Backgrounder

Published by The Heritage Foundation

No. 1689
September 17, 2003

# IMF and World Bank Intervention: A Problem, Not a Solution

*Ana I. Eiras*

On September 23, 2003, the World Bank Group and the Board of Governors of the International Monetary Fund (IMF) will meet in Dubai to discuss the work of their respective institutions in international monetary and development issues. This meeting would be worth its high expense if the discussion were centered on these institutions' own reform rather than on how they should intervene in developing countries.

An examination of the record of IMF and World Bank performance in developing countries shows that, far from being the solution to global economic instability and poverty, these two international institutions are a major problem. For one thing, their lending practice deters growth because the money they loan removes incentives for governments to advance economic freedom, and breeds corruption. For these reasons, the vast majority of recipient countries have been unable to develop fully after depending on these institutions for over 40 years.

The Bush Administration should support reform of these institutions' lending practices. To that end, the Administration should use the work of the congressionally mandated International Financial Institutions Advisory Commission (IFIAC), chaired by Allan H. Meltzer of Carnegie Mellon University, to establish a solid framework for reforming the IMF and the World Bank.[1] The reforms should maximize their effectiveness, increase accountability for their lending decisions, and limit their harmful influence in the developing world.

- The literature on economic growth, development, and prosperity mostly agrees that the key to prosperity is economic freedom built on a strong rule of law.
- The problem is not so much that the World Bank and the IMF are ineffective as it is that they create disincentives in the countries they are trying to help.
- According to the *Index of Economic Freedom*, the Bank's money has done nothing to improve economic freedom in recipient countries.
- Bangladesh is the World Bank's third highest recipient of funds, despite being the world's most corrupt country.
- Financial crises around the world have increased over the past 15 years, even as the IMF has committed ever-greater resources to combat them. In many cases, the recipients of IMF loans are worse off today than before the IMF loans began to flow.

This paper, in its entirety, can be found at:
*www.heritage.org/research/internationalorganizations/bg1689.cfm*

Produced by the Center for International Trade and Economics (CITE)

Published by The Heritage Foundation
214 Massachusetts Ave., NE
Washington, DC 20002–4999
(202) 546-4400 heritage.org

## The 10 Steps for Growth and Stability

The literature on economic growth, development, and prosperity mostly agrees that the key to prosperity is economic freedom built on a strong rule of law.[2] Economically free countries have a sound monetary policy, minimal and transparent regulation, minimal state participation in economic activity, and a strong rule of law that permits the enforcement of property rights and regulations.

The annual Heritage Foundation/Wall Street Journal *Index of Economic Freedom*[3] provides a framework for understanding how free citizens of any given country are to engage in economic activity; the degree of state intervention in the economy (whether through taxation, spending, or regulation); and the strength and independence of a country's judiciary in enforcing rules and protecting private property.

The *Index* is like a 10-step road map that, when followed closely, leads to development and economic stability. Some countries have a substantial degree of freedom in all factors; others have a degree of freedom in just a few. One of the most important findings of the *Index* is that economic freedom is required in all aspects of economic life—that is, in all of the 10 factors—in order for a country to achieve its economic potential, improve economic efficiency, grow sustainably, and consequently improve the living standards of its people.

Chart 1 illustrates the relationship between economic freedom and income per capita. It shows that the freer the economy, the higher the country's per capita income. Some countries have substantial economic freedom, but not the per capita income of a developed country. This may be the case, for example, if a country is undergoing reform. Nevertheless, not a single economically unfree or repressed country in the world has a high income per capita.

The 10-step road map also refutes the false excuse of "free market failure." It is very common to hear political leaders in developing countries say, "We opened our markets, but it is not working for us." However, in almost all of these cases, the *Index* shows that those countries have economic freedom in only three or four factors, as opposed to all 10.

