Chapter IV

The Role of the IMF

Introduction

When balance of payments crises have arisen in the past in various forms, the IMF has been subject to criticism. However, in the current Asian economic crisis the "bad IMF" has been subject to a torrent of abuse. A discussion of the IMF's role is certainly necessary, but before we do so we would like to make two points.

First, we should remember that "we are the IMF". Along with Germany, Japan is the second largest contributor to the IMF after the United States, and has appointed executive directors to the board. As such it is important to remember that Japan shares responsibility for the IMF's operation. Debate on the IMF's plans and role is necessary, but it would be inappropriate if we forgot our involvement as a contributing nation when we criticize. Just as shareholders have a responsibility to monitor the operations of company when it has problems, if there are problems with the IMF, they are the responsibility of contributor nations. At this point we anticipate the objection that "the US's influence at the IMF is absolute, and Japanese views are mostly ignored". However, even if Japan lacks competence at the IMF, that does not change its responsibility as contributor the slightest bit.

Second, IMF programs are in various stages of implementation in many countries at this very moment. Therefore, discussion on IMF plans involves a very delicate matter. If beneficiaries of IMF programs lose confidence in the IMF, this means losing confidence in their own ability to recover. We must give due consideration to the costs of criticism. Adopting the IMF's stance that justifies existing its policies programs may be to a certain extent a necessary evil.

Even given the above two points, a debate on the IMF's role is necessary. We would like to begin by reviewing the IMF's place in Section 1. In Section 2, we will divide the IMF's role into three broad areas, evaluating and examining problems in each area. We make our proposals in Section 3. In Supplementary Article the IMF conditionality is explained.

1. What is the IMF?

1-1. From the IMF's Launch to the 1970s: The Fixed Exchange Rate System (The Bretton Woods System) Where the IMF's Function was to Help With Short-Term Balance of Payments Problems

Having experienced great depression before World War II, the collapse of the gold standard, competitive exchange rate devaluations, the division of the world economy into trading blocks, and a retreat in world trade, for the post-war international community reviving the global economic order through encouraging trade was of major importance. It was therefore decided to maintain a single system of fixed exchange rates on a global scale. This became known as the **Bretton Woods System**. Under this system, the IMF was created in 1945 to provide liquidity (loans) when a country became unable to meet its international obligations due to a 'temporary (short-term)' current account deficit. At about the same time an institution for long-term lending was launched, the World Bank (the International Bank for Reconstruction and Development).

If a current account deficit is not temporary but 'chronic (long-term)', it means that the currency of the country in question is overvalued. In this case, a currency devaluation is necessary. In contrast, a temporary current account deficit comes when imports rise above their average level at the peak of the economic cycle but not at the bottom. From a long-term perspective, this does not pose a problem. If a temporary deficit arises, and there are sufficient foreign exchange reserves, these can be drawn down and used for external payments. However, when reserves are insufficient the IMF's assistance is necessary. Certain conditions (conditionality) must be met depending on the amount of assistance relative to contributions, and they are basically measures to prevent the economy from overheating and reduce imports. To be specific, this means tightening fiscal and monetary policy. These are called **macroeconomic stabilization policies**[1].

However, the Bretton Woods system collapsed in the 1970s, and most industrial countries shifted to a floating exchange rate system. In theory under a system of floating rates, balance of payments problems are eliminated automatically through price (exchange rate) changes, and short-term balance of payment assistance becomes unnecessary. Moreover, sources of funds expanded with growing international financial markets, and demand for IMF funds from industrial countries disappeared. On the other hand, because many developing countries maintained links between their currencies and the currencies of industrial countries such as the US dollar and the British pound at a fixed rate, **there was a shift in beneficiaries of IMF funds to mainly developing economies**.

