Preliminary

The IMF and the 1982 and 1994 Debt Crises: Who is in Charge?

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The International Monetary Fund is a small but apparently important participant in what might be called the political credit market. In this market governments conduct a variety of interrelated financial transactions. Relationships in the political market are influenced by military, commercial and other types of sovereign relationships but for this paper we will abstract from nonfinancial matters. The IMF "intermediates" a very small part of this financial business. It seems to follow that in order to understand the role of the Fund it is important to understand why governments use a financial intermediary to conduct some types of business but not others. A coherent answer to this question might also explain why an institution such as the Fund with very limited resources is often thought to be a powerful participant in the political credit market.

In this paper we argue that the Fund's power does not derive from its participation in making policy rules for allocating political credit. This is much too important a matter to be delegated to an international organization. In Dooley (1995), for example, I argue that the substantive negotiations that resolved the 1982 debt crisis were between the commercial banks and their own governments and perhaps between the governments of Mexico and the United States. The IMF is not a convenient forum for discussing policy for the obvious reason that a number of countries that have no real power to affect the outcome participate in the discussions. Perhaps more important, the Fund's role as a financial intermediary gives it no comparative advantage in formulating basic credit policies. Once the major creditor governments agreed that it was necessary to take the banks out of the process through restructuring and debt reduction, the Fund screened potential programs in essentially the same way as other cases where the developing
countries have needed Fund resources.

The Fund does have some power. Its power is derived from its private information about potential debtors in the political credit market. Private information is captured by the Fund as a byproduct of continuously screening potential borrowers. As with any successful intermediary, this effort yields economies of scale in evaluating political credit risks and allows the Fund to build institutional capital that could be bypassed by governments but only at considerable cost. The Fund also acquires private information in circumstances where potential borrowers can make information available to the Fund that it could not credibly or confidentially provide directly to creditor governments.

Private information implies that Fund credit may be "special" for the same reasons that commercial bank credit is thought to be special in private markets. The simple point is that if banks have inside information about their customers, it is difficult to bypass these intermediaries since debtors and creditors cannot easily reproduce the information that is necessary for lending. Thus, in the short run many borrowers are rationed out of credit markets when banks for any reason cannot perform their usual intermediary role.

From the point of view of individual borrowers bankers are powerful in that they decide who does and does not get credit. They are also generally disliked by regular people. Depositors (creditors) wish the banks would do better with their money while debtors naturally resent the bankers inability to see that they are honest and creditworthy people. At the margin everyone is unhappy because of the market failure generated by adverse selection and moral hazard. The banks' role is to minimize this unhappiness.

The importance of information in private markets is suggested by the observation that
private creditors seldom bypass the banks. Even in the United States only about 15 percent of nonfinancial firms' external borrowing takes the form of commercial paper and other nonbank credits. For similar reasons, creditor governments will usually not bypass the Fund in the political credit market because potential lenders know that the Fund has information not available to them. Thus, a Fund seal of approval is necessary not only for the Fund's own very limited credit but also for most bilateral official lending. It is not too surprising that both debtor and creditor countries and their advocates also dislike the Fund.

Adverse selection, moral hazard and the political credit market

Creditor governments have difficulty distinguishing between potential debtors that plan to abide by agreements and those that do not. This is the well known "adverse selection" problem. The analogy with private markets is that potential debtors that are willing to agree to harsh terms (high interest rates in the private market model) include both honest debtors and those that plan to default. In a similar way, tough conditionality does not separate governments that are committed to an adjustment program from governments that plan to default on the program. There are governments that will agree to any set of conditions because they do not plan to attempt to abide by the conditions set. In this environment honest governments will be turned away from the political credit market and too little credit will be extended.

The Fund is presumably better at making such distinctions as compared to creditor governments because it is continuously in contact with each government through Article Four consultations. The Fund is also informed by the executive director for the region and intermarriage of career bureaucrats. The Fund management and staff is more likely to know
which coalition is really in charge of a debtor government, their likely tenure, and their attitude toward the type of economic program that creditor governments favor. Moreover, the staff of the Fund is often quite familiar with individual ministers reputation for honesty and effectiveness.

The Fund's ability to keep its mouth closed encourages debtor governments to supply information that they would not want revealed to domestic political rivals. In my experience at the Fund, incompetence was seldom a cause for censure -- the more civilized procedure is promotion to a less sensitive job -- but talking too much can result in termination.

