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Corruption and Globalization

At least since the Asian financial crisis, the International Monetary Fund (IMF) has, from time to time, included transparency and anti-corruption measures as part of the conditions for countries to borrow its funds. Because of this, it has been criticized as having overstepped its mandate, or even having made crises worse in countries the IMF is supposed to help.

This brief will argue that anti-corruption is central to the IMF's mission of promoting economic and financial stability in its member countries, and central to its mandate of minimizing disequilibrium in the international financial system. In fact, as the world economy becomes increasingly globalized, the IMF's anti-corruption efforts are becoming more important.

The very first of the Articles of Agreement of the IMF states that the purposes of the Fund are, among other things, to promote and maintain "high levels of employment and real income." In addition, the IMF is set up "to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members." From this language, critics of the IMF conclude that it should "limit the scope of its conditionality to monetary, fiscal, exchange rate, and financial-sector policies," according to a 1999 Council on Foreign Relations Independent Task Force report, and should stay away from corruption and transparency issues. Isn't that what is required by its mandate?

The short answer is no. The world economy is becoming increasingly integrated. While globalization brings benefits to developing countries and economies in transition, embracing globalization can also bring new risks to developing countries. For example, the sudden reversal of capital flows, such as a recall of loans by international banks or a massive sale of emerging market stocks by international mutual funds, can spark or at least contribute to currency crises such as those in Asia and Latin America.

What does corruption have to do with the IMF's core mission? Very few people would disagree that the IMF needs to take measures to prevent outright theft of the funds it lends to countries. But it goes beyond that. First, corruption may hinder a country's ability to absorb the benefits of globalization—which the IMF was set up to promote—by reducing foreign direct investment, for example. Second, while the IMF is put in charge of minimizing the risks associated with globalization and the likelihood of currency crises, corruption may make a country more vulnerable to the risks of a currency crisis. Therefore, lending support to anti-corruption efforts in the developing countries is very much consistent with the central mission of the IMF.

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Is Fighting Corruption

Which Corruption?

It is important to begin with a definition. While there may be many types of corruption, I focus here on official corruption—the abuse of public office in exchange for private benefits. Critics might say that this type of corruption has a long history and is widespread around the world. It clearly is not easy to deal with. Moreover, what is called "abuse of power" or "corruption" in one cultural context may not be so labeled in another. However, just because something has a long history, is widespread, and is difficult to control, does not warrant its neglect.

The exact boundary of what is considered "corruption" may depend on culture. A survey in Thailand in the early 1990s revealed that the Thai people are willing to regard a wide range of behavior by government officials as "permissible" that would have been considered "corrupt" in the United States or Western Europe. Still, there are abuses of power that are considered "corruption" everywhere in the world. It is these extreme forms of abuse that generate the highest risk of macroeconomic instability in these countries and in the international financial system. The same Thai survey revealed that the Thai people, despite their higher tolerance for misbehavior by government officials, still considered official corruption to be a major issue in their country. An overwhelming majority of them wished something could be done to substantially reduce it. This is not just a Thai phenomenon. From Russia to Indonesia, and from China to Venezuela, corruption is being denounced as a threat to economic development.

Corruption Reduces the Benefits of Globalization

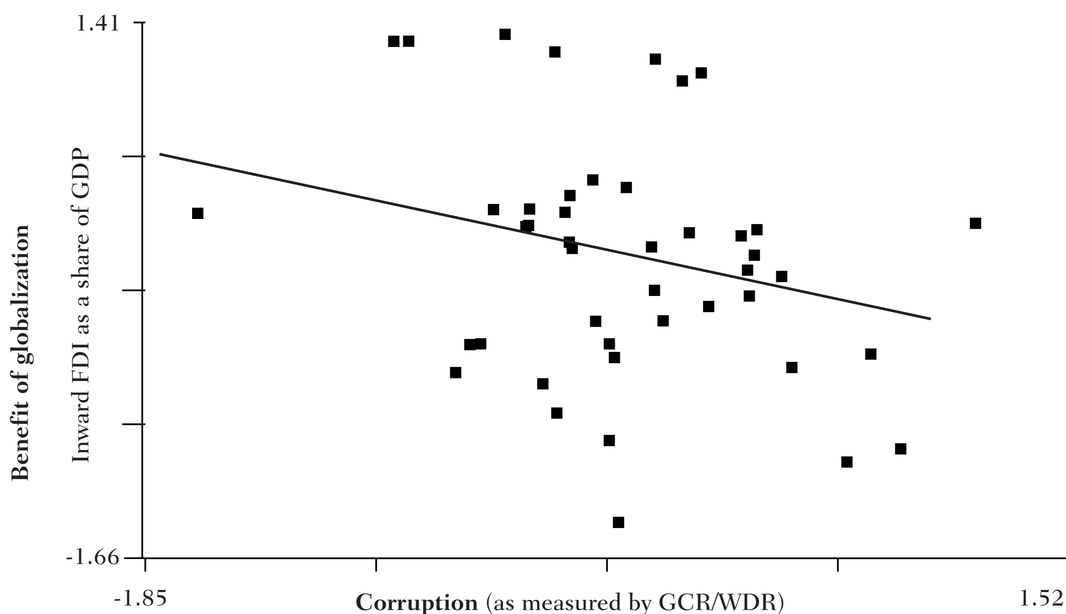
The IMF, the World Bank, and the regional development banks are charged with promoting economic growth in the member countries and channeling the benefits of globalization to the developing countries. Research in the mid-1990s showed that corruption is a hindrance to economic growth. More recent research showed that more corrupt countries receive fewer benefits of globalization.