1-2. The 1980s: The Change to an Institution for Development Assistance and the Latin American Debt Crisis

In order to respond to demand for funds from developing countries, in addition to its original funding device (standby credit), in the mid-1970s the IMF began to provide expanded credit in ways not originally provided for, including Expanded Financial Facilities (EFF), Structural Adjustment Facilities (SAF), and Expanded Structural Adjustment Facilities (ESAF). The most outstanding feature of the new funding systems was the lengthening of maturities. This was because of the addition of a new goal, "**improving the economic structure** of the country in question," to be achieved over the medium- and long-term. Such policies were called **Structural Adjustment Programs**.

On the other hand, Latin America's debt problems broke out in 1982. This was due to excessive external debts, leading to the inability to repay (default), and was different from a simple short-term balance of payments crisis.

In this kind of situation it is necessary not only to carry out a traditional macroeconomic stabilization policy, but in addition to take measures to restructure repayment terms to make them more realistic. In addition to **rescheduling** – repayment periods lengthened – in many cases **debt relief** – where interest payments are reduced or excused, or the principal curtailed – is necessary.

Taking these kinds of measures required new efforts to coordinate negotiations among creditor governments and private financial institutions and debtor governments, and the IMF came to fill the "function of intermediary" in these debt negotiations. As an observer the IMF would explain the economic situation and future prospects of debtor nations, and was expected to serve as a source of information for groups of creditors. In addition, requests from groups of creditors to act as their credit guarantee organ grew more intense. A willingness by the debtor country to accept an IMF program and submit to policy supervision became a de facto condition for debt negotiations. By taking on this new role, the IMF became the central organization for dealing with debt crises in developing countries.

1-3. The 1990s: Supporting the Shift to the Market Economy in the Transition Economies of Eastern Europe and the Former Soviet Union

A big change in the 1990s was the shift to the market economy in the former Soviet Union, Eastern Europe, and other countries in the socialist economic block after the collapse of the Soviet Union (this shift has lead these countries to be called **transition economies**). This was an enormous task that entailed rebuilding the entire domestic economic systems of these countries[2].

In a typical socialist economy, the state (1) was directly responsible for production, (2) directed the distribution of goods, and (3) allocated capital directly through state (all transactions between state enterprises were settled through the state banks). **Thus in transition economies, production, distribution and finance had all to be revolutionized.** Specifically, state-owned enterprises had to be reformed and privatized (production), private distributors had to be fostered (distribution), the central bank separated from commercial banks, operations of commercial banks privatized, and financial markets created (finance). It was also necessary to create legal systems and regulatory authorities in each area. All these are within the scope of reforms of the economic structure (structural reform policies). **Thus measures for structural reform were given the most emphasis** in the IMF's assistance to transition economies. Thus, as-

Supplementary Article — What is Conditionality?

In order for member states to receive funds (of over than 25% of the amount of their quotas), in general three conditions must be met. 1) preconditions, 2) performance criteria, and 3) a letter of intent, a document in the form of a letter from the member state's finance minister and central bank governor to the managing director of the IMF. The preconditions are to show the readiness of a member state wishing to receive funding to implement a program, and are measures to be implemented before the board of directors approves funding, and often includes monetary policies such as lowering the exchange rate and raising interest rates. Performance criteria are the criteria to be used when the IMF audits/investigates implementation of the program by the recipient country when making quarterly or other disbursements; they play a decisive role in ensuring continued assistance. If they are not strictly observed, subsequent disbursements will be suspended until agreement on a new program can be reached. The measures contained in the letter of intent are those in areas where reform is necessary, as well as concrete actions for which deadlines (which include measures in the midst of implementation) are given in the letter (at the IMF's site, www.imf.org, letters of intent are posted with the cooperation of recipient governments). Referring to the June 24 agreement with South Korea as an example, measures – including those in progress – are noted in great detail in five areas: macroeconomic policies; financial sector restructuring; prudential regulations and supervision; developing capital market and liberalizing trade and capital account; and enhancing transparency, monitoring and data reporting in the financial industry. Formally the letters are meant to display firmness of purpose, and are ostensibly not enforceable as performance criteria. However, because the implicit understanding is that by the IMF indicating these measures and providing funding their implementation is guaranteed, in fact many of these measures are put together and carried out together with the recipient country authorities by the IMF as "advisor". The tightness of conditionality or lack thereof is currently seen as depending on how substantial the content of the letter of intent is, and on the gap between the target figures used in the performance criteria and reality.

sisting these economies greatly expanded the scope of the IMF conditionalities.

