Do Institutional Distortions Matter?: IMF Moral Hazard and Excess Reserve Accumulation

"It is important to recognize that the current distribution of IMF quotas represents another form of unsustainable global imbalance."

-Toshihiko Fukui, Former Governor of the Bank of Japan

"Major countries have increased their foreign exchange reserves in preparation of a possible liquidity crisis. The main reason for the sharp increase of currency reserves is that the IMF and the World Bank have failed to set up effective systems for the prevention of a crisis."

-Lee Myung Bank, President of Korea

Phillip Y. Lipscy

IPES, November 2010

Motivating Puzzles

- IMF Path Dependence (Lipscy, 2010) – are there any real economic consequences?
- How to explain excess reserve accumulation by some countries?
- Why do some countries care so much about IMF reform?

Theory

- IMF = Biased Global Insurance Mechanism
- Uneven international distribution of coverage and moral hazard
  - Economies and Banks with close ties to US, Europe → greater expectation of rescue; moral hazard
  - Economies and Banks with close ties to Japan/Asia → reliance on self-insurance
- Disadvantages East Asian economies and financial institutions
- Contributes to global imbalances

Unbalanced IMF Representation

- IMF lending subject to parochial political influence (Thacker, 1999; Vreeland, 2003; Oatley and Yackee, 2004; Broz and Hawes, 2006; Dreher and Jensen, 2007; Stone, 2008; Copelovitch, 2009, etc.)
- Quotas, staff, informal power heavily tilted towards US and developed Europe; Little change over time
- Result: skewed determination of liquidity provision vs. moral hazard tradeoff
- → Some countries are more subject to moral hazard than others

Measures of IMF Influence vs. Shares of World GDP

	IMF Quota Share (pre-reform)	Share of IMF Economists	Shares of World GDP (Nominal)	Shares of World GDP (PPP)
ASEAN+3	13.4%	7%	21.5%	27.0%
United States	17.4%	24%	17.2%	20.3%
OECD Europe	29.6%	30%	26.7%	19.4%

Also: Managing Director historically goes to European national; headquarter location in Washington D.C.; US only country with unilateral veto

