

CRISES AND RECOVERIES: MULTINATIONAL FAILURES AND NATIONAL SUCCESSES

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The overused phrase “economic crisis” became surprisingly familiar over the past decade, being more often used than the word “panic” a century ago. The more the International Monetary Fund attempted to predict and repair economic crises, the more unpredictable and irreparable such crises have seemed to be. Perhaps the cure is not helpful. Perhaps the cure is the more serious disease.

Criticism of IMF lending generally focuses on two issues: (1) the allegedly counterproductive impact of IMF-demanded adjustment programs on the borrowing countries’ economic performance, and (2) the moral hazard effect in which the sheer availability of loans at below-market interest rates encourages more national politicians and their foreign lenders to take imprudent and excessive risk.

This paper will focus on the first point, but I believe it is closely related to the second. If IMF-required policies are perceived of as leaving the country with less income and more debt, then we should expect them to be poorly received by financial markets. In 1997–98, the Korean stock market fell very sharply shortly *after* the IMF program was revealed, Indonesia’s credit rating was downgraded *after* the IMF program was revealed, and Russia devalued and defaulted a few weeks *after* the IMF program was revealed. Lane and Phillips (1992) suggest “weighing the possibility of moral hazard against other implications of the availability of IMF financing in alleviating the effects of crises.” I suggest there is no such trade-off: IMF loans involve moral hazard *and* IMF programs aggravate rather than alleviate economic crises.

My past work on this topic consisted of event studies demonstrating that two conditions commonly attached to IMF loans invariably cause or aggravate inflationary recessions, thus making countries poorer and

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less able to service their debts (Reynolds 1998a, 1998b). The generic idea that IMF policies are harmful is no longer the heresy it was in the early 1980s, when I began to document the IMF's track record (Reynolds 1985). Joseph Stiglitz (2000) and many others (e.g., Henderson 1999, Hanke and Baetjer 1997) have recently condemned IMF advice as harmful. Much of this criticism, however, comes from within the IMF's own Keynesian demand-side framework (Lindsey 1998; Schultz, Simon, and Wriston 1998).

I differ mainly by emphasizing the importance of structural, microeconomic tax policy in both crises and recoveries. The IMF's director of research, Kenneth Rogoff, found Stiglitz's criticism similar to that of "extreme expositors of 1980s Reagan-style supply-side economics" (Rogoff 2002). Intended as a slur, that remark reveals typical IMF misunderstanding of the difference between a demand-side and supply-side approach. As early as 1981, World Bank economist Keith Marsden observed that "South Korea, Singapore, Malaysia, Mauritius, the Ivory Coast and Brazil are among the countries that have pursued supply-side policies for several years" (Marsden 1981: 2). The IMF's usual advice, by contrast, resembles that of U.S. President Hoover, who enacted prohibitive tariffs in 1930 and tripled income tax rates in mid-1932. The usual results are also similar.

I disagree with those IMF critics (including Stiglitz) who complain about fiscal austerity in the Keynesian sense—making no distinction between punitive taxation and protectionist tariffs on the one hand and frugality in government spending on the other. In my view, government purchases compel the private sector to compete for resources, damaging the profitability of private investment (Alesina et al. 2002). Government transfers are a disincentive for both those who receive the benefits and taxpayers who pay. In this respect, my event studies confirm the cross-country studies of Alesina et al. (2002) and Barro (1991) who find reductions in government spending to be expansionary—conducive to economic growth—while higher tax rates are contractionary.

Ireland slashed government spending by more than 7 percent of GDP in 1986–89, but the results were the opposite of those predicted by a demand-side model. They also cut the tax on corporate profits to 15 percent and cut the tax on indexed capital gains to 20 percent. As a recent IMF report puts it, Ireland also "significantly reduced the exceptionally progressive nature of the progressive tax structure and increased work incentives." What happened? Economic growth from 1989 to 2001 averaged 7.2 percent per year. The IMF now views such prosperity as evidence of insufficient tax effort: "Although Ireland's effective tax rate on consumption is already relatively high," says an

August 2002 IMF report, “increased effort in this area could be achieved” (Cerra and Soikkeli 2002). Fortunately, Ireland is in a position to ignore such IMF lectures.