2. Three Major Roles of the IMF

When the IMF was first started, its primary mission was to **support short-term balance of payments (macroeconomic stabilization policies).** Then with the debt crisis in the 1980s, it also took on the role of **intermediary in external debt problems**. Already, since the collapse of the Bretton Woods system, the trend was for the focus of IMF assistance to move to developing countries. However, in the 1990s, with assistance to transition economies, the IMF's role in providing assistance (or intervening) in the form of "**structural reform policies**" became increasingly important. In this section we consider each of these three areas in turn.

2-1. Macroeconomic Stabilization Policies (Short-Term Balance of Payments Improvement Policies)

(1) In Principle, Not Much Is Unclear

The aim of a macroeconomic stabilization policy is also to secure enough foreign exchange earnings. Fundamentally the problem can be considered in the framework of economic theory, and in principle, not much is unclear. We will explain by looking at three cases below.

Firstly, under a fixed exchange rate system (particularly under the Bretton Woods system), because an increase in exports cannot be expected from currency devaluation, improvement in the balance of payments must focus mainly on cutting imports. Slowing down the economy is an effective method of reducing imports, which is achieved by tightening fiscal and monetary policy, in other words through austere macroeconomic policies. However, there is also the view that monetary policy is ineffectual under a fixed rate system[3], and emphasis is generally placed on tightening fiscal expenditure in this case.

Secondly, the fundamental effect is the same in conjunction with the case of an adjustment (cut) in the exchange rate level. When an adjustment in trade may be expected by the one-time devaluation, the austerity measures to be taken would not have to be as severe as when maintaining fixed rates. But it is important to remember that the effect of a devaluation takes several months to become evident.

Lastly, the problem is what kind of macroeconomic stabilization policy should be taken under circumstances like the Asian currency crisis. In this case, it is the market that force an adjustment in exchange rate levels, and the government becomes incapable in maintaining its fixed rate regime. This is a de facto floating rate system. In this case, monetary policy might be the most effective tool[4]. (Still, in practice a policy of both monetary and fiscal tightening is used.) However, since exchange rates are being altered likewise in the case of exchange rate adjustment, it should be possible to use less austere macroeconomic policies.

This brings us to the areas where opinion diverges the most, the most hotly debated topic in the Asian crisis: interest rate policy (monetary policy). The IMF claims that high interest rates are indispensable for exchange rate stabilization. It has been quite determined in enforcing this policy. In the above explanation we showed that the reason why an austere monetary policy (raising interest rates) is necessary is to cool down an overheated domestic economy and reduce imports. However, the IMF's reasons for advocating high interest rates are slightly different. The IMF claims that (1) fiscal policy should be the tool used for austerity (reducing the government's fiscal deficit), and (2) a high interest rate policy is necessary for exchange rate stability. Why should a high interest rate policy stabilize the exchange rate? Because a high interest rate will invite new foreign investment from overseas investors, protect against capital flight by domestic investors. The IMF insists that the government can protect the capital account from worsening. The theory is often summed up with the phrase, "**maintaining investors' confidence**". As this is a very important point, let us examine the benefits and hazards of a policy of high interest rates in more detail below.

(2) Regarding High Interest Rate Policy

(i) The Side Effects are Extremely Great

Along with the financial reforms that are part of structural adjustment programs, the IMF has promoted the disposal and rationalization of financial institutions whose operations have deteriorated. In this kind of situation, it would normally be necessary to cut interest rates to provide indirect support to ease negative impacts on the economy (to appreciate how much of a problem a high interest rate policy poses for financial restructuring, please see Chapter 3).

There is another side effect that relates to financial difficulties. A high interest rate policy further damages the soundness of banks, causing loss of confidence in the soundness of the overall financial system of the country in question. This damage is also manifested in confusion and delays in the trades of small and medium enterprises (for example, they are not able to have letters of credit issued from commercial banks) which can be a factor retarding improvement in the balance of payments, particularly on the export side[5].

