STRAIGHT TALK

Rules versus Discretion

Should the IMF have less of a free hand in resolving crises?

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THE IDEA that policymakers may actually be better off binding themselves through rules rather than giving themselves a free hand seems strange to the layperson. After all, isn't it hard to predict the circumstances in which policy has to be made? Why tie policymakers' hands with rules, which, because they are set in advance to cover a wide variety of circumstances, are likely to be inadequate for the specific situation?

Everyone knows discretion is problematic in the hands of the corrupt. But the 2004 Nobel prize winners in economics, Finn Kydland and Edward Prescott, received the prize in part for showing that even well-meaning policymakers could be better off with rules. The idea is as follows. Suppose the government in a country favors low inflation and high output, but that surprise inflation leads to higher output (for a while businessmen are fooled into thinking there is truly higher demand for their products even though it is only the government printing more money). Suppose also we are nearing election time, when higher output is particularly helpful for the government's prospects. Without rules, the authorities will be tempted to generate a little more surprise inflation to get a timely surge in output. But the public will rationally recognize this temptation and build it into their wage demands (and businessmen will not be fooled). Now, if the government does not generate the inflation, real wages will be too high and output will suffer. So the consequence is that the government is forced to generate higher inflation, no one is fooled, and output is no higher. In many ways, this fine piece of theory has led many central banks to tie their hands through inflation and price level targets.

Does the theory apply elsewhere? What about the IMF's crisis lending? The case for discretion is similar. In theory, the IMF should lend when a country is suffering a liquidity shortage and pledges to take corrective policy action. If the country is fundamentally insolvent, the IMF should ask it to restructure its debts. Given that it is hard before the fact to tell a liquidity problem from a solvency problem, it seems clear that the IMF should have discretion in deciding to whom to lend, how much to lend, and how much conditionality should accompany the lending. But is there any rationale for rules?

The most important reason is that without rules, it may be hard to be selective. If it is difficult to tell liquidity problems from solvency problems even in a crisis, then well-meaning IMF officials (and the IMF's major shareholders) may be biased toward intervention, simply because it is too hard politically to stand back and let a country collapse, even when the crisis is self-induced. Only on a few such occasions will the fragility of the country's political institutions and the threat of the crisis spilling over to other countries warrant intervention.

Difficulties of discretion

As markets become more important to a country's financing, the difficulty of exercising discretion will increase. Markets attempt to anticipate the IMF's behavior. If the IMF has been as silent as a sphinx as a crisis approaches—not revealing whether it will step in or not, but letting it be known that it will use discretion based on the circumstances—markets may force its hand. If market participants take positions believing that the IMF will step in, and the IMF does not follow through, it will be accused of precipitating the crisis and roiling markets. To the extent that the IMF is already biased toward intervention, markets could reinforce that behavior by anticipating it, much as wage pressure in the Kydland-Prescott model forces the unwelcome higher inflation on policymakers.

What are the costs of excessive intervention? One is that a country that should have negotiated down its unsustainable debt, adds the cost of a rescue to that debt, including the cost of bailing out the banking system. The country totters for a few more years before it enters a fresh crisis. In the meantime, the citizenry pay the price through low economic growth and high taxes. A second is that moral hazard is encouraged—not just the traditional version of investors getting complacent (the evidence is very mixed on this) or governments overborrowing but also the possibility that domestic interest groups may have too little incentive to compromise on inflated budgets, excessive wage demands, or inefficient monopolies if they know the country will not be allowed to fall off a cliff. The point is that far from reducing the overall expected pain borne by countries, discretion may enhance it, as Kydland-Prescott might argue.

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Why would a country agree to a rescue if it promises longer-term pain while offering only short-term relief? The adage "any port in a storm" is probably much of the explanation. But my colleagues in the IMF's Research Department, Olivier Jeanne and Jeromin Zettelmeyer, have proposed another. Bailouts may help governments shift the burden of a crisis off the shoulders of the domestic business elite onto domestic taxpayers. To the extent that the latter lack strong influence, they bear the brunt of excessive intervention, and everyone else who has influence is willing to go along.

Using more rules

What would the Kydland-Prescott thesis suggest? Rules, of course. The IMF has recognized this and has rules in place, such as those on exceptional access. But would more rules help? For instance, access to IMF lending could be tied to a country's policies and reforms in normal times, as suggested by Jeanne and Zettelmeyer. If a country follows sound policies and undertakes needed reforms, there should be a presumption that if it faces a crisis, it is likely to be a liquidity crisis or a solvency problem (such as a permanent terms of trade shock) that is not of its own making. The IMF should intervene in the former and will be providing insurance in the latter case—not an entirely bad use of IMF resources.

These additional access limits could be set in the regular annual Article IV consultations, where they would be based on in-depth analysis of the country's policies. To the extent that a country's policy environment changes significantly, interim assessments could also be undertaken. The assessments would be a clear signal to the markets about the IMF's view of a country's policies, putting steady pressure outside normal IMF programs on the country to stay the course of reforms (effectively a "nonborrowing" program), and putting more pressure on IMF staff to do a good analysis because inadequate assessments will be contested.

Overly constraining?

Two immediate concerns arise. First, if the IMF is to intervene successfully in a liquidity crisis, it usually makes sense to pump in enough funds to stop the panic. Smaller amounts may not do the job, and access limits, if set too low, may inhibit successful intervention. While IMF staff may not be able to judge whether a crisis is one of liquidity or solvency, they can certainly judge how much is needed from the facts of the crisis. So would the rules not be overly constraining?

The answer, of course, is yes, but that's the point. To the extent that the access limit is deemed too restrictive for the crisis at hand, the IMF will have to convince bilateral or private parties to join, which will limit excessive intervention. Otherwise, the IMF will have to stay out. Thus, the access limit will effectively translate into a probability of intervention.

An alternative, though, would be to link the probability of intervention, rather than the amount of assistance, to the country's policies and reforms in normal times. For instance, for countries in good standing, a decision to help might need approval by only a minority of the IMF's Executive Board, while for countries in poor standing, it might need approval by a supermajority. A politically independent minority of the members could then block loans to countries that have not shown much ownership of policies.

Too intrusive?

But this leads us to the second concern. Setting the terms for conditionality in advance, which is effectively what such rules would amount to, is more intrusive than anything the IMF currently does—even members not under programs would be subject to greater scrutiny. Members would be rightly concerned about the kind of policies IMF staff would encourage and the possibility of political interference in setting access limits (or voting requirements). This implies the IMF's governance would have to be seen as legitimate by all the members. Not only would issues of voice and representation need to be addressed, but members of the Board would also need a certain amount of independence from their authorities so that they could base their decisions on the economics of the situation, about which they are likely more knowledgeable than their ministry thousands of miles away.

In sum, while rules might indeed help, they would require the significant change in the IMF's modus operandi. Adding to the difficulty is the fact that no one really wants to give up discretion. But if central banks can do it, perhaps the task is not impossible. ■