Austerity and the IMF

Kenneth Rogoff

The Fifth Annual

Richard H. Sabot Lecture

April 2010

The Center for Global Development

The Richard H. Sabot Lecture Series

The Richard H. Sabot Lecture is held annually to honor the life and work of Richard "Dick" Sabot, a respected professor, celebrated development economist, successful Internet entrepreneur, and close friend of the Center for Global Development (CGD) who died suddenly in July 2005. As a founding member of CGD's Board of Directors, Dick's enthusiasm and intellect encouraged our beginnings. His work as a scholar and as a development practitioner helped to shape the Center's vision of independent research and new ideas in the service of better development policies and practices.

Dick held a PhD in economics from Oxford University; he was Professor of Economics at Williams College and taught previously at Yale University, Oxford University, and Columbia University. His contributions to the fields of economics and international development were numerous, both in academia and during ten years at the World Bank.

The Sabot Lecture Series hosts each year a scholar-practitioner who has made significant contributions to international development, combining, as did Dick, academic work with leadership in the policy community. We are grateful to the Sabot family and to CGD board member Bruns Grayson for the support to launch the Richard H. Sabot Lecture Series.

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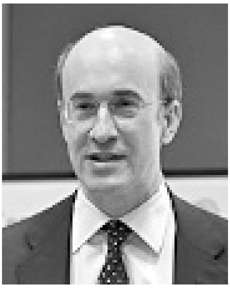

Kenneth Rogoff, one of the world's leading experts on global economics, is the Thomas D. Cabot Professor of Public Policy and Professor of Economics at Harvard University. His treatise, *Foundations of International Macroeconomics*, is the standard text used in graduate courses throughout the world, and his monthly syndicated column on global economics is published in over 30 countries.

Rogoff served as Economic Counsellor and Director of Research at the International Monetary Fund from August 2001 to September 2003 and, before that, as Director of the Center for International Development at Harvard. He also holds the life title of international grandmaster of chess.

He received a BA from Yale University in 1975 and a PhD in economics from the Massachusetts Institute of Technology in 1980. His most recent book, with co-author Carmen M. Reinhart, is *This Time Is Different: Eight Centuries of Financial Folly*, an empirical investigation of past financial crises.

In this year's lecture, "The Perils of Financial Globalization and the IMF," Professor Rogoff will discuss historic vulnerabilities of developing countries to financial crises, alternative approaches to mitigating risks and dealing with crises in the future, and the past and prospective roles of the IMF and the G-20.

Austerity and the IMF

It is a great honor to present the fifth annual Richard H. Sabot lecture at the Center for Global Development. In this talk, I will take up a relatively narrow but absolutely fundamental question in the international monetary system, particularly in developing countries: Is the International Monetary fund (the IMF) guilty of bringing excessive austerity to the countries that turn to it for bailout funding? Should the IMF instead put much more weight on encouraging countercyclical fiscal policy, as it does in rich countries? Extremely difficult and complex issues underlie these seemingly straightforward questions. My modest aim in this lecture is to help clarify the issues so as to promote rational dialogue.

I will argue that the simplest and perhaps most cutting version of the IMF austerity charges is simply confused. IMF loans typically relieve austerity; they do not make it worse. IMF support helps a country engage in less procyclical budget contraction than it might have been forced to do otherwise. That said, the IMF's judgments in calibrating programs involve a huge range of subjective decisions about politics, psychology, and economics, judgments that are difficult to get "right" consistently. Toward the end of my remarks, I will argue that in many respects, the greatest problem with IMF programs is not excessive austerity with debtors but excessive generosity toward creditors.

It is a fascinating time to think about the future of the International Monetary fund in its efforts to help countries deal with the perils of financial globalization. Just a few years ago, the IMF seemed on death's doorstep, set to go into prolonged hibernation if not extinction. Castrated by a failure to adequately explain its role in the Asian crisis, and made seemingly irrelevant by the long 2000s credit boom, the IMF found itself virtually bereft of borrowers. Even poor African countries shunned IMF money. Today, of course, the world has been turned upside down. The historic April 2009 meeting of the G-20 leaders in London assigned the IMF a pivotal role in stemming the global financial crisis and pledged a massive quadrupling of its resources. G-20 presidents urged the IMF to prevent the crisis from infecting developing countries and emerging markets. A clear subtext to their message was that world leaders wanted the IMF to be generous and forthcoming with its resources, lending now and asking questions later. At the same time, the IMF was charged with taking a more forceful role in global macroeconomic surveillance, and a supporting (albeit ill-defined) role in financial market regulation. Now, with the IMF returning to Europe after a nearly three-decade hiatus (Portugal had a program in the early 1980s), an institution that had so recently been dormant has come to take perhaps the largest role on the world stage it has ever had.