The governments of creditor countries are not known for their ability to keep a secret and so it is difficult to transmit sensitive information to creditor governments directly. Observers from industrial countries should realize that economic data is a state secret in many of the Fund's clients. The old joke in Washington is that any information in the hands of more than three people is public information since there is no set of three ministers with common interests. Thus, a leak is bound to be in the interest of at least one of the three.

A more familiar part of the Fund's role is in monitoring the behavior of the debtor after the loan is made. Clearly the loan itself encourages the bad behavior that brought the debtor country to the political credit market in the first place. This unavoidable moral hazard is offset by the nature of the contract, covenants in private contracts, and conditionality and periodic performance reviews in IMF contracts. This is important because it is very difficult to write a political credit contract that is contingent on many factors not under the control of the debtor. For example, a decline in oil prices is often cited as grounds for adjusting performance criterion for oil exporters. For this reason a consistent ex post procedure for granting waivers to the contract is an important implicit part of the financial market. The standard Fund practice of releasing funds in tranches as
performance criterion are met is an important part of its monitoring role.

Private information and the role of the Fund

This way of analyzing the role of the Fund has a number of implications. The most relevant at the moment are the likely effects of proposals in the wake of the Mexican crisis that would require the Fund to make public its information concerning member countries and to involve the Fund as a lender of last resort to backstop international credit markets. It is argue below that such proposals would effectively end the institutions usefulness. As an agent for both debtor and creditor countries, the Fund: understands the set of policies that are acceptable to creditor countries at a point in time, verifies that the program proposed by the debtor country conforms to this set, declares that it believes the country intends to implement the program, and finally monitors compliance and informs creditors of deviations from the expected results.

The Funds own lending is a convenient way to keep track of its performance in screening potential borrowers, but it is also important to keep that lending small in order to limit the temptation to paper over past mistakes with new credits. In fact the Fund's own lending could be eliminated without changing much the basic role of the institution. Removal of the Fund's access to inside information, in contrast, would transform the institution into an uninteresting debating society.

Does the Fund favor debtor or creditor countries?

There is no doubt that the balance of power between debtor and creditor countries is tilted
toward the creditor. When the debtor government has lost access to private credit markets, its alternatives are to default on existing contracts or to agree to conditionality imposed by the creditor governments through the Fund. Since default is apparently more costly to debtors than to creditors, debtors are willing to agree to conditions set in the political credit market by creditor governments.

The Fund, acting as agent for the creditor countries appears to have significant power over debtor countries. This is an illusion. The Fund can neither redress nor intensify the unequal bargaining power of the debtor and creditor governments. If the institution tried to do so one of the two parties would prefer bilateral negotiations or arms length negotiations in another forum. This point is nicely made by Von Furstenberg (1992) "The more an agent like the Fund is coerced into working for the interests of one party, and not the other, the less business it will be able to arrange between creditor and debtor nations" (p.120).

As a footnote I would add that the common misconception that the Fund can escape its role as an intermediary by creating credit on its own is a serious analytical error. SDR allocations and other forms of Fund credit are ultimately matched by increases in creditor countries debt to the private sector.(see Dooley, 1985). The creditor governments understand this (even the US Congress) even if some academics do not.

Policy making after the 1982 debt crisis

This framework also helps explain why the Fund is unlikely to participate in policy debates. None of the factors discussed above would tempt a government to make the Fund its
agent in formulating policy. Following the 1982 debt crisis the Fund played its usual role in implementing policy as set out by the member governments. There are now a variety of good sources describing these policy choices (Dooley (1995) Cline (1995) Krugman (1994)). What is remarkable about these retrospectives on the debt crisis is how little the international institutions are seen as formulating policy. The Fund supported research into the problems facing debtor countries. As Jim Boughton points out in his paper in this conference, this research may have help win the hearts and minds of policy makers in the creditor countries, but it did not generate a change in Fund policy till the creditor governments proposed changes.

The Fund's role as an agent was nicely demonstrated in implementing the Brady Plan. The institution brought several things to this table. The modalities of how debt reduction might work had been. The Fund was told (by the US) that Mexico would be the first to benefit by the plan, but creditors generally allowed the Fund to decide what countries should follow and when they were ready to undertake a successful restructuring.