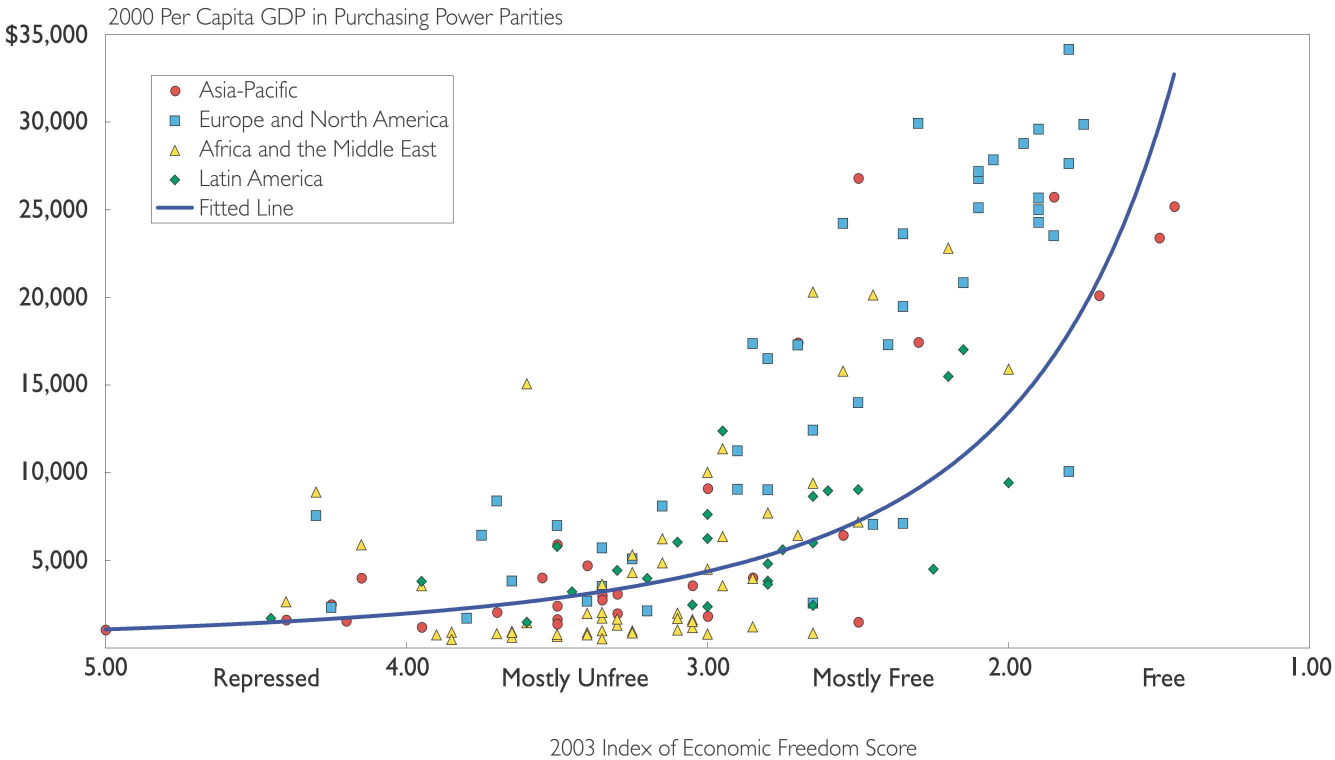
One clear example of this is the failure to reform the judiciary and strengthen the rule of law in almost all the developing world. A market economy is almost unthinkable without a strong rule of law that protects property, enforces the rules, and punishes corruption. As shown in Chart 2, countries with a moderate to very low protection of property rights have an average maximum per capita GDP of $4,900—clearly neither the per capita income of a developed country nor one that promises a high standard of living.

Specifically, attempts in the 1990s to "liberalize" mostly achieved deregulation of foreign investment and capital flows, price liberalization, privatization, low inflation, and a goal of fiscal balance. But almost no country in the developing world improved its rule of law, deregulated the labor markets, and reduced bureaucratic regulations on small and medium business—all part of the 10-step plan. Just as a cake cannot be made with just eggs and a hot oven, prosperity cannot happen with only privatization and some deregulation.