Some IMF programs that concern, say, national labor market regulations may be constructive but they are nonetheless unjustifiable objects of neocolonial meddling (Chari and Kehoe 1998). In any case, my own criticism is limited to only two perennial IMF themes: (1) recommendations of higher tax rates to meet dubious targets for the budget deficit, and (2) recommendations of massive and deliberate currency devaluations to meet dubious targets for the current account deficit. These are ineffective policies aimed at inappropriate objectives, involving destructive methods of eliminating hypothetical “twin deficits” in budgets and current accounts.

This paper reviews and updates some of my past work in order to make a different point—namely, IMF policies cannot possibly take credit for post-crisis recoveries unless IMF policies remained in place. But whenever the key IMF policy tools of increasing tax rates and devaluing currencies have remained in place (e.g., Turkey except during the mid-1980s and Argentina except the early 1990s), recoveries are weak, rare, and brief.

IMF Programs in Crises, National Programs in Recoveries

Most countries naturally recover from crises after a year or so, even though a few keep repeating the same mistakes (and are rewarded with IMF loans for doing so). Mexico recovered after 1995, for example, as did the East Asian countries and Russia after 1998. The fact that crises are normally temporary, just as they were before the IMF existed, makes it much too easy for the IMF to claim that it deserves zero blame for the bad years but ample credit for the good ones.

One reason the usual before-and-after comparisons are not credible is that economic policy often went in one direction while the country was under the IMF’s direction but in a quite different direction after the country was no longer subject to IMF rule. Back in 1985, for example, the IMF said its “orthodox economic policies” in 1980 explained why South Korea became a “successful adjustment” in later years. Yet in 1980 and early 1981, while Korea was under an IMF stand-by agreement, “economic conditions deteriorated sharply and . . . output declined. At the same time, inflation soared” (IMF Survey 1985). South Korea cut its highest income tax rate by 19 percentage points as soon as the IMF program ended, and by another

20 points by the time the IMF decided the strong recovery must have been due to those “orthodox” policies imposed during Korea’s worst postwar year.

Table 1 offers a rough sketch of policy changes the IMF required in a sample of 11 countries (some mix of higher tax rates, tariffs, and currency devaluation) contrasted with policies subsequently followed after the IMF program ended (dramatic reductions in tax rates and/or tariffs). It makes no sense to credit IMF for improved economic growth in countries that completely reversed the IMF policies. Policy conditions attached to IMF loans often caused or aggravated inflationary contractions. The most successful recoveries or “miracles” have occurred only after countries reversed the IMF-mandated policies. As Table 1 shows, the Korean example was typical, with growth resuming and inflation falling only after the IMF left.

In my chapter in the 1998 book *Money and the Nation State*, I offered many more examples showing that IMF requirements to raise taxes and debase the currency had always contributed to crises, while policies that lifted countries out of crises—and even created “economic miracles”—were always home grown (Reynolds 1998a).

The IMF mandated massive currency devaluations and higher taxes and tariffs for South Korea in 1980, Chile and Mauritius in 1982, Jamaica in 1978 and 1983. In every case the result was a deep collapse in production and employment and a huge increase in inflation. A survey of 34 IMF programs by Sebastian Edwards (1989) showed “inflation increased quite significantly.” IMF plans always resulted in extreme cases of “stagflation.” In South Korea, a relatively moderate example, the economy shrunk by 5 percent in 1980 while inflation jumped to 35 percent. The IMF nonetheless expresses pride in the fact that current accounts in such situations usually “improved”—because devastated economies could no longer afford essential imports.