Yet, even as the IMF is now able to be more generous with its expanded resources, the challenge of persuading countries to reign in their budget deficits to restore confidence in international markets is very much a central one. After the financial crisis, the IMF poured resources into Central and Eastern Europe, even into governance-challenged economies such as Romania and the Ukraine. For the moment, the IMF does not need to call in any of its loans, but what will happen over the next couple years as the IMF is inevitably forced to tighten the screws? Will the austerity charge again cripple its efforts to restore stability? How well will Western Europe deal with the sustained budget austerity resulting from the crisis in the euro, particularly across the Southern Cone countries?

Before turning to my main topic, I will digress briefly in the next two sections to the role of the Center for Global Development, Richard Sabot's vision in helping found it, and to my own journey from macroeconomics to development.

Richard Sabot and the Role of the Center for Global Development

I did not have the privilege of knowing Richard Sabot, but his important contributions to development research and policy, as well as his role as a founder of the Center for Global Development, are well known. Sabot pioneered the exploration of topics that remain at the heart of development research today, including the importance of rural-to-urban migration (witness China today), the role of women in successful development, and also the relation between inequality and growth. Dick developed many of these ideas in his tenure at the World Bank, where he influenced a generation of economists. Of course, his vision helped create the Center for Global Development.

The Center has a critical role to play in the development policy research nexus. While universities are a huge resource for producing both ideas and energetic young students, the research bias at universities is weighted heavily toward producing academic journal articles. The greatest rewards in academia are for influencing methodology and technique rather than policy. The World Bank itself, of course, produces a great deal of applied research. In addition to sponsoring outside research, the bank produces a large number of its own studies. Indeed, four years ago, I served on a committee chaired by Angus Deaton and including Abhijit Banerjee and Nora Lustig that reviewed a decade of World Bank research. Drawing on meetings, interviews and reports from more than two dozen of the world's leading development researchers, the Deaton committee produced a report (Deaton et al. 2006) that encompassed both the state of development research in general and the state of development research at the World Bank in particular.

The bank has, of course, produced a great deal of important research throughout its history, and the decade under examination (ending in 2005) was no exception. Nevertheless, I was impressed by how many important gaps and question marks remained in the bank's research program. The bureaucracy also faces challenges prioritizing resource allocation for creating and (even more so) maintaining data sets, and in synthesizing diverse results from around the bank. With all due recognition of the bank's accomplishments, the exercise highlighted the importance of having independent think tanks such as CGD, which have a critical mass of scholars and no political agenda to undermine their credibility.

A Short Personal Digression on My Introduction to Development

I came to development economics from a background as an international macroeconomist. In the early 1980s, I was working on topics such as empirical exchange-rate modeling and forecasting. My paper on central bank independence (Rogoff 1985) offered a rationale for why countries might want to delegate monetary policy to an independent central bank that is more focused on stabilizing inflation than is society as a whole. In a world where most developing countries were attempting to fix their exchange rates, exchange-rate forecasting was not a topic on the front burner. As for central bank independence, even if rigidity in exchange rates did not constrain the scope for independent monetary policy, it would have been virtually impossible politically and institutionally to imagine a meaningfully independent central bank in most developing countries.

How times have changed! Although of course there are differing degrees of interpretation, central bank independence is now the norm throughout much of the world. Imagine: India has (to some extent) a flexible exchange rate, and Brazil has one of the most flexible exchange rates in the world. At the same time, the central banks in both countries have developed into powerful independent institutions. As developing economies have advanced, their macroeconomic problems look increasingly like the ones that faced advanced countries a few decades ago.