1. The full International Financial Institutions Advisory Commission (IFIAC) report is available in English at *www.house.gov/jec/imf/meltzer.htm* and in Spanish at *www.heritage.org/library/efp/efp00-04.html*.
2. Examples of these studies include Richard Roll and John Talbott, "Why Developing Countries Just Aren't?" at *www.worlddevelopmentnow.com/id21.htm*; Robert J. Barro, *Determinants of Economic Growth: A Cross-Country Empirical Study* (Cambridge, Mass.: MIT Press, 1997); Robert Cooter, "The Rule of State Law and the Rule-of-Law State: Economic Analysis of the Legal Foundations of Development," 1996, in Edgardo Buscaglia, William Ratliff, and Robert Cooter, eds., *Law and Economics of Development* (Greenwich, Conn.: JAI Press, 1997); and Hernando de Soto, *The Other Path* (New York: Harper and Row, 1989).
3. Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, *2003 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2003).

Chart 1 B 1689

## Economic Freedom and Income




**Note:** Per capita GDP figures were not available for the following countries: Armenia, The Bahamas, Bahrain, Bosnia, Democratic Republic of Congo, Cuba, Djibouti, Iraq, North Korea, Kuwait, Lebanon, Libya, Malta, Oman, Qatar, Suriname, Taiwan, Tajikistan, United Arab Emirates, Yugoslavia. Per capita GDP figures are in current international dollars and are from1999.

**Source:** The World Bank, 2001 World Development Indicators on CD-ROM.

## Running Developing Countries Off The Road to Prosperity

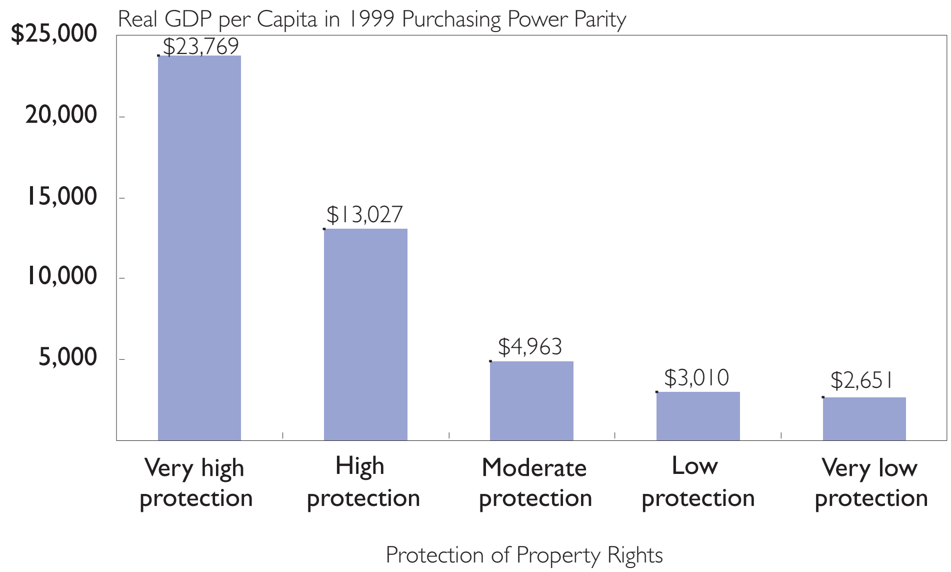
The debate on the ability of international financial institutions to influence reform in other countries had its peak about five years ago, when the U.S. Congress created the IFIAC. The IFIAC assessed the role and effectiveness of the World Bank, the International Monetary Fund, the regional development banks, the Bank of International Settlements, and the World Trade Organization.