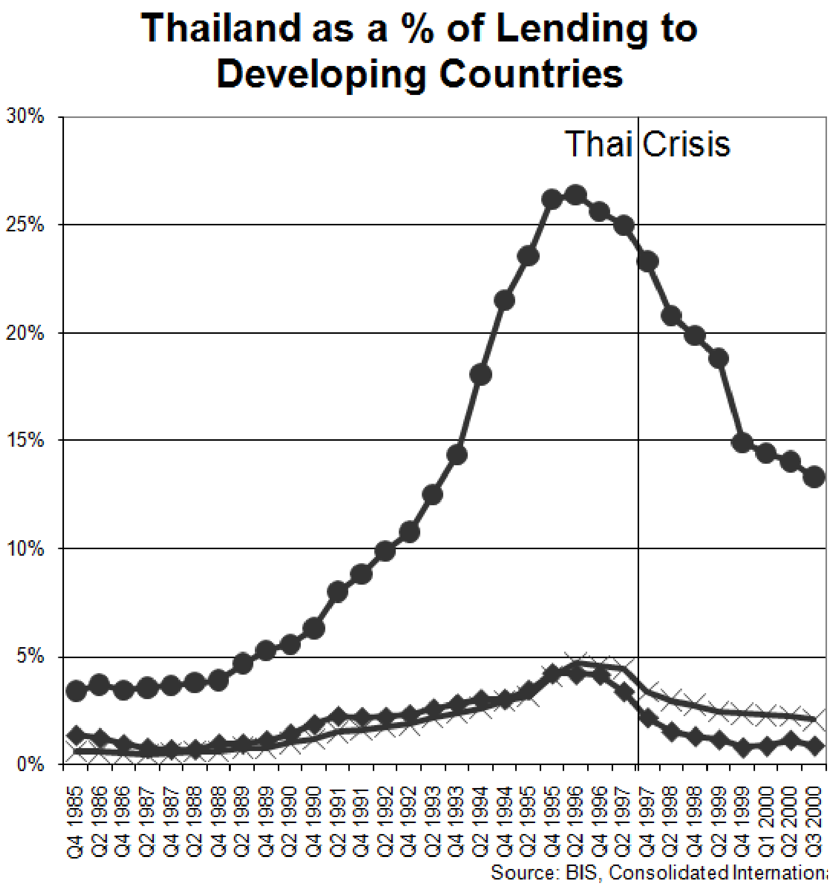
Asian Crisis

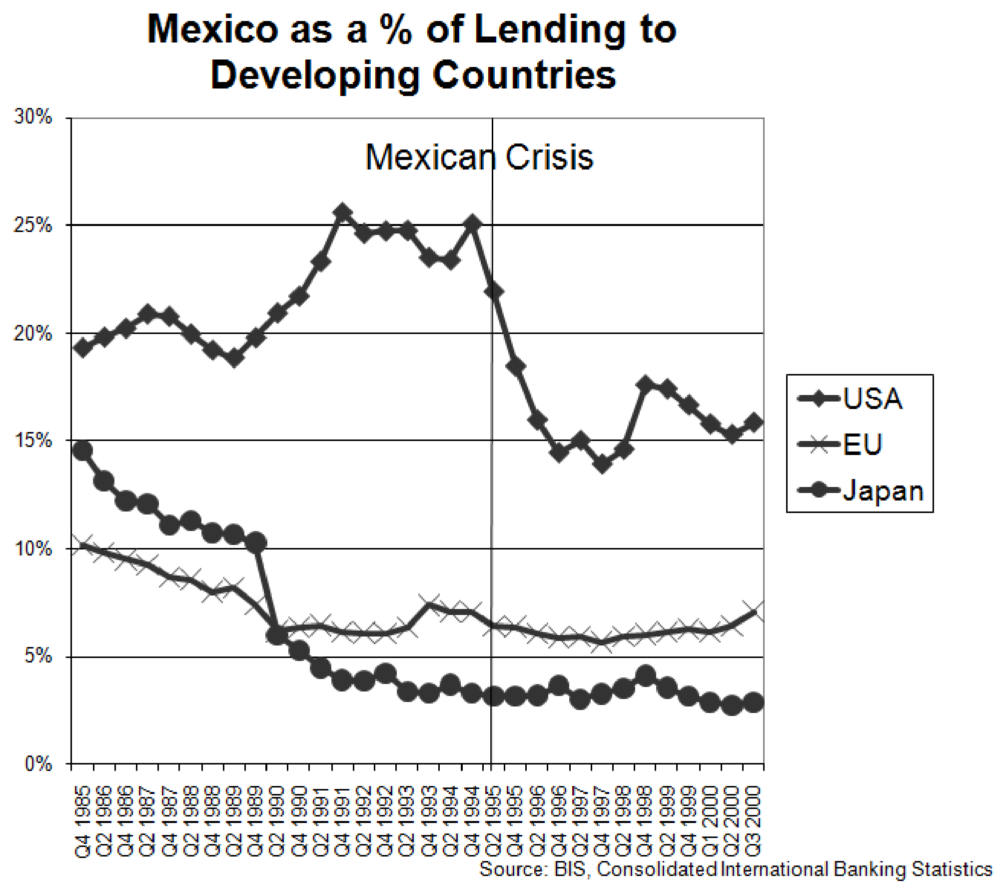
- IMF largely ignores advice from Japan and other Asian members, implements harsh conditionality
- Negative views towards IMF, e.g.:
  - "Flagellation of dead bodies" –Japanese MOF
  - "National Economic Humiliation Day" – Kim Dae-jung
- Reserve accumulation as self-insurance
- Regional Response (CMIM) though still dysfunctional
- In 2008, of 30 countries that seek IMF lending, zero from East Asia despite need

