

When developing countries lurch into economic crisis, there's a natural inclination to help. But a new study suggests that help can hurt because . . .

Bailouts beget bailouts



A police officer stood guard outside a bank in Uruguay's capital of Montevideo last month as customers waited in line a week after a \$1.5 billion emergency loan allowed the government to reopen banks that had been closed amid panicked withdrawals. Backed by the U.S. government, the International Monetary Fund announced financial rescue packages for Uruguay and Brazil, and is negotiating another package with Argentina.

Roberto Candia/
Associated Press

By Tim Kehoe and Art Rolnick

Backed by the U.S. government, the International Monetary Fund (IMF) announced financial rescue packages (more critically known as bailouts) for the governments of Brazil and Uruguay in early August. The IMF currently is negotiating another package with the government of Argentina.

When a developing country such as Argentina, Brazil or Uruguay is faced with an economic crisis, it seems appropriate for the United States and the IMF to want to help. Concern for the welfare of the citizens of the developing country alone would justify some assistance.

The possibility that the crisis might spill over to other developing countries — as the crisis in Argentina earlier this year seems to have spilled over into Brazil and Uruguay — increases the case for intervention. The conundrum here is that the more the IMF intervenes now the more likely it will have to intervene in the future.

Although the case for outside assistance to the government of a developing country in financial trouble is strong, a persuasive case can be made that IMF bailouts do more harm than good. In a book re-



The authors

Tim Kehoe, left, is a professor of economics at the University of Minnesota. **Art Rolnick** is an economist with the Federal Reserve Bank in Minneapolis.

cently published by MIT Press, "The Elusive Quest for Growth," William Easterly provides data showing that countries that have received IMF bailouts do worse economically than those that have not.

Cause and effect

Easterly's analysis attempts to disentangle the cause-and-effect relations between financial assistance and financial crises. He concludes that on the whole, IMF assistance, including bailouts, actually causes developing countries to do worse. Although some of Easterly's arguments are open to

debate, the reason that a bailout, or the prospect of one, can cause harm is well understood by economists. It is the concept of "moral hazard" originally studied in the context of insurance markets.

Although it can take many forms, moral hazard typically promotes risky behavior by insulating risk-takers from the full economic consequences of their actions. In auto insurance, for example, the knowledge that the car will be replaced in the event of an accident might cause some drivers to take more risks behind the wheel than they would if the total cost of a new car came out of their own pocket.

The moral-hazard problem erupted in the United States in the 1980s. The government's generous deposit insurance policies — including its "Too Big To Fail" policy — induced savings and loans and banks to take on more-risky loans than they would have in the absence of such policies. The outcome was the collapse of the savings and loan industry, more than 1,000 bank failures, a substantial misallocation of resources, and an estimated \$150 billion taxpayer bailout.

In the context of a developing economy facing the possibility of a crisis, the prospect of

a bailout by the IMF can induce the government to undertake riskier policies — policies that make the crisis worse if they fail.

If the policies succeed, great. If not, the IMF will come to the rescue. Economists in Argentina now talk about their government "gambling for redemption" in late 2001. Even after the crisis has taken place, a bailout can have a negative effect in allowing a developing country to put off reforms that it would have undertaken absent the bailout.

Reversal on rescues

The concept of moral hazard is familiar to economists and policymakers in Washington, both in the U.S. government and in the IMF. Indeed, the recent bailouts of Brazil and Uruguay are turnabouts in stated policy. Up until last month, the Bush administration and Anne Krueger, the new managing deputy director of the IMF, had been highly critical of previous bailouts.

Given the moral-hazard problem and given the evidence, why does the IMF still come to the rescue? The answer is found in a concept known as "dynamic inconsistency," which was formalized in

economics in the late 1970s by Professors Finn Kydland and Edward Prescott, now at Carnegie Mellon University and the University of Minnesota, respectively.

Because of the problem of moral hazard, the IMF would prefer to have a no-bailout policy so that developing countries would be more likely to follow prudent domestic policies.