My first work that focused on developing economies, however, consisted of a series of joint papers with Jeremy Bulow on sovereign debt crises, written in the second half of the 1980s. Bulow and I argued that the reigning approach (in the academic literature) of Eaton and Gersovitz (1981) was unsatisfactory both theoretically and empirically. At the very least, Eaton and Gersovitz's narrow focus on exclusion from capital markets as the penalty for default was elegant but far too narrow. Later work has by and large supported the view that, at the very least, one must work with a much broader notion of reputation and the penalty to default, one that covers trade, banking, and possibly even national security issues. Perhaps even more importantly, the reputation view obscures the fundamental importance of legal and political institutions, making it virtually impossible to think about policy design. Why have a world bankruptcy court, as some have proposed, if the whole underpinning for sovereign debt repayment is reputational? (See Rogoff and Zettelmeyer [2002] for a survey of the literature on international bankruptcy mechanisms.)

Later, my stint as chief economist at the International Monetary Fund from 2001 to 2003 had an enormous influence on my research. I became immersed in a range of development issues, learning a great deal from my colleagues in the research department and throughout the International Monetary fund as well as from economists and policymakers around the world. My paper with Ayhan Kose, Eswar Prasad, and Shang-Jin Wei (Kose et al. 2006) attempted to take a detached view of the empirical literature on international capital market integration and development, a topic about which there had been a high ratio of polemics to fact. We found the mass of literature to be surprisingly ambiguous with respect to growth and macroeconomic volatility, which we attributed in later work to the fact that the indirect effects of capital market integration—both positive and negative—swamp the effects of the traditional capital accumulation, consumption smoothing, and diversification effects emphasized in the literature.

It was also during this period that I began a long ongoing collaboration with Carmen Reinhart. Since leaving the IMF in 2003, Carmen and I have been doing research on the history of international financial crises going back almost 800 years. Our recent book, This Time Is Different: Eight Centuries of Financial Folly, shows the universality of financial crises across time and space. The analysis of the book suggests that it was indeed folly in the mid-2000s to predict the demise of the IMF as an organization that was no longer needed because there would never again be a major sovereign debt crisis.

Thanks to the G-20, the IMF has the capacity to hand out more and larger loans than ever. To be effective, however, the IMF ultimately has to be able to help countries live within their means, at least on a long-term basis. Its efforts to help spendthrift governments reign in their budgets has often led to the charge that it mindlessly preaches austerity with little regard to social consequences. It is this core topic that I wish to take up in today's lecture.

The IMF and the Austerity Charge

Perhaps the leading charge against the IMF over its long history is that it invariably imposes harsh austerity conditions on hapless developing countries in their time of greatest need. Over the past three decades the world press has been replete with images of mass demonstrations against IMF programs, with food riots against price hikes and shortages being a particularly compelling graphic. Although the IMF has been accused of many mistakes over the years (most famously perhaps by Joseph Stiglitz [2002]), the austerity charge is the one that cuts most deeply at the IMF's moral authority and ultimately its power and effectiveness. Is the austerity charge fair?

The short answer is that the IMF almost always makes austerity for a bankrupt country lighter than it might otherwise have faced. The superficial view that the IMF creates needless austerity is just naïve and wrong. However, even as the IMF relieves austerity, a great deal of judgment is required in calibrating how much and for how long the IMF should help, and under what conditions. The deeper question of how the IMF should design and calibrate its rescue programs to relieve austerity is a legitimate one over which views on best practice are constantly evolving.

Traditional anti-IMF rhetoric is so effective that most people are shocked when they are told that IMF programs usually relieve austerity rather than make it worse. How can that be, they will ask, given so many press articles and so much political rhetoric reinforcing the populist view that the IMF puts budget balance and the interests of foreign banks ahead of the welfare of ordinary people? Straightening out the simplest misconceptions about the IMF and austerity is an essential starting point to any rational conversation about what the real issues are.

The basic point is that, in most cases, the International Monetary fund is effectively a lender of last resort. Countries typically go to the IMF when other lenders have turned their backs, and there is nowhere else to turn. Unlike private lenders, the fund is a quasi-UN organization that draws on money from governments around the world rather than private lenders.