Regarding the IMF and the World Bank, the IFIAC concluded that the work of these institutions left much to be desired. Specifically:

> The IMF has given too little attention to improving financial structures in developing countries and too much to expensive rescue operations. Its system of short-term crisis management is too costly, its responses too slow, its advice often incorrect, and its efforts to influence policy and practice too intrusive.
>
> High cost and low effectiveness characterize many development bank operations as well. The World Bank's evaluation of its own performance in Africa found a 73% failure rate.… In reducing poverty and promoting the creation and development of markets and institutional structures that facilitate development, the record of the World Bank and the regional development banks leaves much room for improvement.[4]

Chart 2 B 1689

**Protection of Property Rights and Per Capita Income**




**Sources:** The World Bank, World Development Indicators, 2003, on CD-ROM; Central Intelligence Agency, The World Factbook 2001, at *www.theodora.com/wfb/2001/wfb_2001.html*; and Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, 2003 *Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Co., Inc., 2003).

The problem is not so much that the World Bank and the IMF are ineffective as it is that they create disincentives in the countries they are trying to help. Sending money to countries with misdirected policies and weak rule of law increases the recipients' debt without visible economic growth. Nevertheless, no significant reform of these international institutions has taken place.

For example, at the entrance of the World Bank building in Washington, D.C., is a sign that reads "*Our dream is a world without poverty.*" To fulfill that dream, the World Bank employs over 10,000 people in more than 100 offices around the world with an annual budget of $1.5 billion. Despite such monstrous display of resources, according to the *Index of Economic Freedom*, the Bank's money has done nothing to improve economic freedom in recipient countries. Predictably, those countries are still just as poor as they were 40 years ago when they started receiving World Bank loans.

The International Development Association (IDA) is the branch of the World Bank Group that lends money to the world's poorest countries. For each of

4. See note 1, *supra*.

the IDA's top 10 recipients, Table 1 shows the cumulative amount received from the Bank, the GDP per capita in the country's first and last year of receiving funds, and the level of economic freedom in its economy.

India, for example, remains poor despite receiving $28.8 billion since 1961. That money did nothing to make India open its economy, which remains "mostly unfree" according to the *Index*.

Similarly, Bangladesh is the World Bank's third highest recipient of funds, despite being the world's most corrupt country according to Transparency International (TI).[5] This is not something to take lightly. According to TI, corruption in Bangladesh caused a loss of economic activity equivalent to 4.7 percent of GDP in 2001. It is not difficult to guess, therefore, where the World Bank's money may be going, since Bangladesh today is the world's third poorest country.[6]

Table 1 B 1689

**World Bank Loans by Country**

| Country | Cumulative IDA Loans Received ($billions) | GDP per Capita When First Receiving Aid | GDP per Capita in 2002 | 2003 Index Score |
|---|---|---|---|---|
| India | $28.844 | $183 (1961) | $494 | 3.50 (Mostly Unfree) |
| China | $9.947 | $69 (1961) | $942 | 3.55 (Mostly Unfree) |
| Bangladesh | $9.914 | $213 (1973) | $396 | 3.50 (Mostly Unfree) |
| Pakistan | $6.642 | $186 (1961) | $527 | 3.30 (Mostly Unfree) |
| Ghana | $4.016 | $447 (1962) | $432 | 3.40 (Mostly Unfree) |
| Tanzania | $3.910 | N/A (1963) $181 (1988)* | $204 | 3.35 (Mostly Unfree) |
| Vietnam | $3.862 | N/A (1978) $185 (1984)* | $412 | 3.70 (Mostly Unfree) |
| Ethiopia | $3.779 | N/A (1961) $117 (1981)* | $124 | 3.50 (Mostly Unfree) |
| Uganda | $3.401 | N/A (1963) $236 (1982)* | $367 | 2.85 (Mostly Free) |
| Kenya | $3.237 | $205 (1964) | $325 | 3.10 (Mostly Unfree) |

*Earliest year for which data are available.

**Sources:** The World Bank, World Development Indicators, 2003, on CD-ROM; Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, 2003 *Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Co., Inc., 2003); and The World Bank, The World Bank Annual Report 2002, at *www.worldbank.org/annualreport/2002/pdf/IBRDAppendixes.pdf*

Summing up the results in Table 1, after receiving IDA funds for an average of 37 years, the economies of all these countries are today "mostly unfree" according to the *Index*—except for the economy of Uganda, which is only slightly better than the rest. As a result, the recipient countries' per capita income went from between $117 and $447 in the 1960s to between $124 and $527 in 2002.