After myopic politicians grabbed all the IMF loot they were likely to get, they or their successors abruptly reversed course. In 1982, only months after the IMF scheme ended, South Korea slashed its highest income tax rate by 19 percentage points, later cutting the IMF’s 1980 tax rate in half. In 1983, Mauritius cut the top tax from 70 to 35 percent, which Paul Romer (1993) later thought was the most plausible explanation of that country’s dramatic turnaround. In 1985 Chile briefly slashed its top tax from 65 to 35 percent (later raising it 10 percentage points), massively reduced tariffs and corporate taxes and eliminated Social Security taxes through privatization. In 1986, Jamaica cut its top tax rate from 58 to 33 percent. To paraphrase Rogoff, these countries were just a tiny sample among many “extreme experi-

TABLE 1
IMF PROGRAMS IN CRISIS AND NATIONAL PROGRAMS IN RECOVERY

Country	IMF Plan	Devalue?	Raise Taxes	Raise Tariffs?	National Plan	Reduction of Top Tax Rate	Lower Corp. Tax?	Lower Tariff?
Argentina	1989	Yes	?		1990-92	45 to 30%		Yes
	1996	?	Yes					
Bolivia	1983	Yes			1986	45 to 30 to 10%	Yes	
Brazil	1998	?	Yes		1990	50 to 25%		
Chile	1985	Yes	Yes	Yes	1986	65 to 35%	Yes	Yes
S. Korea	1980	Yes	Yes		1981-82	89 to 70%		Yes
Jamaica	1978	Yes	No		1986	58 to 33%		
	1983	Yes	Yes					
	1990	Yes	Yes					
Mauritius	1979-82	Yes	Yes	Yes	1983	70 to 35%	Yes	
Mexico	1983	Yes	?		1989-90	60 to 35%		
	1989	Yes	?		2001	40 to 30%		
	1995	Yes	Yes					
Peru	1977-79	Yes	Yes		1992-93	50 to 30%	Yes	
					2001	30 to 20%	Yes	
Russia	1992	Yes	Yes		1993	60 to 30%	No	
	1998	No?	Yes		2001	30 to 13%	Yes	
Turkey	1970	?	?		1985-86	75 to 50%		Yes
	1979	Yes	Yes					

NOTES: Question marks indicate that the exact nature of the IMF program is uncertain, even though the policy (e.g., devaluation) may have been adopted. Blanks indicate no known change.
SOURCE: Reynolds (1998a), updated by author.

tors of supply-side economics.” All the Asian Newly Industrializing Countries fit that description very well.

Deep, Deliberate Devaluations

When complaining about the IMF requiring currency devaluation as a precondition for loans (often *before* the loan can be authorized), I mean a *substantial* devaluation intended to eliminate a current account deficit (and capital account surplus). This works, in a sense, but only because deep recessions shrink imports. If devaluation is not the IMF’s favorite panacea, it is a close second to new and higher taxes. Indeed, it is has not been uncommon for IMF economists to make blatantly proinflation comments—such as “high-inflation countries have often failed to depreciate their currencies sufficiently,” or “if depreciation of the exchange rate is ruled out, a tightening-up of monetary policy may be needed” (Corden 1987: 21–23). Because the IMF’s 1957-vintage Keynesian models rely on the Phillips Curve (which rules out stagflation by definition), the fact that devaluation and tax increases create inflationary recessions always appears to surprise them. IMF inflation projections are “systematically below outcomes (a finding that confirms the conclusions of previous studies)” (Musso and Phillips 2002: 47).

The 1989 issue of the World Bank’s annual *Trends in Developing Countries* described how one IMF devaluation program helped disintegrate Yugoslavia:

The dinar was devalued in real terms by 19.3 percent [and] strict limits were imposed on the growth of nominal wages. . . . The program was supported by the IMF. . . . Output declined about 2 percent, and inflation accelerated to 251 percent by the end of the year [Reynolds 1998b].