The circumstances of IMF lending programs vary, but certainly the most common include a government, after many years of running large deficits borrowing heavily from the private sector, finding itself unable to "roll over" its old debts as they mature (unable to find new loans to cover old principal payments as they come due). At the same time, of course, the government is unable to finance ongoing budget deficits. There are many nuances, depending for example on the extent of exposure to private sector foreign creditors, but the "twin deficits" of government budget deficits and current account deficits is the canonical predicament. In the typical case, whether triggered by a shift in international capital markets or the domestic economy, the country experiences a Dornbusch-Calvo "sudden stop" of financing flows. Perhaps the world price of the country's primary commodity export has suddenly plummeted. Perhaps a political upheaval has caused creditors to doubt whether the country will continue on its old growth path. Perhaps a shock to world markets stemming from a sudden monetary tightening or risk event affecting the rich countries has caused a sudden retreat from risky lending abroad. (For example, the Volker monetary tightening in the early 1980s, together with a concomitant drop in global commodity prices, was a key trigger of the Latin American debt crisis of the 1990s. See Bulow and Rogoff [1990] or Reinhart and Rogoff, [2009].)

One way or the other, the funding spigot is shut off and the country finds itself in deep financial trouble. Absent an international lender of last resort, not only would a country likely be forced to default on its existing debt, it would be unable to continue sustaining trade balance (current account) deficits of any kind. A country cannot buy more than it sells unless someone is willing to lend it money. Not every country on the brink of default is running an ongoing deficit (sometimes it simply cannot refinance its existing debt), but that is the most common situation. Examples include Argentina in 2000 and much of Eastern Europe in the run-up to the 2007–09 financial crisis.

Here is the key point. In the face of ongoing deficits, a sudden stop in international lending implies that citizens would feel the effects of a tightening belt even without an IMF program. And that does not include any penalties lenders might impose for defaulting, such as making it difficult for exporters to access the bank trade credits that are the lifeblood of international trade. That is precisely why, in the canonical case, a country turns to the IMF.

When the IMF comes in, it typically makes a country a bridge loan at an interest rate far below what it could imagine getting on international markets, even prior to the crisis. That is, the IMF usually charges an interest rate only slightly greater than the rate that triple-A borrowing countries such as the United States and Germany pay. In principle, the IMF bridge loan allows the troubled debtor time to adjust to the shift in international lending, to sustain essential services, and to restructure finances for an eventual return to international borrowing. Again, one must underscore the point that the IMF does not impose itself on a country; it comes in only by invitation. A country opens its doors to the IMF (admittedly usually quite reluctantly) precisely because the government knows that an IMF bridge loan can help cushion austerity.

Thus, as I have argued in the past (e.g., Rogoff 2003, which restates my review of Stiglitz 2002), the fact that the IMF is often found near the scene of sharp budget cutbacks does not mean that it is the primary cause. Doctors can be found treating plague victims; this does not mean doctors cause plagues. Fire engines are found near fires; this does not mean fire engines cause fires. The simplistic populist notion that the IMF is the root cause of austerity in a crisis is utterly naïve and wrong, despite the huge success of many polemicists in propagating this view.

For the most part, financial crises are caused by countries mismanaging their own finances, at the very least taking undue risks during boom times (in the spirit of the title of my 2009 book with Reinhart). Whereas foreign lenders are not necessarily blameless, in the first instance it is the debtor country's past governments and perhaps current government that are responsible. Of course, there often is a huge desire to pin the blame elsewhere. In fact, one of the IMFs primary role's in a crisis is often to serve as a lightning rod for domestic unrest, thereby giving the government cover to implement austerity measures that would, in fact, have been harsher in the IMF's absence.

The Difficult Judgments in Designing IMF Programs to Relieve Austerity

Dispensing with the usual populist argument against the IMF, however, is only a starting point for evaluating IMF programs. The fact that the IMF does not make austerity worse by no means implies that it always does the best possible job calibrating its relief programs. This is a much more complex issue involving a myriad of subtle judgments. I will attempt to give only a flavor of the arguments here.