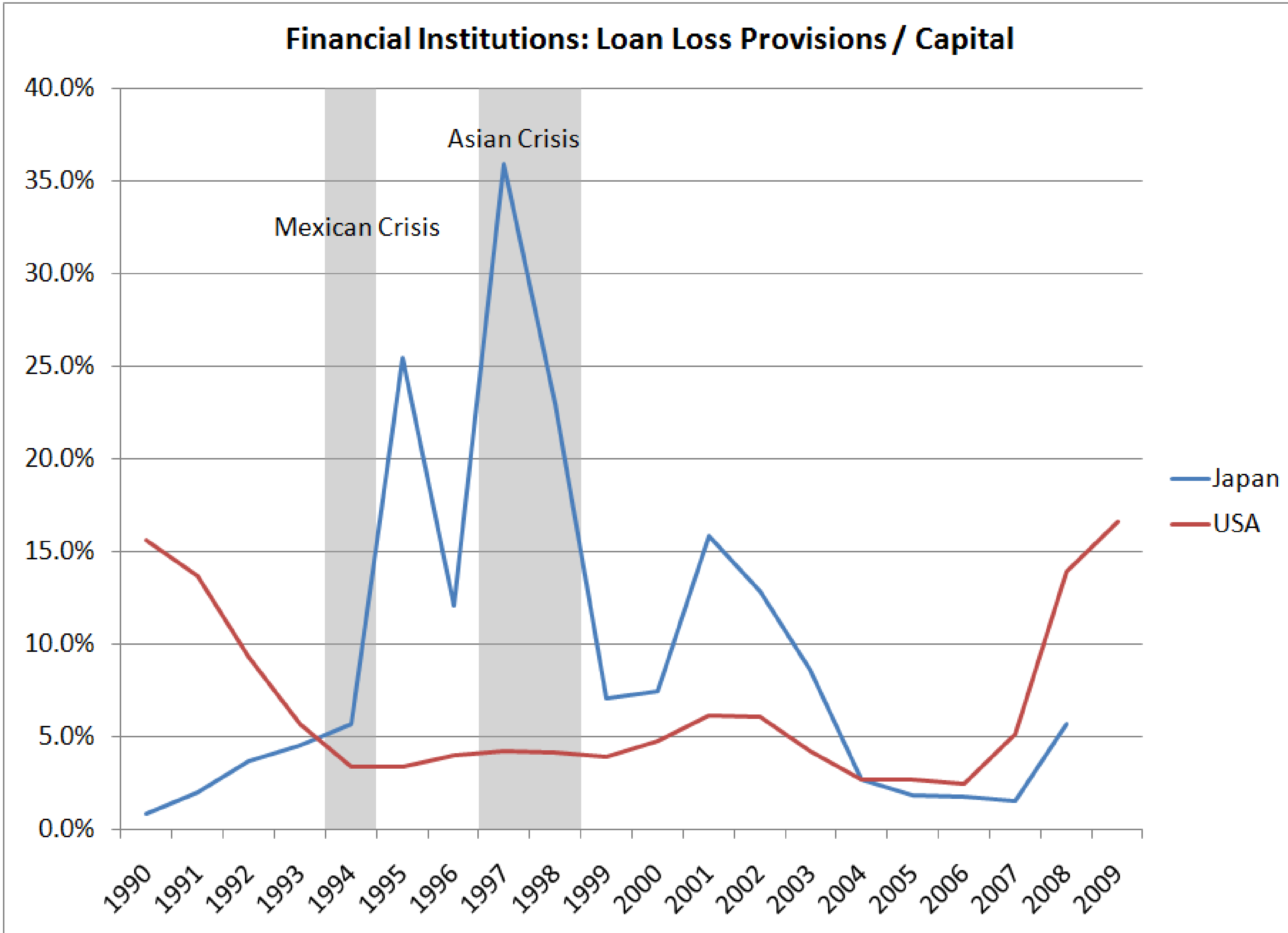
Effect of Crises on Banking

- Japanese Banks, Asian Financial Crisis (1997-1998)
  - 0.75%-1.3% negative shock to GDP Growth
  - All major Japanese Banks downgraded by Moody's citing East Asian Crisis exposure
- US Banks, Mexico (1994-1995)
  - Very little economic impact, no credit downgrades citing crisis

Exposure to Mexico, Thailand






Financial Institutions: Loan Loss Provisions / Capital
40.0%
35.0%
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
Asian Crisis
Mexican Crisis
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
Japan
USA