But a no-bailout policy is not credible. As noted above, if a crisis should occur, as it has in South America, policymakers will want to provide assistance. Since everyone including the governments of the developing countries knows — or at least suspects — that this is the case, any claims that the IMF will not provide financial assistance in the event of a crisis are not dynamically consistent and therefore are not credible.

The challenge facing the IMF is to construct a dynamically consistent policy that at least mitigates the moral-hazard problem. Before a crisis

arises, the policy must induce the governments of developing countries to act to minimize the probability. In the event of a crisis, the policy needs to provide the IMF an alternative that is more attractive than a bailout.

Designing such a policy is not an easy task. For example, in response to the savings and loan debacle, the U.S. banking law of 1991 attempted to make a government bailout of a large banking institution more difficult than it had been in the past. Critics of the bill, however, see too many loopholes that in some circumstances still leave bailouts as the most attractive alternative.

Given that domestic policymakers have difficulty designing consistent policies, international organizations such as the IMF have their work cut out for them. Until they succeed, however, we are likely to see more IMF bailouts in the future and unfortunately little to show in the way of economic progress.

Short-term gains

Even if it ends up in the pockets of the people who actually need it, financial assistance from the International Monetary Fund might actually do a recipient country more harm than good.

By Mike Meyers
Star Tribune National
Economics Correspondent

In the aftermath of the 1997 Asian financial crisis, the economy of South Korea was in turmoil and fears of rapidly rising unemployment and falling incomes loomed.

But a \$53 billion loan from the International Monetary Fund gave South Korea the financial wherewithal to undertake banking reforms, move

away from "crony capitalism" and take other steps toward economic health.

"Korea is a much more efficient, vibrant economy because of what the IMF did," said Sung Won Sohn, chief economist at Wells Fargo & Co. in Minneapolis. Sohn called the nation "a spectacular success story" for the value of international aid.

And South Korea isn't alone. "Mexico today is one of the better-managed, healthy economies, in part because

they went through an IMF [loan and economic reform] program," Sohn said.

Nevertheless, Tim Kehoe, Art Rolnick and other members of the Star Tribune Board of Economists argued that loans from the IMF may do more harm than good in most cases. For one thing, they said, foreign leaders might take economic risks and pursue irresponsible economic policies chiefly because they know the industrialized world might offer a financial bailout.

And although the work of the IMF may seem arcane and practiced only in faraway places, Americans have a great stake in whether the international assistance works, economists say.

The IMF

The primary source of IMF resources is quotas, or capital subscriptions. Each member is assigned a quota, designated in special drawing rights (SDR). A member's quota determines its financial commitment and voting power and is the basis for access to financing.

► **Total quotas:** 212.7 billion SDR (about \$280 billion)

► **Largest member:** United States, 37,149.3 million SDR

► **Smallest member:** Palau, 3.1 million SDR

► **Total members:** 184 countries

Source: IMF

Attempts to extend aid often fail

"Argentina and Brazil, taken alone, may not be all that important," said Rolnick, director of research at the Federal Reserve Bank of Minneapolis.

Taken together, however, Latin American economies are important U.S. trading partners and have the potential to be either political assets or liabilities, Rolnick said.

"If we don't have these economies growing, they remain poor and economically untenable and we'll see them be politically unstable," Rolnick said. "Unfortunately, we've seen the consequences of that sort of thing."

Successes and failures

Success stories such as South Korea's keep the International Monetary Fund operating even though in case after case, from Latin America to Africa, attempts to prop up faltering economies have failed, said Kehoe, a University of Minnesota economist.

Argentina, which has received billions in IMF aid year after year, has proven as stark a failure of the IMF as Korea and Mexico are successes, in Kehoe's view.

"The IMF has been involved in Argentina for some time," Kehoe said. But instead of moving on a path to prosperity, he said, "Argentina in the last two years was cut off from private capital." In other words, Argentina represents too great a repayment risk for private lenders to accept.