The first point is that the IMF is in the business of making bridge loans only, usually until a country can return to international credit markets. Sometimes getting repaid is not always a reasonable expectation when dealing with the poorest countries in Africa and elsewhere. The IMF has on occasion been persuaded to effectively write off part of its loan, but this applies to only a very small fraction of its portfolio. For the most part, the IMF is a revolving credit facility that relies on its de jure seniority in international lending markets to get repaid in full even when other creditors are forced to take "haircuts" on their loans. The World Bank, with its greater flexibility to make concessional loans and far larger staff to give basic development advice, generally takes the lead on the poorest countries. The IMF's meat and potatoes are richer middle-income countries and sometimes upper-middle-income countries. The IMF needs to be repaid on these huge loans, which sometimes reach $25 billion or more. If countries consistently defaulted on the IMF, then the IMF itself would find itself unable to pay the creditor countries who lent it money. The IMF itself would be bankrupt.

The length of IMF bridge loans is not set in stone. The terms are to some extent fixed by IMF rules, but setting the length is the first of many subtle judgments that the IMF and its overseers must make. In the past, the fund would typically aim to be repaid within two or three years, sometimes longer in special cases, often issuing new loans to pay back the old ones. After the recent financial crisis, the G-20 leaders have arguably given the IMF the green light to stretch out its bridge loans slightly further (say to five years) on the grounds that the crisis will likely have long-lasting effects and that private credit markets may not have strengthened sufficiently to replace IMF funding within the usual time window.

There are, of course, no hard and fast rules about the traditional implementation period, or the extended one. The fund has learned over the years that a country must be given a significant period of time to adjust, but at the same time there must be some pressure for sustained adjustment. As a matter of political expedience, backloading adjustment is risky because it makes it much harder for a government to reach the finish line of a program. After all, the ultimate objective is to bring a government's finances under sufficient control, with sufficient credibility that private investors are willing to reenter. Also, of course, the typical business cycle downturn after a financial crash lasts a little over eighteen months and sometimes significantly longer (Reinhart and Rogoff 2009). A country is much more likely to be able to return to private markets after its economy starts growing again, making debt sustainability calculations less grim. Still, calibrating the adjustment period and the speed of adjustment is a judgment call.

The fund must also decide how large its package needs to be. If the sum is too large for the IMF alone, as it sometimes is (e.g., in the recent Greek financial crisis), the fund often works together with a consortium of wealthy individual country lenders. Typically, at least one financially strong country has a pronounced interest in helping the debtor country. This was what happened, for example, when the United States helped Mexico during its mid-1990s financial crisis.

In determining the size and duration of a loan package, there are two further crucial issues. First, to what extent can the fund persuade private creditors to continue extending loans, thereby alleviating the its need to pay off the country's loans as they come due? The question of private sector involvement is a very contentious one. In principle, the IMF could bully private lenders into significant concessions because they might well be forced to make larger ones without IMF involvement. The fund, however, also takes into account potential costs to the country's long-term credit standing as well as disruption to international credit markets more generally. My own strong bias is that the IMF gets far too easily sucked in to bailing out private creditors, but we will return to this issue later when we are ready to discuss moral hazard more fully. Suffice it to say that determining the extent of private sector involvement is a key decision the lender of last resort invariably faces.

A second issue is how large a deficit the country will be allowed to run and for how long. The IMF aims to relieve austerity and forestall procyclical fiscal policy, but by how much and for how long? Again, there are very subtle judgments to be made about economics, politics, and market psychology. If adjustment is very slow, will it be credible to markets, and will politicians be able to sustain it? The fund knows that governments very often backslide on programs, sometimes badly missing budget targets. If the planned trajectory is unambitious to start with, what happens when the government underperforms? Critics may rightly argue that in some cases the IMF's trajectory is too harsh, that a softer, slower trajectory would have been just as successful in restoring market credibility, perhaps more so if it had been politically easier to digest. But these are enormously subtle judgments, often very difficult to calibrate in the heat of battle, or even after the fact.

