Why bad news for the Fund is excellent news for its clients

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The International Monetary Fund is in financial crisis. That will give its critics reason to cheer. But its supporters should cheer as well, for the reason the IMF is facing financial disaster is that its clients are not.

The Fund needs crises, as doctors need illnesses. But this particular doctor has been too successful. As a result, Fund credit outstanding has fallen to its lowest level in 25 years. The Fund's income under current policies is expected to fall from Dollars 1,125bn (Pounds 603bn) this financial year to Dollars 757bn three years from now. Its expenses are expected to rise from Dollars 955bn to Dollars 1,036bn. The looming shortfall is evidently impressive. Bad news for the Fund is excellent news for its borrowers. Financial markets herald the reduction in the perceived riskiness of emerging market finance. Spreads have, as a result, collapsed (see chart). Investors are also pouring money in: last year, according to the March 2006 report from the Washington-based Institute for International Finance, the foreign private sector poured Dollars 400bn into the group of emerging market countries on which the IIF focuses attention.

"We do not need this money, thank you," said the recipients. "After all, we are running an aggregate current account surplus of Dollars 232bn, which we are determined to keep." So, they pushed the money right back out again, predominantly into the liabilities of an insufficiently grateful US Treasury. In aggregate, the reserve accumulations in 2005 were Dollars 416bn.

Remarkably, a paper by three senior Fund researchers, presented at the Jackson Hole conference I discussed last week, suggests they may have been right to do so: "Developing countries that have relied more on foreign finance have not grown faster in the long run, and have typically grown more slowly. By contrast, we find that among industrial countries, those that rely more on foreign finance do appear to grow faster."*

Emerging economies with current account surpluses grow faster. Consequently, "the current anomaly of poor countries financing rich countries may not really hurt the former's growth", largely because of of their inadequate institutional and financial structures.

Does this mean that foreign finance plays no role in development? Not at all. As Frederic Mishkin of Columbia University, now a governor of the Federal Reserve, argues in an important new book, foreign capital can bring big gains at the microeconomic level: more competition, new technology and modern managerial know-how. Inflows of foreign direct investment into the financial system itself are particularly valuable to an emerging country.**

What this does mean, however, is that there seems to be no benefit to being a net importer of capital. Emerging countries should smoke in the capital markets, but not inhale.

Why might that be? It is not because of a lack of investment opportunities, as is shown by the flood of foreign capital looking to invest in these countries and, indeed, by the high investment rates in Asia, in particular. It may well be because the fastest-growing countries save a great deal already and so do not need the extra capital foreigners wish to provide (see chart).

Another explanation seems to be the financial systems, which are incapable of allocating capital inflows successfully. Thus, foreign direct investment, where the project is chosen by the foreign investor directly, makes a positive contribution to growth that financing the liabilities of bad banks or profligate governments does not. Moreover, large net inflows of private capital will lead to an appreciation of the real exchange rates, unless offset by official capital outflows. That will damage industries producing tradeables, particularly manufactures.

Most important of all, I suggest, is the link between large current account deficits and financial crises, particularly when inflows consist largely of foreign currency denominated debt. Such inflows tend to create currency mismatches within the economy. Then, when the exchange rate falls - as will happen once the capital inflow stops - mass bankruptcy is the result.

For many individual emerging market economies, the decision not to be a net importer of capital appears to make sense. But that series of decisions also has global consequences, particularly in a world of high oil prices and large trade surpluses in oil-exporting countries. Since the world cannot run surpluses with Mars, other countries must run deficits. The US does, acting as the world's largest emerging borrower.

By accident, the world has found a way to make the crisis-prone world of financial globalisation work. Investors consider emerging market economies appealing destinations, but the governments of many of the most courted countries hate the idea of absorbing the capital. So they resist pressure for currency appreciation and recycle the inflow predominantly into US liabilities. The US then complains about the deficits, while enjoying the inflow of resources.

Ironically, therefore, the very changes that have helped make emerging market economies less crisis-prone have led to the "global imbalances" with which the Fund is now grappling. But the Fund has no leverage on the US as a deficit country and as never had leverage on countries in surplus. To add insult to this injury, the IMF's finances become more desperate as its clients become ever more solvent.

Between the end of 1999 and May of this year, the world as a whole accumulated Dollars 2,780bn in additional foreign currency reserves. Three-fifths of the reserves accumulated since the dawn of time have been accumulated over this brief period. So much then for the myth that we live in a world of floating exchange rates! It is almost impossible to believe that these have been the highest return investments the world's governments could make. But it is the one they have decided to make, largely to preserve export competitiveness and the strong current account positions they desire.

The Fund's economists seem to suggest that it makes sense for a country to allow sizeable net inflows of capital only when it has a first-rate financial system. If that is how long the world has to wait, we cannot hold our breath. But it does not make sense for the people of poor countries to finance consumers in the richest.

Change is surely needed. But it is unlikely to come easily or soon.

*Foreign Capital and Economic Growth, Eswar Prasad, Raghuram Rajan and Arvin Subramaniam, August 11 2006, www.kc.frb.org**The Next Great Globalization, Princeton University Press 2006