The Fund staff also provided technical analyses of the restructuring and debt reduction agreements that insured that the creditors money was used efficiently in buying out the banks. This was very strongly resisted by the US government and reflects their view that the Fund did not have any inside information on how negotiations should balance the interests of the debtor countries and the banks. James Darman at the US Treasury was particularly critical of any "interference" by the Fund's staff in negotiating the Brady plan workouts. This created the rather comical practice of secret meetings between Fund staff and debtor country officials both in Washington and in their capital cities. Of course, the creditor governments had a point. The Fund in general does not have any particular expertise in evaluating a private credit agreement as
being consistent with the best terms available in the market. This is a nice example of the general rule that the creditor governments rely on the Fund only to the extent justified by its inside information.

The one area of strategy that may have been shaped by the Fund as an institution was its own attachment to not lending the Fund's money to a country until the country had reached an agreement to reschedule its obligations to the commercial banks. This is an interesting footnote to the debt strategy because few people outside the Fund understood the importance of this procedural matter. The logic behind this policy was astonishing. Advocates of the policy argued that a formal agreement was necessary to "safeguard" the Fund's loans in support of a program because agreement with the banks insured that the financing gap was closed and that the banks had done their share. Critics pointed out that this policy gave the banks effective veto power over any financing initiative offered by the debtor country. Since the value of the Fund's own claims on the debtor country is determined jointly and inversely with the value of the banks' claims it seems curious for one creditor to assume that the other is looking after the interests of the other.

Not surprisingly, this policy was (and is) very popular with creditor governments that believed that the main objective of debt policy was to put the maximum pressure on debtor governments to pay their bills on time. This is also the commercial bank's only objective so this is a natural coalition. The policy also meant that the Fund had given up its only real role in the political credit market since the banks rather than the Fund decided which countries would have access to Fund credit. This was in my opinion recognized by a few of the Fund's senior staff.

The Fund staff however also knew that any apparent back sliding on this doctrine would upset the creditor governments. What to do? Pick out a country that is not important to the
banks and that has strong political ties to an important creditor country. Costa Rica, the first country to default before 1982, was too small to be of much consequence to the banks and too democratic to risk retaliation by the United States' government.

The key to the strategy change was the removal of the rule that debtor countries must reach a rescheduling agreement with the banks before a Fund program would be approved. Costa Rica chipped away at this requirement in that Fund lending proceeded in the face of "arrears" with the banks. But this principle was not applied to the larger debtors until the US and several other creditor countries realized that requiring that bank arrears be eliminated gave the banks an effective veto over political lending. The German government never agreed as a matter of principle but agreed to disagree quietly in the context of Brady Plan.


As in 1982 the debt crisis was triggered by a rise in US interest rates. In 1994 the same trigger again generated pressure on debtor governments and, again, the Fund acted as agent for the creditor and debtor countries. This time the main policy decision was a very aggressive initiative by the US government to protect private creditors in order to stop "contagion" from threatening solvent debtor countries. The increased credit line for the Fund proposed at the June summit would apparently increase the Fund's role as the dominant intermediary in the political capital market. But the approach suggested in this paper suggests the opposite.

Along with the credit line the Fund is supposed to provide early warning based on its inside information. If the Fund is forced to do so by creditor countries, it will lose its incentive and ability to gather this information. Potential debtors would not provide information to the
Fund for fear that the Fund will use it to advertise its displeasure. This may be what the proponents of these proposals have in mind. Those that mistrust and dislike any power held by an international organization are correct in going after the source of that power, namely the private information held by the organization. Those that believe that the Fund plays a useful economic role should be opposed. It follows that a large part of the US government's policy to force greater transparency in the Fund is counterproductive. Debtors will lose a valuable agent and the Fund itself will no longer see information as the source of the institution's power.

The US Congress has never liked the idea that any institution, the Federal Reserve, the CIA or the IMF has any information that cannot be shared by the congress. Barney Frank, for example, held a series of hearings in 1994 designed to open the international organizations' evaluations of country's economic policies. A surprising number of people that should know better supported the idea.

Our analysis also suggests that "automatic" Fund facilities are inconsistent with the organization's basic purpose. Any lending that is not based on the Fund's information could be done as well or better by the creditor countries themselves. Thus, the US push for a lender of last resort is an attempt to enlist other creditor counties in sharing the expense associated with such operations. Clearly, this increases the adverse selection problem since countries now know that if they allow their banking systems to take high risk positions the Fund stands ready as the lender of first resort. Since such lending does not require screening or conditionality so the Fund is not a natural choice to administer such a facility.