(ii) Doubts as to *"Maintaining Investors' Confidence"*

There is no question that a policy of high interest rates has a stabilizing effect on exchange rates, which we are not trying to dispute. However the discipline "high interest rates restore investors' confidence" is not persuasive in some parts.

First of all, the funds attracted by high interest rates are naturally short-term and speculative. Trying desperately to attract these funds heightens the risk of re-igniting chaos, depending on circumstances. Moreover, in as much as economic growth has dropped sharply in countries hit by the crisis, investors' confidence cannot be restored in any true sense in this way. The discipline "high interest rates restore investors' confidence" outwordly persuasive, but we should say that it is merely a first-aid to cover the loss of investors' confidence.

Therefore, the discipline is not the supreme choice. A decision whether to implement it should be made only after the benefits (exchange rate stability) has been weighted against the costs, in terms of financial reform and other costs discussed in (i) above. In particular, when the number of market participants drops sharply due to extreme exchange rate volatility, as is the case in Indonesia, where the foreign exchange market has essentially disappeared, it is questionable whether there is any sense in putting a priority on exchange rate stability (see Chapter 5 for more information on the circumstances of the Indonesian foreign exchange markets).

(iii) Significance of High Interest Rates as an Anti-Inflationary Measure

High interest rates are plausible as an anti-inflationary device, but this requires a great deal of consideration. Inflation can be due to (1) demand exceeding supply, or (2) too great a supply of money. However, there is also a kind of inflation caused by a rise in import prices due to a fall in the exchange rate (import inflation). Let us look at these causes in turn. First of all, under the current very negative economic conditions in Asia, inflation due to excessive demand is simply not plausible. Next, an excessive supply of money is also not likely at present. The process of money supply growth requires bank lending (credit creation) but what is actually occurring at present is a violent credit crunch (see also Chapter 3, Section 1). Banks are not lending, and so there is no way for the money supply to grow. Naturally, in order to pay for government fiscal expenditure, the government could cover a fiscal deficit by issuing currency, for example via the central bank buying government bonds - but this is a different story. The only way to prevent this would be for the international community to provide the necessary funds; it could not be prevented with a high interest rate policy.

The remaining candidate is rises in prices for imported goods. We should first note that this is very hard to avoid to a certain extent. What would happen if we tried to negate the domestic effects of rises in the prices of imported goods by reducing demand through higher interest rates? Assume that 50% of products consumed are imported goods, and the rest 50% are domestic goods. If import prices doubled here, the only way to maintain the general price stability would be to cut the prices of domestic goods. In this example, it would be necessary to cut the cost of domestic goods by more than 50%, but this would surely cause the extinction of domestic industry. In consequence, if the exchange rate has fallen greatly, protecting against a rise in the general price level by a high interest rate policy seems like very imprudent. Of course, if the aim is not to cut the demand side but to "suppress import inflation by halting the falling exchange rate through high interest rates" then the logic is flawless. However, this merely brings us back to the debate on the appropriateness of high interest rates to stabilize exchange rates. All it has done is added to the list of merits of exchange rate stability, namely a stable exchange rate means stable prices for imported goods.

(iv) Are High Interest Rates the Only Possibility?

Whether there are alternatives to high interest rates is very important. If not, then high interest rates would be necessary regardless of the damage they cause. However if there are alternatives, then we can examine there benefits and hazards in turn and pick the most appropriate policy.

In theory, we can conceive of the following two alternatives. They are Krugman's proposals for capital controls (see Chapter 2), and the proposal for abandoning exchange rate stability by Sachs and others. First of all, let us look at the interrelationships between the three policies, including the IMF's high interest rate policy. Krugman calls the IMF's policy "Plan A", and his own "Plan B". Let us add the abandonment of exchange rate stability as "Plan C".

In general, it is considered that of the following three: (1) free movement of capital, (2) freedom to set domestic monetary policy (lower interest rates), and (3) exchange rate stability, only two can be implemented simultaneously (all three cannot be pursued at the same time). Plans A, B, and C differ in which of these three they are willing to sacrifice.