Reserves Before and After Crises
East Asia vs. Mexico

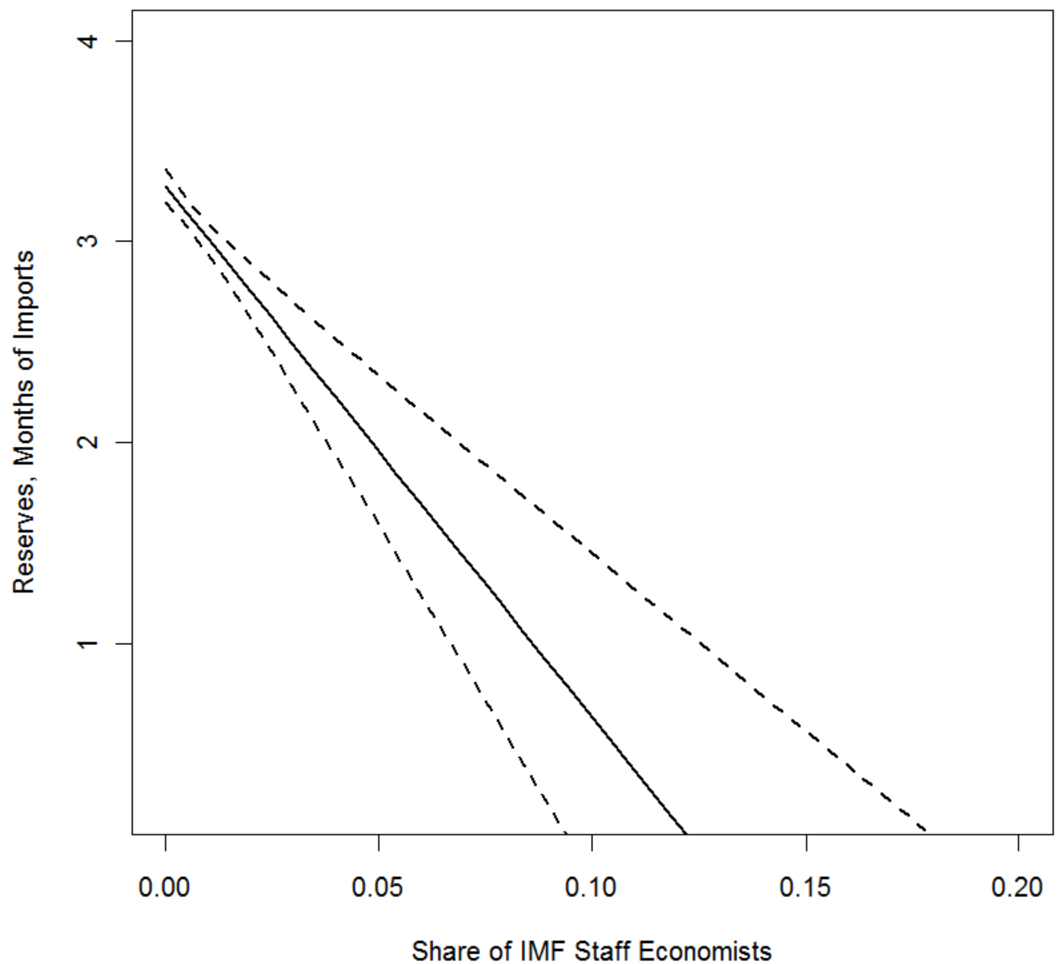
	1987-1996	1998-2007	% Increase
China	6.28	11.28	80%
South Korea	2.22	7.02	216%
ASEAN Average	2.97	4.21	42%
	1984-1993	**1995-2004**	
Mexico	2.65	2.57	-3%