Such deliberate devaluations are literally impossible under a truly fixed exchange rate, such as the euro bloc or the Hong Kong and Estonia currency boards, and that means my criticism of using big devaluations to crush imports has nothing to do with whether small countries “should” fix or float. If exchange rates can be deliberately devalued then they were neither floating nor fixed. A so-called “pegged” exchange rate is equivalent to a “dirty float” because both rely on the unpredictable whim of political pressures, including IMF pressures. “The pegged rate system,” says Mundell (1997), “deserves to be discredited as the worst of all systems.” And Milton Friedman (1997: 44) adds that “For most developing countries, I believe the

best policy would be . . . to unify its currency with the currency of a large, relatively stable developed country.”

In February 2001, U.S. Treasury Secretary Paul O’Neill said, “We fully support the government of Turkey’s actions today to float the Turkish lira.” He predicted this would strengthen “growth and disinflation in Turkey” (Moore 2001). Did the Treasury secretary’s advisers imagine the Turkish lira was *fixed* as it sank from 200,000 to 1.6 million per dollar under various IMF programs since late 1997? Did they suppose Turkey or the IMF thought the lira might suddenly float *upward* in 2001, and thus contribute to disinflation? In reality, the Turks have long been star pupils of IMF exchange rate management. If inflation is 40 percent, they devalue by about 50 percent to make sure their exports remain “competitive.” When inflation then rises to 60 percent, they devalue by 70 percent, and so on. Interest rates have to stay above the inflation rate or this game of chasing your tail could slip into hyperinflation. High nominal interest rates ensure that debt service swallows most of the budget, producing a huge nominal deficit that has to be financed. Inflation pushes everyone into high tax brackets, so what is left of the economy moves underground. The deficit cannot be financed by selling bonds because perpetual devaluation comes in endless waves. The central bank ends up printing money to pay the inflated interest on government bonds, which feeds another round of inflation, another devaluation to stay competitive, more inflation, and so on. The only way to escape such a downward spiral is to stop taking IMF money and the policy conditions that go with it.

Political Affluence, Private Pain

IMF apologists might reply that the “painful” policies that preceded the successful non-IMF policies were necessary for short-term adjustment. Even some IMF critics accept the idea that good policies must be painful, in the sense of making the economy smaller and weaker, but I do not. You cannot make borrowers more creditworthy by reducing their ability and incentive to earn more income, and that is just as true of countries as it is of families and firms. Frugality in government spending may indeed be painful for politicians, but it is not painful for taxpayers or for the private economy that depends on taxpayers’ after-tax incomes and incentives.

There is no logical separation between policies required for short-term adjustment and policies required for long-term development, and no fundamental separation between macroeconomic goals and the microeconomic policies needed to reach those goals. Yet the division of labor between the IMF and the World Bank appears

predicated on the assumption that short-term adjustment takes priority over the needs of long-term development, so the World Bank will not lend until an IMF scheme is in place. In one important sense, the World Bank and IMF have contradictory objectives. The World Bank attempts to encourage private capital to flow into poorer countries with potentially attractive investment opportunities. To the extent that this effort is successful, however, the developing country will experience a surplus on capital account and matching deficit on current account. Unfortunately, the most crucial goal of IMF adjustment programs is to eliminate current account deficits, which is exactly equivalent to eliminating capital inflows—including even foreign equity flows to private enterprises (as opposed to multilateral credit flows from Western taxpayers to dubious foreign politicians).

The requirements for a secular improvement in living standards are never inconsistent with what is needed to “adjust” to short-term difficulties. Successful economies need secure property rights, competitive markets for factors and products (which presumes free trade), commercial laws that are sufficiently clear to thwart regulatory whim, and a tax and transfer system with the lowest possible distortions and disincentives (Reynolds 1996). No country gets a perfect score in every respect, but those who do the best can be found in Cato’s index of economic freedom. In a crisis, countries need these key ingredients even more than usual.