We have shown the relationships in Table 1. The table is very easy to follow if you think in terms of the categories marked with an "×". For example, only Plan A has an "×" under "lowering interest rates". This means that if emphasis is placed on lowering interest rates, then Plan A is undesirable. In the same way, Plan B has an "×" under "free movement of capital". This makes Plan B com-

Table 1 Three Plans for Macroeconomic Stabilization*

	(1) free movement of capital	(2) lowering interest rates	(3) exchange rate stability	advocate
Plan A	○	×	○	IMF
Plan B	×	○	○	Krugman
Plan C	○	○	×	Sachs, etc.

* Among three policy targets (1), (2), and (3), we can pursue two targets simultaneously (○ in columns), giving up the rest one (×). All the possibilities are theoretically explained by the three plans: Plan A suggests to stabilize the exchange rate keeping interest rates high; Plan B to eliminate capital movements; and Plan C to surrender the exchange rate stability.

pletely unacceptable to those for whom the free movement of capital is desirable[6].

Seen this way, it is clear that all of the plans involve gains and losses (namely, a **trade-off**). Thus it is necessary to decide what is important. As we have already stated, the high interest policy is no exception; **a decision on whether to implement it or not must be taken based on a consideration of its benefits and hazards**, a conclusion which should now be clearer than ever.

2-2. Debt Problems (The Role of Intermediary)

(1) The Criticism that the IMF Creates Moral Hazard[7]

Wherever debt problems exist, the criticism inevitably follows that "perhaps the IMF is not trying to help borrowers – the countries it is assisting, but rather creditors – the investors." This became a major domestic issue in the United States at the time of the 1994 Mexican Crisis. This is because it was suspected that the huge aid package agreed on by the US government and the IMF might have actually been designed to rescue private US financial institutions who held large quantities of Mexican government bonds.

If investors believe that should a balance of payments of crisis arise in a developing country, an IMF rescue package will in any case be set in motion, then they will happily lend more than is necessary to developing country governments and enterprises. It cannot be denied that this could cause yet another currency crisis in the future. However, it is difficult to demonstrate the existence of moral hazard – the problem with this criticism is that it cannot be proved.

It must be pointed out that the moral hazard issue has become a political bargaining chip in the US Congress. Dealing with the problem of moral hazard is too important an issue for it to become a ball batted around in political games.

(2) Negligence in Dealing with Private External Debt Problems

In Chapter 3 we noted that Indonesia's INDRA scheme (measures to deal with private external debt) was not truly functional. The amount of information available on the process and state of negotiations on the private external debt problem, including INDRA's planning process, is extremely limited. The role of international institutions such as the IMF and World Bank is extremely opaque. The indifference of the mass media probably plays a role, but it seems as though the IMF is not fulfilling its function as an intermediary adequately. Stronger measures must be taken to lead to advances in realistic debt negotiations.

(3) The Danger of Conflict of Interest

When one institution is made responsible for numerous goals, **it gives rise to the danger that in order to reach one goal, the institution will take measures that sacrifice another one**. This is called a **conflict of interest**. We would like to point out the possibility of a conflict of interest arising between two of the IMF's roles we have discussed, conducting macroeconomic stabilization policy, and acting as intermediary in debt problems. To be more direct, it might be that the IMF is wedded to exchange rate stability not because of its goals in terms of macroeconomic stabilization policy, but due to its position as intermediary in debt problems.

For example in Indonesia's case, even if exchange rate stability were achieved, a lot of borrower firms would already be insolvent. The only kind of results that could be hoped for would perhaps be lowering the degree of their insolvency. However, from the standpoint of foreign banks, preventing the shrinking of collectible assets due to a falling currency is of the utmost importance. The possibility exists that the IMF's position, in its role as intermediary in debt problems, might come to reflect the interests of creditors[8].

