nothing could be further from the truth.

In reality, all financial crises have a significant random element. It's easy to say, with the benefit of hindsight, that the tech boom of the 1990s had to end in a crisis. (By the way, the IMF's *World Economic Outlook* warned of a tech bubble for several years before it burst, just as it now warns of a housing bubble in some countries.) The same goes for Japan's bubble economy in the 1980s. But, in the real world, these calls are tough. State-of-the-art theoretical models of financial crises emphasize that all crises have an irreducible random element. No doubt, poor economic fundamentals (such as overvaluation of equities or land) may set the stage for a crisis or even make a crisis inevitable, while relatively strong fundamentals may lend some immunity. However, most of the action occurs in a large gray area where the economy is vulnerable but not certain to undergo crisis. Typically, in a vulnerable economy, a crisis will take place only if a sufficiently large pool of investors panic simultaneously. (Admittedly, the weaker the fundamentals, the less panic it takes to push the economy into crisis.)

Why should the IMF have to say anything? Won't markets keep excessive borrowing in check, and can't developing country governments be relied on to avoid excessive risks? Experience suggests not. Investors are willing to lend to developing countries at high enough interest rate premiums, but with premiums of 5–10 percent, occasional—and frequently costly—defaults are inevitable. Moreover, governments tend to be shortsighted and anxious to stay in power. The IMF, on the other hand, is supposed to look beyond the needs and desires of current governments if their policies are clearly driving their economies off a cliff.

Yes, it is true that the IMF ultimately reports to its 184 member governments, none of whom would look kindly on having IMF surveillance trigger a potentially politically destabilizing crisis in their own country. At the same time, the IMF's Executive Board is generally appreciative of the fact that the institution needs to fill its role of averting global financial crises. And, if the IMF gives in too much to the pressures and temptations of cheerleading, it risks allowing local problems to fester, thereby leading to much bigger, and potentially global, crises in the future.

Take the Asian crises of the late 1990s. In the run-up period, the IMF looked far too benignly on the huge capital flows going into a region where most governments were married to exchange rate pegs—pegs that were highly vulnerable to speculative attacks once capital accounts were liberalized. When governments portrayed the capital inflows as a sign of strength and market confidence rather than as a buildup of vulnerabilities, the IMF should have spoken out earlier and more decisively. Similarly, in Latin America in the 1990s, many governments trumpeted themselves as following the Washington Consensus (an oxymoron if ever there was one) when, in fact, few of them had tackled the deep structural problems facing their economies—such as excessive tariffs, rigid labor markets, weak regulation, and, above all, unsustainable government deficits and undeliverable pension promises. The international community was right to encourage reform efforts, but it was wrong not to take much stronger action to limit government and external borrowing.

Candor can lead to minicrises

Granted, too much cheerleading can be problematic, but what's the case for more whistle-blowing? First, although the IMF is often blamed for its dark assessments of economic realities, my own strong sense is that ***the institution's future hinges on its being more candid***—even if that means sometimes bringing forward a crisis that might have been delayed, and even if that means sparking a minicrisis that might never have happened!

This proposition isn't as radical as it sounds. Economic crises have been with us for many centuries (long before the IMF's creation in 1944), and they will be with us for many centuries to come. The main object of policy, I would maintain, is to stop really big crises from developing. That is, the IMF should work to prevent the kind of crises that give rise to deep and protracted losses of economic well-being—such as Latin America experienced in the 1980s, Japan has experienced since the early 1990s, and Germany today risks if it fails to engage in decisive labor market and pension reforms. Indeed, given the unpredictable and tenuous nature of economic and financial markets, I would argue that, if IMF surveillance is never so candid publicly as to cause an occasional minicrisis, there must be room for more candor. (Here, I am not speaking of excessive candor in the *midst* of a crisis that is already under way!)

Second, ***by being candid early on, the IMF can help keep an economy from moving too close to the brink***. One might argue that such candor could fuel investor gloom, potentially creating a self-fulfilling prophecy, as scale backs by one group of investors drive down prices and reinforce pessimism on the part of others, triggering a downward spiral in the economy. Perhaps, but more often than not, increased transparency and candor breed stability in markets and boost investor confidence; investors do not like extraneous uncertainty. By the way, although the IMF plays a valuable role, I don't want to attribute too much power to its economic surveillance activities. The IMF is hardly the only channel through which individual countries can reveal information. Indeed, many governments are increasingly transparent in their relations with private investors. If IMF assessments are out of line with those of market analysts and are consistently proved wrong, the IMF will risk becoming irrelevant. And if the IMF never acknowledges problems until they are too deeply rooted, it will also risk becoming irrelevant.

Third, ***assessing crisis risks is never going to be an exact science***. A number of researchers inside and outside the IMF have worked on so-called early warning system models of debt and exchange rate crises in emerging market countries. These statistical models incorporate factors such as exchange rate overvaluation and debt maturity structure to try to arrive at probabilistic predictions of financial crises. The models seem to work pretty well, after the fact, in detecting vulnerabilities in countries that actually experienced crises. However, if the models are tuned broadly enough so that they don't miss many crises, they also "cry wolf" in many cases where no crises occurred. Famously, the models have been described as successfully predicting 30 out of the last dozen international financial crises.

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Fourth, ***even industrial countries need watching***. After all, problems in rich countries are much more likely to spill over to the rest of the world and become "systemic" than crises in poor or middle-income countries. While none of the IMF's recent borrowers are industrial countries, its surveillance activities still apply to all countries, including industrial countries. We've already talked about Germany and Japan, but let's not leave out the United States, which is on the biggest external borrowing rampage in the history of the world, with current account deficits projected at 5 percent for as far as the eye can see.

A delicate balance

In sum, the IMF has to walk a fine line between its desire not to throw sparks on the tinder of global financial markets and its desire to defuse potential crises before it's too late. Even though our models of financial crises are far from perfect, I think the historical experience suggests that the IMF would be moving in the right direction if it did a little less cheerleading when debts were building up and a little more whistle-blowing, to try to steer clear of really major crises. ■