Irrelevant Bad Advice for Asia

In 1997–98, there were widespread comments that the Asian crisis proved the previous “miracle” had been nothing but an illusion, with many predicting it would take decades for Indonesia, Malaysia, and others to get back on their feet. There were even predictions that “contagion” would push the big Western economies over the cliff—a prediction that provoked the leading central banks to cut interest rates in the fall of 1998 (*after* industrial production had bottomed in May for Indonesia and in July for Korea). This all proved unduly hysterical. There was an insolvency problem compounded by IMF requirements that all the affected countries adopt austerity plans, and particularly that they cut imports. Since all relied heavily on regional trade, even Hong Kong, requiring each country to slash imports amounted to IMF-mandated “contagion.”

To this day, the IMF insists that “the crisis that struck a number of Asian countries in 1997 came as a surprise to almost all observers” (Berg 2000). But if the IMF had bothered to read the *Financial Times*, they might have noticed headline such as these:

- June 19, 1996: “Malaysia: Signs of Cracks in Mahathir’s Edifice.”
- August 12, 1996: “Tigers Pause for Breath: Adverse Currency Movements and Faltering Demand for Electrical Goods Are Upsetting the Region’s Progress.”
- August 16, 1996: “Philippine Trade Deficit Widens: Pressure Grows to Engineer a Devaluation of the Peso.”

On May 16, 1996, the subtitle of a *Far Eastern Economic Review* feature was “Thailand May Want a Livelier, Riskier Baht.” The baht was pegged to a basket of yen, dollars, and marks, and the IMF was pushing for a “wider band.”

A *USA Today* headline of October 8, 1996, noted that, “Asian Economies Begin Losing Momentum.”

In 1997, the IMF’s infamous first move in Asia was to instruct Thailand to increase the value-added tax. This was followed by demands that Indonesia and Korea also run budget surpluses. There is no school of economics that could make any sense of relying on fiscal austerity to fix a banking or monetary problem. The closest the IMF comes to defending itself for thinking budget surpluses are helpful is to recycle the hoary myth of “twin deficits”—a theory that unambiguously predicted the United States would have a big trade surplus by the year 2000 and Japan an equally large trade deficit.

Ultimately, most IMF fiscal and regulatory fiddling in Asia was largely irrelevant and often ignored. Hutchison (2001: 2) found “the unexpected (forecast error) collapse of output in Malaysia—where an IMF-program was not followed—was similar in magnitude to those countries adopting IMF programs.” Later, with few foreigners even noticing, Malaysia quietly absolved taxpayers from any income tax liability for 1999—a rather bold test of the irrelevancy of the IMF’s fiscal orthodoxy.

Argentina Tried to Raise Taxes Every Year but Russia Adopted a Flat Tax

In recent years, IMF tax increases and devaluations continued to bring great pain. And relief still arrives only if and when those policies were discarded and reversed. Ignoring contrary advice from Sebastian Edwards (1996) and Steve Hanke, Argentina repeatedly capitulated to IMF demands by enacting new or higher taxes in 1998, 1999, 2000, and 2001 (serious business concerns about even that first round of taxes are described in Warn 1998). Predictably, the economy fell into recession and stayed there. In January 2002, Argentina robbed its citizens once again by renegeing on a pledge to convert pesos to dollar

at par and then closing the banks as peso deposits were shrinking in value. It is unclear whether or not the IMF recommended the previous tinkering with the currency board that ultimately doomed it, but former IMF economist Michael Mussa and others had long been claiming devaluation would make Argentina richer rather than poorer, using Brazil as a highly questionable example. Whoever is to blame, the results of rising taxes and devaluing money are once again painfully obvious. Inflation was soon worse than the IMF predicted, as always.

Brazil then fell into its second currency collapse in four years. The first one resulted from disregarding the “real” plan and increasing the monetary base as foreign exchange reserves were dwindling (creating new cash through the open market desk and then buying it back at the foreign exchange desk, as Mexico did in 1994). That foolishness may have been the consequence of IMF advice (O’Grady 1998). Meanwhile, Turkey keeps pleading for IMF “support” (i.e., rolling over a growing snowball of IMF debt) by keeping its tax rates unbearably high and its currency increasingly worthless.