So much for "a world without poverty."

The IMF has had similar results. The Fund's goal is "to promote international monetary cooperation,

5. Transparency International, *Corruption Perception Index 2002*, at *www.transparency.org/cpi/2002/cpi2002.en.html*.

6. World Bank Group, *Country Brief: Bangladesh*, August 2003, at *lnweb18.worldbank.org/lo%20web%20sites/bangladesh%20web.nsf/1382158c33bcc8dd4625667200239762/dc5134fc4dabb9b985256b05007c6629?OpenDocument*.

exchange stability…to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment."[7] However, financial crises around the world have increased over the past 15 years, even as the IMF has committed ever-greater resources to combat them. In many cases, the recipients of IMF loans are worse off today (e.g., Argentina) than before the IMF loans began to flow.

The reason is simple. Financial crises are the result of poor policymaking and corruption, not of some inexplicable evil design. For example, if the IMF were to bail out a country called Neverlearningland from an impending crisis, it would not allow Neverlearningland's leaders to face the consequences of poor policymaking and corruption. Hence, the leaders of Neverlearningland would have no incentive to change the poor way in which they run the country.

At the same time, Neverlearningland's government bonds would be sold in the market at a very high yield—reflecting the high risk of default from poor policymaking. But because the IMF continuously bails out Neverlearningland, regardless of continued corruption and poor policy, buying the bonds would become a unique investment: a high yield bond bearing no risk.

Far from achieving the IMF's stated goal, in other words, bailout loan packages reduce the political risks associated with faulty economic decisions, and recipient countries consequently end up with greater debt, lower standards of living, higher unemployment, and less savings.

For each of the IMF's top 10 recipients, Table 2 shows the cumulative amount received from the IMF, the GDP per capita in the country's first and last year of receiving funds, and the level of economic freedom in its economy.

Table 2 B 1689

**IMF Loans by Country**

| Country | Cumulative Amount of IMF Loans Withdrawn ($billions) | GDP per Capita in the Year of the First Loan | GDP per Capita in 2002 | 2003 Index Score |
|---|---|---|---|---|
| Brazil | $53.05 | N/A (1958)<br>$1,742 (1960)* | $4,644 | 3.00<br>(Mostly Unfree) |
| Turkey | $31.63 | N/A (1961)<br>$1,619 (1968)* | $2,942 | 3.50<br>(Mostly Unfree) |
| Argentina | $26.46 | N/A (1958)<br>$5,419 (1960)* | $6,579 | 2.95<br>(Mostly Free) |
| Mxico | $24.77 | N/A (1954)<br>$1,639 (1960)* | $3,713 | 2.80<br>(Mostly Free) |
| South Korea | $21.01 | $1,547 (1965) | $14,280 | 2.70<br>(Mostly Free) |
| Russia | $15.64 | $2,967 (1992) | $2,734 | 3.70<br>(Mostly Unfree) |
| Indonesia | $14.44 | $259 (1961) | $1,060 | 3.30<br>(Mostly Unfree) |
| India | $8.47 | N/A (1957)<br>$180 (1960)* | $494 | 3.50<br>(Mostly Unfree) |
| Philippines | $3.80 | $753 (1962) | $1,195 | 2.85<br>(Mostly Free) |
| Pakistan | $3.62 | N/A (1958)<br>$181 (1960)* | $527 | 3.30<br>(Mostly Unfree) |

*Earliest year for which data are available.

**Sources:** International Monetary Fund, "IMF Lending Arrangements," at *www.imf.org/external/np/tre/tad/extarr1.cfm*; The World Bank, World Development Indicators, 2003, on CD-ROM; Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, 2003 *Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Co., Inc., 2003).

7. International Monetary Fund, *About the IMF*, at *www.imf.org/external/about.htm*.

Brazil, for example, has received $53 billion from the IMF since 1958. That money did nothing to open Brazil's economy, which remains "mostly unfree" according to the *Index*. Consequently, Brazil has been unable to grow sustainably, and 49 percent of the population therefore remains poor,[8] with Brazil's huge debt burden crippling growth prospects.