In addition to politics, the fund often has to be concerned whether it is getting reliable figures. In its everyday surveillance activities the fund makes a great effort to help countries, and in some cases to persuade them, to provide reliable budget figures on an internationally comparable basis. This is an extremely difficult task, even in the richest, most-developed countries. Budgets are both very political and very technical. Governments have both incentive and means to distort figures, not just for foreign investors but also for local consumption. For example, in many countries, the government effectively controls a significant share (up to 50 percent or more) of the overall economy, through quasi-government agencies, national utility companies, and others. Particularly in the case of governments that are under pressure from international markets, this can create enormous incentive to use delays in payments of various forms to make the short-term budget picture seem better than it is. This might involve delays of payments to national utilities for resources consumed or, very frequently, delays of payments to civil servants. This is part of the reason Reinhart and I find that debt explodes in the years after a financial crisis, as these hidden debts come flying out of the woodwork. Some of these devices are relatively easily detected even by the IMF's very small staff on the ground. Other tricks involve deeper camouflage and are harder to uncover.

A classic device that remains very popular today even in rich countries is to sell buildings and sign long-term leases to rent them back. Suppose, for example, the postal service owns a building it uses. It will sell the building but at the same time sign a ninety-nine-year lease to rent it back. On the books, the sale will show a big gain, whereas the offset from the first year's annual rent will be relatively small. On paper, there is a big improvement in the budget, but from an economic perspective, there is very little or no change. A related issue arises, of course, with privatization of large national companies. The government gets a lump sum payment in the short run but often loses a significant stream of revenue from the company or utility in the long run. The IMF often encourages such sales in cases where it perceives the possibility of large efficiency gains, that is, if the private sector will run the company more efficiently. The same gain appears on the government's balance sheets, but the desired efficiency gains are not always forthcoming, especially if there is no effective regulation or antimonopoly legislation.

The IMF must also judge the country's political capacity to absorb austerity measures. When countries experience sovereign debt and repayment problems, social unrest and government turnover is frequently the norm. The fund must put together a program that will be credible with markets. One that is obviously politically unsustainable will not be credible. Again, a great deal of judgment is involved.

Typically, a key element of persuading markets that a country's finances are sustainable involves demonstrating that its debt-to-income ratio, typically soaring in the aftermath of the financial crisis, will eventually start falling. Sustainability analysis is extremely tricky in IMF programs since, typically, the programs call for the debt-to-income ratio to rise in the early years. Initially, growth is usually slow or negative, the country's exchange rate usually declines (raising debt-to-income ratios to the extent debt is denominated in foreign currency), and the fund typically allows the country to run deficits, often even on the primary deficits, that is, deficits excluding interest payments on debt. Greece's recent EU/IMF–designed austerity program, where debt began at approximately 120 percent of GDP and is expected to rise to 150 percent of GDP, is a case in point. That such programs are difficult to sustain is not surprising. Reinhart, Rogoff, and Savastano (2003) and Reinhart and Rogoff (2009) demonstrate the fragility of sustainability analysis.

Nevertheless, the central importance of a country's debt-to-income trajectory underscores the importance of growth as a central goal of fund programs. Austerity helps the numerator of a country's debt-to-income ratio but can impede the growth of the denominator (income) as well. Again, complex judgments are involved. Clearly, to the extent the fund can help the debtor country institute supply side reforms (e.g., creating more efficiency in its tax and pension systems, reducing monopoly and corruption), it is more likely to succeed in establishing a credible program. Supply side reforms are even more delicate politically than austerity measures in many cases, and the fund can only afford to become involved in cases where there is no other approach. In the case of the 1997–98 Asian financial crises, the fund was accused of having gone too far in specifying detailed supply-side reforms. In the recent cases in Eastern and Central Europe, the fund has tried to scale back conditionality on supply side and structural reforms. This helps the fund keep a low profile in the short run, but of course may cause problems in the longer run, as supply side reforms are essential to achieving the growth necessary for long-term sustainability of these countries' massive deficits. In the case of Turkey in the 2000s, the fund seemed successful in being a catalyst for supply-side reforms that the government aimed to achieve without being accused to the same degree as in Asia of being too involved with details.