Note: 10 Year Average of Reserves in Month of Imports

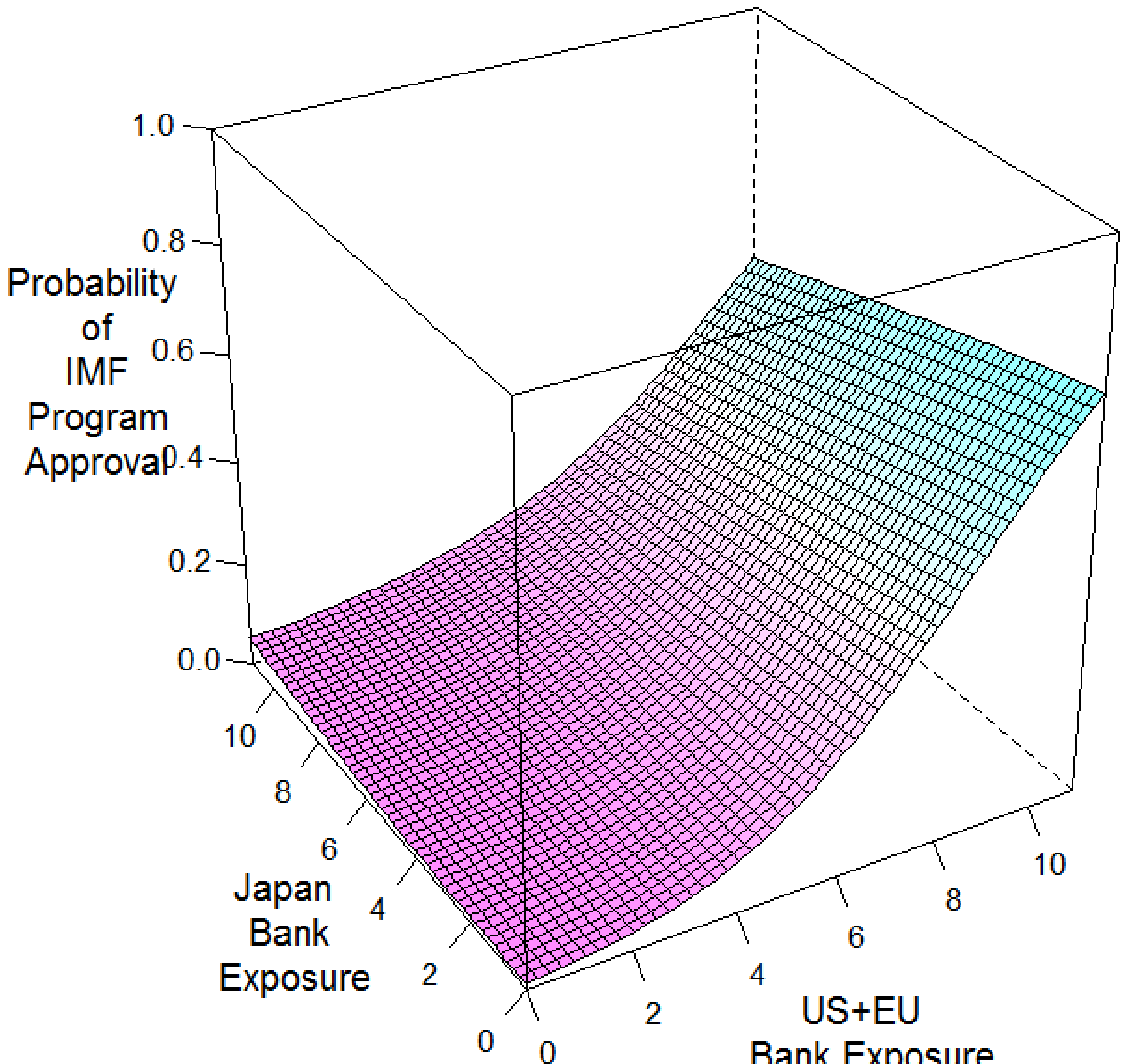
Data

- Test for indications of moral hazard according to proxies for influence over IMF decision-making
- Dependent Variables:
  - IMF Program Approval (Probit)
  - Reserves, Month of Imports (Tobit)
  - Currency Crisis (Probit)
- 5 year periods; 1975-2010; ~Barro and Lee (2000)
- Independent Variables:
  - Bank Exposure by source; Measure of Broader Economic Ties; UN Voting; Share of Nationals among IMF Economists; Quota Share
- Generic Controls Variables:
  - per capita GDP and growth rate, GDP Level, OECD dummy, year dummies, trade openness, inflation