Argentina is the third highest recipient of IMF funds and perhaps the most obvious example of IMF failure. Over $26 billion in IMF loans since 1958 has not encouraged Argentina to move toward substantially open markets. At first glance, the few changes that Argentina has undertaken appear to have made it "mostly free" according to the *Index*, but it is still on the cusp of being a "mostly unfree" economy. As a result, Argentina's GDP per capita has not changed much since 1958.

IMF lending practices in Argentina have had two negative consequences that apply, in fact, to all IMF lending. First, the IMF assistance became predictable, eliminating investor risk through repeated bailouts: Investing in Argentina would bring a guaranteed profit regardless of how poor the economic conditions were. Second, the Argentine government had little incentive to reform; the money would still come in. These lending policies are a major cause of Argentina's worst economic, social, and institutional crisis.

In sum, after receiving IMF funds for an average of 42 years (except Russia, which first received funds in 1992), the economies of most of the IMF recipients are today "mostly unfree" according to the *Index*—except Mexico and Argentina, which are only marginally better. As a result, the recipient countries' per capita income went from between $259 and $5,419 in the 1960s to between $494 and $6,579 in 2002. South Korea is the only country that grew and developed to a significant degree, today enjoying a per capita income of $14,280; but the reasons for that development are an extensive opening of the economy and the preservation of a strong rule of law—a very different story from other IMF recipients.

## Reforming the IMF and World Bank Should Be a Priority

One of the main causes of continued poverty in the world is the work of the World Bank and the IMF. In order to foster a more stable and peaceful world, the Bush Administration should address the failure of these institutions to provide the developing world with incentives to move toward economic freedom. To that end, the Administration should restrict the ability of international financial institutions to interfere in the international economy, particularly through the IMF's lending habits.

The President's Millennium Challenge Account (MCA) is a step in the right direction for reforming the World Bank. The MCA differs from other aid programs in that its recipients must meet certain criteria to qualify for funds. Those criteria have been selected based on the "evidence that they contribute or are complementary to long-term growth and prosperity rather than on subjective, political motivations unrelated to development."[9]

The Administration should rely on the work of the IFIAC to establish a solid framework for reforming the IMF and further reforming the World Bank. The IFIAC advocates a new system of preconditions that countries must meet to qualify for an IMF loan. These include sound fiscal policy, freedom of entry and operation for foreign financial institutions, and adequately capitalized commercial banks. Dependence on foreign loans and future economic crises around the world will decline only in an environment that promotes the efficiencies and benefits of open markets.

## Conclusion

The upcoming World Bank–IMF high-level meeting in Dubai will better serve the world if these institutions begin to discuss reforming themselves to create incentives for countries to increase economic freedom. Because the work of these institutions deters economic freedom, the vast majority of

8. World Bank Group, *Country Brief: Brazil*, updated April 2003, at *lnweb18.worldbank.org/external/lac/lac.nsf/Countries/Brazil/9978DEF586DEE64485256D0B004A3630?OpenDocument*.

9. Brett D. Schaefer and Paolo Pasicolan, "How to Improve the Bush Administration's Millennium Challenge Account," Heritage Foundation *Backgrounder* No. 1629, February 28, 2003, p. 1.

recipient countries have been unable to develop fully after over 40 years of dependence.

The Bush Administration should strongly and actively support reforming these institutions' lending practices. To that end, the Administration should continue to support its MCA initiative, but also use the work of the IFIAC to establish a solid framework for reforming the IMF and the World Bank.

Specifically, reforms of the World Bank and the IMF should maximize these institutions' effectiveness, increase accountability for their lending decisions, and limit their harmful influence in the developing world. Such reforms would bring more stability, economic growth, and peace around the world.

—*Ana I. Eiras is Senior Policy Analyst for International Economics in the Center for International Trade and Economics at The Heritage Foundation.*