2-3. Structural Reforms

(1) The Contradiction of Macroeconomic Stabilization Policy (Structural Reform Needs Time)

The purview of structural reforms is extremely broad. From financial reform to trade, distribution, and the relationship between the public and private sectors, structural reform can in fact involve anything. In many cases, there are numerous problems that take a certain time to solve.

The fact that time is required leads to a contradiction with macroeconomic stabilization policy, which must be achieved on a short-term basis. It has been observed that it is strange, when short-term liquidity problems (lack of foreign exchange reserves) are involved, to make implementation conditional on confirmation of the results of structural reforms, which takes time. For example, if it is judged that there is a problem implementing structural reforms, the possibility exists that IMF funding will stop in the midst of the program. When IMF funding is halted it gives the markets a negative impression, leading to expectations of a further fall in exchange rates. It is precisely these conditions that present profit opportunities to speculators, and might be a factor in loss of "confidence"[9].

(2) The Risk of Becoming Partially Involved in the Political Process of the Country in Question

Reforming the structure of the economy is in no way a bad thing for any country. However, a real problem is that structural reforms are intricately entwined with political decision making in the country in question. The IMF does not have the authority or the means to intervene in a country's political process. Nonetheless, the fact that the process of formulating conditionality can include eliminating subsidies and stripping influential businesses of special privileges can cause all manner of disruption. This is because the nature of these policies to reform structural problems is that they only become possible to implement when the political will exists. Taking Indonesia as an example, the tug-of-war between the IMF and the political authorities not only delayed formulation of the program itself, but also greatly damaged market confidence, worsening matters[10].

This may be because the real political process was more complex than economists realized. For example, there are reformers and conservatives in every country. In Indonesia and other countries, there was a faction of reformers who had been educated in economics in the United States known as the "technocrats". They were the IMF's outlet for negotiations (see Chapter 5). It is only natural that these technocrats, who were part of Indonesia's political process, would use IMF conditionality as a lever to reform their country's economic structure. Thus the danger that by becoming deeply involved in the structural reform policy, the IMF can inadvertently became entwined in a country's politics.

(3) The Risk of Becoming Entwined in the International Political Process

The US's contribution to the IMF for fiscal 1999 ($18 billion) was only finally passed on October 21, 1998 with conditions attached, after long debate in Congress. One of the reasons for the delay was demands by some on the left for "improvements in inadequate working conditions" and by some on the right for "halting assistance to countries carrying out abortions", among other demands. The idea that "he who pays the piper calls the tune" is completely understandable, but it is hard to approve of using conditionality as a means of making demands completely unrelated to the IMF's original purpose. If the IMF becomes a tool for political disputes between developed and developing countries, then its functions will be impaired. Might it be that this kind of confusion is the result of structural reform policy being too broadly defined, and fundamentally too vague?

3. Proposals

As we have seen, the IMF wears too many different hats. The proposals that we will make here are to relieve the IMF of excessive expectations and an excessive burden in terms of human resources and number of functions to be filled.

The IMF is an institution with outstanding staff and systems. However, it is a form of bureaucracy. The drawback of bureaucratic institutions is that they are unable to reduce the amount of work to be done, indeed, they tend to create more work. Might the fact that the range and detail of conditionality has tended to expand also be an expression of the dynamics of bureaucratic institutions?

The IMF has come under strong criticism for foisting conditionality on countries that ignores their particular circumstances. However, it is likely that this was not intentional on the IMF's part, and that things had to happen as they did due to human resource constraints and the format of funding schemes. At this point to turn to the IMF and say "fill out a prescription that fits conditions in each developing country" is surely to get things backward. Asking the IMF to perform even more functions than it already does is just to further shrink its latitude in terms of time and staff, with a high risk of making the situation worse (and seeking to expand conditionality, as the US Congress has, carries the same risk). Rather, the role of the IMF should be limited, making it possible for it to invest its human resources in a focussed way. Realistically, the IMF is not all-powerful. No matter how talented its staff, it cannot be expected to write a prescription and then oversee a cure for every economic problem.