I have framed the entire debate as having to do with how much, and for how long, the IMF can and should relieve austerity by its programs. For completeness, it is worth noting that the debate is often framed in terms of whether the IMF should endorse Keynesian countercyclical policy in the face of the inevitable recession that accompanies a sovereign debt crisis (see The Economist 2008). That is, should the country run countercyclical fiscal policy to fight the effects of the recession; in other words, should it run large deficits. The reader will already recognize that at one level this argument is absurd. If a country were in a position to run large countercyclical deficits, it would not be at the IMF's doorstep. Countries come to the IMF precisely because there are no other lenders. At a deeper level, there is a legitimate point that if the country cuts expenditures too drastically too quickly, it risks dramatically deepening its recession and destabilizing its economy. In evaluating the extent to which a country should be lent money to run ongoing deficits, the IMF can and should take the effects on output into account. Of course, there is great uncertainty, with academic research on Keynesian fiscal multipliers by and large yielding very mixed results. We will return to Keynesian countercyclical policy in our discussion of the IMF policy towards austerity in richer countries.

In sum, although polemicists have been extremely effective in pinning the austerity moniker on the IMF, the naïve view that the fund is the cause of austerity is wrong. So too is the naïve view that the IMF should be encouraging Keynesian countercyclical fiscal policy in bankrupt countries. This is not to say that the IMF's job of lessening austerity and rescuing countries from having to contract deficits too quickly is easy, or that it always gets it right. There are indeed a myriad of difficult judgments that involve not only macroeconomics but politics, sociology, and psychology. These judgments are difficult to boil down to a simple formula, and it is perfectly reasonable to second guess the fund's choices and calibrations, both for the sake of improving existing programs and for better designing future ones. But the simplistic polemics about excessive austerity and failure to understand Keynesian countercyclical fiscal policy are, by and large, vacuous.

Is the Real Problem with IMF Program Generosity (with Creditors)?

In my mind, the big question about IMF programs is whether they are far too biased toward bailing out creditors, stoking moral hazard and sowing the seeds of future crises. That is, does the fund design its programs with a view to making sure a country is able to pay off its creditors, particularly foreign creditors? One obvious interpretation of this bias, of course, is simply that the fund places a heavy weight on the interests of creditors, perhaps because its voting structure gives such large weight to the rich countries who, at least over the past three to four decades, have by and large always been lenders rather than borrowers. Foreign lenders, both bond and bank lenders, typically come disproportionately from rich countries as well.

Now, to some extent, the view that the fund takes into account rich-country creditors is correct. But the fund would claim a deeper rationale for promoting full repayment of debts, based on the view that ensuring creditors are repaid is ultimately in both the debtor country's interest and in the broader interest of the global financial system. Both arguments have merit but do not necessarily withstand a considered cost-benefit analysis in many cases.

Why might it be in the country's interest to repay its creditors? As Eaton and Gersovitz (1981) famously argued, one of the reasons a country pays its debt is to preserve its reputation for repayment, thereby preserving future access to capital markets. As noted earlier, Bulow and Rogoff (1989) argue that countries face legal obstacles to trade finance and other problems if in default. In either case, countries suffer important penalties to default. But as Bulow and Rogoff show in their bargaining-theoretic framework, and as Grossman and Van Huyck (1988) show in a generalization of Eaton and Gersovitz's reputation model, the fact that the debtor may be pressed into paying something does not mean it should always do everything possible to pay in full, regardless of consequences for stability and welfare. In fact, it can be in creditors' interests to recognize that when they do not have the leverage to collect full repayment, they might do better by accepting partial repayment.

Both theory and the long history of sovereign debt crises before the IMF suggest that creditors left to bargain on their own without expectations of a bailout might well allow a country in difficulties to default partially. Indeed, as Ozler (1993) and others have shown, countries often return to bond markets surprisingly quickly after a partial default, with only modestly higher risk premia than they might have paid otherwise. The notion that default is necessarily a disaster for a country is no more simple or straightforward than the austerity argument we dispensed with earlier.

Of course, having one country default might have destabilizing effects more broadly on the international monetary system and these effects must be taken into consideration. But again, the risk of contagion is very difficult to assess; the international monetary system has withstood literally hundreds of individual country defaults in over the course of history, and it is hardly the case that every country default has proved systemic.