Russia is the newest and most fascinating example of a country that escaped the IMF’s suffocating embrace by completely reversing IMF tax policies. Russia was under the IMF’s thumb from 1992 through 2000. Getting new IMF loans to repay the old IMF loans then required a series of promises to enact new and higher taxes. On July 16, 1998, Russia’s letter of intent promised “the federal government budget will target a primary surplus of at least . . . 3 percent of GDP . . . on the strength of tax policy measures” (including quadrupling the land tax, adding a new 5 percent sales tax and a 3 percent surcharge on tariffs). That pitiful economic suicide did get the IMF and others to saddle Russian taxpayers with another \$21 billion of debt. Within four weeks, however, that deadly combination of debt and IMF tax policies provoked a mass exodus of capital that pushed Russia into devaluation and into default on debt owed to private lenders (not that owed to the IMF). The Russian economy shrank by 5 percent that year.

The new Putin government soon stopped asking the IMF for loans and advice. Effective in 2001, Russia took the astonishing step of adopting a 13 percent flat tax on individual income (down from 30 percent), cutting the corporate profits tax from 35 to 24 percent, and reducing payroll taxes by 4 percentage points. With more incentive to work in the formal economy and less to evade the low tax rates, the IMF reluctantly notes that “tax performance has exceeded expectations across the board” (Mansoor and Spatafora 2002). In 2001 and 2002, Russia enjoyed the world’s largest stock market gains.

Conclusion

Two economists at the Minneapolis Fed examined the fundamental rationale behind the IMF as it has reinvented itself since 1971 and concluded that “the IMF should cease its lending activities altogether” (Chari and Kehoe 1998). That would be a good start.

The moral hazard of IMF lending has increased the risk that crises will occur, and the policy conditions tied to IMF loans invariably make those crises more severe than otherwise. The IMF uses cheap loans to bribe elected officials to raise tax rates or tariffs and deeply devalue their currency. This always results in an inflationary depression. At that point, a new group of politicians often steps in to undo the IMF damage by cutting tax rates and tariffs and stabilizing the currency—policies that are the polar opposite of those favored by the IMF and its academic advisers.

“It may seem odd,” writes Michael Hutchison, “that countries would choose to participate in an IMF stabilization program if it were not in their best interest to do so” (Hutchison 2001: 2). Actually, that seems odd only if one assumes politicians have the incentive and knowledge to act in the interests of “the country.” IMF programs involve an *agency problem*, because those who acquire the power to spend IMF money for political or personal gain are not those who have to repay the loan. The new debt becomes an obligation of future taxpayers, but those responsible for taking on that obligation are current politicians whose personal interests do not necessarily coincide with those of the actual debtors. Continually rolling-over IMF debt can burden a nation’s taxpayers for many years, but the decision to incur such debts is made by politicians whose tenure is often measured in months.

Politicians who have chosen to participate in IMF programs (but not to repay the loans) include the Taliban, Saddam Hussein, and other dictators from Somalia and Zimbabwe. Does it really seem odd that these “policymakers” gladly con the IMF out of loot regardless of the consequences for “their” people? Even in democratic regimes, elected leaders are extremely vulnerable during crises, so they tend to have a very short time horizon in which IMF loans may be viewed primarily as a means of buying time and votes. In short, inviting countries to try borrowing their way out of debt involves agency problems as well as moral hazards.

Countries faced with too much debt and too little income do not need more debt and less income. Yet that is precisely what happens when inherently myopic politicians succumb to the short-term politi-

cal temptation to accept cheap credit in exchange for capitulating to stagflationary IMF policies.

Countries faced with too much debt and too little income need workouts, not bailouts. They need to adopt policies that encourage their companies and workers to increase production and trade not policies intended to stifle production and trade.

If the IMF has any legitimate role to play in preventing crises or repairing troubled economies, it has yet to be demonstrated in practice.

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