Jeanne Boeh, an Augsburg College economist, said IMF aid too often is directed away from the people who need it

most to line the pockets of the elite of small nations.

"We undertake it because ostensibly it's for the poor," Boeh said. "Like [congressional aid to agriculture in the] farm bill, the small family farmers aren't the ones getting the money."

Indeed, governments receiving IMF loans sometimes cut back on public projects — from road building to public sanitation to hospitals — in the name of austerity, Boeh said.

Dan Laufenberg, chief domestic economist at American Express Financial Advisors in Minneapolis, said the financial problems of Third World countries resemble the missteps of U.S. savings and loan institutions in the 1980s.

Both involved putting money into bad investments that quickly collapsed, and both led to government-financed bailouts. But the similarities end there, Laufenberg said.

In the case of the savings and loans, reckless shareholders in those financial institutions lost their money and officers who broke the law went to jail. The guilty were punished, Laufenberg said.

"The problem with the IMF is how do you do that? Who are the people who should be penalized for making bad decisions?" Laufenberg said. "You don't fix the problem unless you penalize those people. But do you say, 'Replace the government?' No."

The perverse outcome involves putting more money into a troubled nation, often into the hands of the very people who have contributed to economic woes with poor policies or corruption, Laufenberg said.

"What does the IMF do?" Laufenberg said. "It will continue to do what it always does — bailout."

One possible long-term solution suggested by some of the economists on the Star Tri-

bune panel: An international bankruptcy court, which would force economic reforms on any nation that is receiving international aid.

Until that day comes, however, penalties for economic mistakes will be hard to impose on political leaders, said Tom Stinson, Minnesota state economist.

"Their time horizon is extraordinarily short," Stinson said of politicians. "By the time bad policy is revealed, they're gone."

"There isn't any way that you can reach these people and think something further out if they don't think something really bad can happen to them — like riots or prices coming through the roof," Stinson said.

Praise to aid-seekers

Bill Melton, president of Melton Research in Edina, said Third World countries sometimes make heroes out of politicians who are better at luring foreign assistance than at averting financial crises in the first place.

On a visit to Argentina in the mid-1990s, Melton noticed a statue in the office of a government finance minister. It was a likeness of a 19th-century Argentine finance official who had persuaded the British to give financial concessions to the South American country when it no longer could afford to make principal or interest payments on outstanding loans to Great Britain.

"The inscription on the statue says it was given in recognition of his work in getting the loans fixed," Melton said. But Melton saw no statues of officials who repaired the nation's economic problems because those problems remain unsolved more than a century later.

Paul Anton, chief economist at Anton, Lubov & Associates in

Minneapolis, said the IMF and developing world should ask questions before picking candidates for national financial aid.

"How serious is the problem? How much political will or political support can a government have to deal with it? Those two questions suggest which countries could make it and which will need far more," Anton said.

However, regardless of whether a country has received a financial bailout, industrialized nations should offer more humanitarian aid, in Anton's view.

With or without financial aid to Argentina, Anton said, a 5-year-old boy in a barrio in Buenos Aires might not live to see his sixth birthday.

To be sure, the IMF puts strings on loans to financially strapped Third World nations, including calls for reforms that are tough for governments to deliver and for average citizens to endure — from an end to "crony capitalism," where select companies and industries reap government favors; to controls on the price of bread that eventually reduce the supply of food.

But sometimes such reforms are all but impossible to achieve in small, poor and mismanaged countries, noted Jenny Wahl, a Carleton College economist.

"Don't you think that people who aren't economists would laugh [at the suggestion] that market discipline would help Haiti?" Wahl said.

Even if a Haiti or other tiny country institutes reforms, they may come too late to turn around a faltering economy without IMF aid.

"So there is market discipline and Haiti goes down the tubes," Wahl said. "Who's going to rescue it?"

— Mike Meyers is at meyers@startribune.com.

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What if the IMF program was
that big? — **BB**

THE BOARD ON BAILOUTS



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