It is the role of politicians to complement the weak points of bureaucratic institutions. In the IMF's case, politicians from contributor nations must take the initiative, and show the way toward limiting the role of the IMF and reducing its workload. If on the other hand all they do is criticize, all it does is create trouble in the field and increase the amount of work to be done - this is nothing more than bureaucrat bashing. There is no need to shrink the organization or the number of staff; if current levels are maintained and the IMF's functions limited, it will improve the results of programs implemented, with goals easier to achieve than at present.

In deciding to slim down the IMF's functions, a difficult question is which functions to preserve. Based on our analysis in this chapter, **we would attach the greatest importance to macroeconomic stabilization**, next to **improving the function of intermediary in debt problems. With regard to structural problems, we would argue the need for a broad rethink and curtailment**. However, each area requires caution.

First, plans for macroeconomic stabilization require thorough debate from an economics standpoint. In particular, regarding high interest rate policies, it is surely necessary to establish decision-making standards based on varying conditions, and letting go of dogma.

Next, the IMF's function as intermediary in resolving debt problems should be made stronger than it is at present. Indonesia's private debt problems and other similar problems are an extremely important issue that seems not to be receiving sufficient attention. However, for the IMF to act as a truly impartial intermediary, an appropriate framework is necessary. At some point the IMF might come to simply represent the interests of creditor banks without even knowing it.

Finally, as far as structural reforms are concerned, it should be organized so that in principle they are limited to supplementing the implementation of macroeconomic stabilization policy (resolving balance of payment problems). In the case of Asia, the treatment of financial reform has received the greatest attention. There is no denying that financial reform is important, but precisely because it is important it is necessary to avoid rough and ready measures, and making it part of the IMF's role is perhaps asking the impossible[11]. It is necessary to respond by organizing a division of labor between the World Bank and other regional development banks, the BIS and others, as well as creating a readiness to respond on the part of central banks in industrial countries.

Notes:

1. Fiscal and monetary policy are together called macroeconomic policy. Therefore, measures to reduce a current account deficit through macroeconomic policy are called macroeconomic stabilization measures.
2. In addition, the collapse of the international division of labor that had existed between the Soviet republics and Eastern European countries, was a factor making economic dislocation even more painful.
3. It is the conclusion of the Mundell Fleming model with a small open economy, that under a fixed rate

system fiscal policy is effectual, and monetary policy loses its effect.

4. This is the conclusion of the Mundell Fleming model under a floating rate system.
5. In interviews in South Korea (in the machine tools industry) it was found that small and medium enterprises generally settle domestic transactions in cash, so that financing the settlement of drafts for imports and exports had become extremely difficult, with foreign banks refusing to accept letters of credit and banks with which they have relationships disappearing with reform of the domestic financial sector. The government has been slow to respond due to lack of funds, and the domestic situation is urgent.
6. Conversely, we can inquire as to IMF's concern with high interest rates. Leaving aside the question of good or bad, and also whether the IMF is conscious of this or not, a high interest rate policy does not only benefit exchange rate stability, it is also necessary to maintain the free movement of capital.
7. For the meaning of "moral hazard", see the explanation at the beginning of Chapter 1.
8. We are here merely pointing to a danger. We would like to note that there is no evidence of this actually occurring. However, as Prof. Bhagwati (*Foreign Affairs*, May/June 1998) points out, it gives rise to the suspicion of "A Wall Street-Treasury Complex". It is unclear whether there is anything to this, but efforts are necessary to secure systemic guarantees to allay these suspicions.
9. This is one point of Prof. Feldstein's critique of the IMF (*Nihon Keizai Shimbun*, May 7, 1998, morning edition). See *Foreign Affairs*, March/April 1998.
10. Prof. Feldstein has said that "Because the IMF was pushing structural reform, the economies of Thailand, Indonesia, and South Korea became dysfunctional, mismanaged, and corrupt. It is no wonder that at this point foreign lenders pulled out their funds and became unwilling to negotiate new lending. The IMF has greatly deviated from its role, lost the trust of the international economic community, and exacerbated the financial crisis."
11. We would also like to point out that financial reform is not directly related to current account improvement.

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