Perhaps the greatest argument against the fund's strong bias towards bailing out creditors is the moral hazard argument modeled in Bulow and Rogoff (1988 and 1989), a decade before the famous Meltzer report (Meltzer et al. 2000) popularized the idea. If the fund consistently helps bail out creditors, they will not charge sufficiently high risk premia for risky loans. Countries will borrow too much and get into trouble too often. Bailouts may help put a check on the fallout from current crises but lay the seeds of future ones. In my view, the moral hazard argument is a very powerful reason for caution in bailouts if not even for trying to end them entirely. Theoretical academic research certainly suggests that working out an international bankruptcy system could go a long way toward substituting for the fund's bailout mechanism (Rogoff and Zettelmeyer 2002). Instead, the current system effectively subsidizes debt at the expense of other forms of investment such as equity.

I have argued this point for a very long time, prior to my days at the fund in the early 2000s. For example, Bulow and Rogoff (1990) asked whether policy and legal institutions are tilted altogether too much in favor of the bond market over equity markets and foreign direct investment. (This point is similar but distinct from the writings of Bhagwati, Rodrik, and Stiglitz, who all complain of short-term capital flows in general.) It is also consistent with the empirical work of Peter Henry and others that equity market integration is far more clearly beneficial to growth than bond market integration. In general, legal, tax and institutional forces all conspire to favor debt lending.

In some sense, then, the problem is not so much that the fund is uniformly too stingy with countries, though the judgments inherent in virtually every program can be argued on a case-by-case basis. The problem is that IMF policy is too generous toward creditors.

One final point: the IMF's arrival means that bond holders are off the hook. As Qian, Reinhart, and I document (Qian, Reinhart, and Rogoff forthcoming), there have been numerous instances where countries enter IMF programs but end up defaulting anyway. The most famous case is Argentina (2002), but other recent examples include Indonesia, Uruguay, and the Dominican Republic. The IMF can offer country the opportunity and incentives to repay its loans, but it is by no means always successful. The endgame could be the same for some of today's highly indebted European countries (See table 1, next page).

Table 1: IMF programs have often not been enough to keep countries from serial default

Examples of IMF programs preceding default

	Year(s) of IMF program(s)	*Year(s) of Default(s)*
Argentina	2000	2001
Indonesia	1997, 2000	1998, 2002
Uruguay	2002	2003
Dominican Republic	2003	2005
Venezuela	1989	1990
Turkey	1980	1982

Source: Data from Qian, Reinhart, and Rogoff (forthcoming)

The IMF and Countercyclical Policy in Rich Countries

Lastly, we come to the fund's approach to countercyclical fiscal policy in developed countries that have strong open access to international capital markets. Here the fund's advice is suitably more nuanced. During growth periods, the fund typically encourages countries to run smaller deficits or even surpluses, in anticipation of possibly needing to run countercyclical fiscal policy during a downturn. The fund has a further agenda, typically encouraging countries to coordinate countercyclical policy during a recession; without coordination, countries would not internalize the spillover effects of each other's actions. Arguably, the IMF overestimates the Keynesian benefits of countercyclical fiscal policy, rather than ignoring them as it is often accused of in developing countries. In addition, the fund worries, of course, about excessive imbalances in current accounts between countries, a topic Lawrence Summers took up in his Sabot Lecture three years ago.

Conclusions

Over the years, the IMF has morphed many times, including to enlarge its role since the recent financial crisis. But the austerity tag has stuck throughout, sometimes undermining the fund's influence and effectiveness. I have argued here that the most naïve polemic argument that the fund presses austerity is exactly that—naïve. In fact, IMF programs typically relieve austerity, although calibrating and designing them is an extremely complex process that involves a myriad of judgments about politics, credibility, and economics, judgments that are of course fair game for criticism and analysis.

If there is a systematic flaw in IMF programs, it is not necessarily excessive austerity policies toward debtors, but its generosity toward creditors. It arguably overestimates the costs to a country of a negotiated default and, more importantly, underestimates the long-term moral hazard problems created by recurrent bailouts. If the international financial system of the 21st century is to be less prone to crises, a good starting point would be to work toward institutional changes to redirect financial flows toward equity and foreign direct investment, away from debt instruments. In this regard, an International Monetary Fund, with its huge pool of lendable resources and its arguable bias toward ensuring repayment, is problematic. From this perspective, it is the fund's generosity, not its austerity, which is ultimately the problem.

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