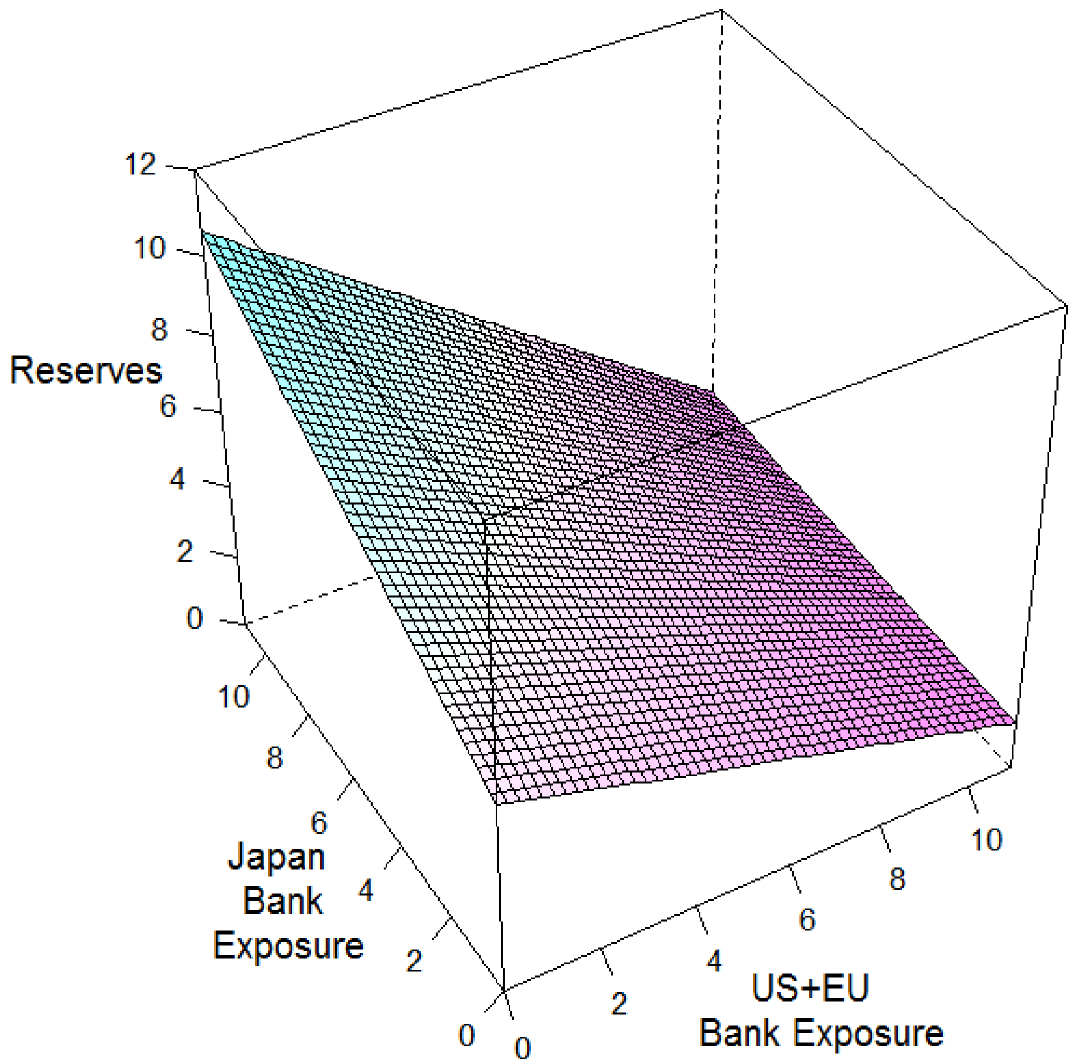
Predicted Values: Reserves



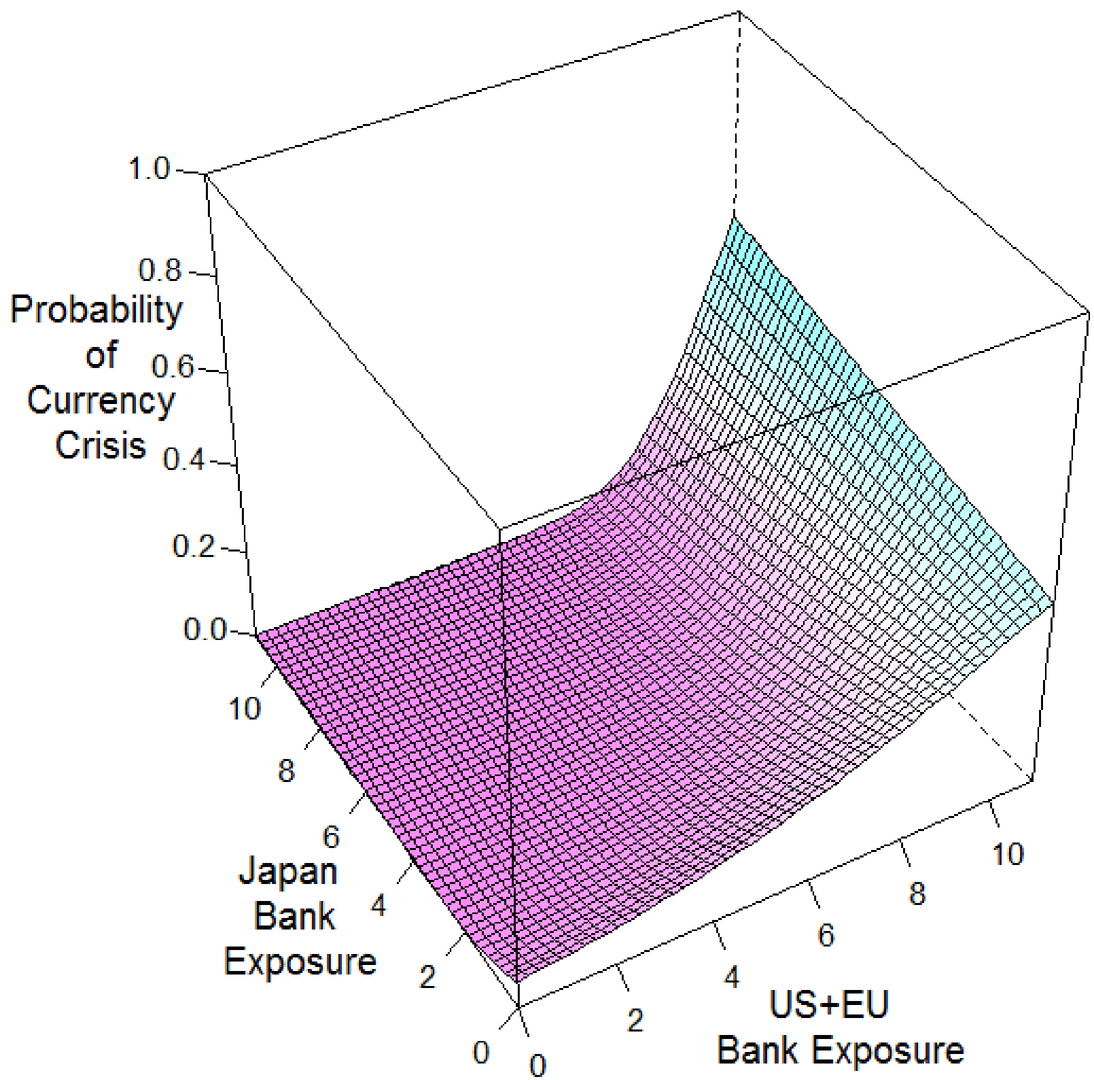
Predicted Probability: IMF Program Approval



Predicted Values: Reserves



Predicted Probability: Currency Crisis



Results

- Countries with strong economic ties to US, EU are associated with indicators of moral hazard: more IMF reliance, less reserves, more frequent crises
- Countries with strong economic ties with Japan are associated with less reliance on IMF, self-insurance though reserve accumulation, and less frequent crises
- “Too Big to Fail” if large exposure to US, Europe
- “Punish to Prevent Moral Hazard” if large exposure to Japan

Conclusions

- Unbalanced influence over IMF lending has important real economic effects
- US and European financial institutions appear to enjoy asymmetric protection in international lending activities
- Lack of influence over IMF leads countries towards excessive reserve accumulation
- Potential negative consequences:
  - Greenspan's Conundrum: excessive demand for US Treasuries
  - Perverse capital flows from developing to developed countries
  - Global imbalances: exchange rate policy & export orientation to build up reserves

Thank You.