One major source of the benefits is international direct investment, which has been expanding rapidly. In 1999, sales of foreign affiliates of multinational firms totaled $14 trillion, nearly twice the value of global exports of goods and services. A small number of countries in the industrial world account for the bulk—about two-thirds—of this investment. Yet international direct investment is especially important for developing countries, for which it is not only a source of scarce capital, but also an important conduit for the transfer of technological and managerial know-how. Economic research has confirmed the positive and quantitatively important role that foreign direct investment plays in promoting the economic development of the recipient countries.

the IMF's Business?

Corruption, however, is a major impediment to the progress of these countries. For international investors, having to pay bribes and deal with official extortion is equivalent to facing an extra tax. Some foreign firms may have obtained business because of the bribes they paid. But for every dollar of business that these firms obtain, the country loses multiple dollars of potential foreign investment. My research estimates that an increase in the host country corruption from a low level such as that in Singapore to a higher level, such as that in Mexico, has the same negative effect on inward foreign direct investment (FDI) as raising the corporate tax rate by fifty percentage points. This negative impact is akin to a tax on firms in that it discourages investment. But, unlike a tax, corruption generates no tax revenue for the government. If anything, the same corruption typically erodes the domestic tax base, since many developing countries are eager to attract foreign direct investment by offering generous tax benefits to foreign firms. My research suggests that reducing corruption could in fact be more effective in achieving this objective without sacrificing government revenues.

Figure 1: Corruption Reduces the Benefits of Globalization



Note: partial correlation based on a regression of log (FDI/GDP) on corruption, tax rate, FDI incentives, FDI restrictions, Log (GDP per capita), and exchange rate volatility.

Source: Author's calculation.

While China may appear to be a counter-example, in reality, corruption hurts China just as much as it does other countries. China is a large and fast-growing economy with a huge reservoir of cheap labor, all of which naturally attracts a large amount of foreign investment. But in fact, more focused econometric work demonstrates that FDI in China is less than what might be expected, given the country's size and growth rate. My research indicates that if China can manage to substantially reduce corruption and red tape, FDI from the world's major source countries can be doubled.

Corruption is a Source of International Macroeconomic Instability

Globalization also brings new risks to developing countries. In particular, international capital flows can be volatile, and subject to frequent reversals. When a dramatic reversal occurs, currency crises and deep recession can occur in some of these countries.

It is important to distinguish among the different types of capital flows: foreign direct investment, international bank loans, portfolio investment, and official debt to other governments or inter-governmental institutions. These categories are not equivalent in terms of their associated risks for the recipient countries. For example, bank lending or portfolio investment may be more sentiment-driven, and thus less stable, than direct investment. In fact, between 1980 and 1996, foreign bank lending to developing countries was about twice as volatile as foreign direct investment (4.4 percent versus 2.2 percent a year), as measured by the standard deviation of the year-to-year changes of their ratio to recipient countries' Gross Domestic Product (GDP). Hence, a small (unfavorable) change in the recipient countries' fundamentals may cause a larger swing in the bank lending flows (e.g., from massive inflows to massive outflows) than direct investment. This shift in flows can strain the recipient country's currency or financial system sufficiently to cause or exacerbate its collapse.

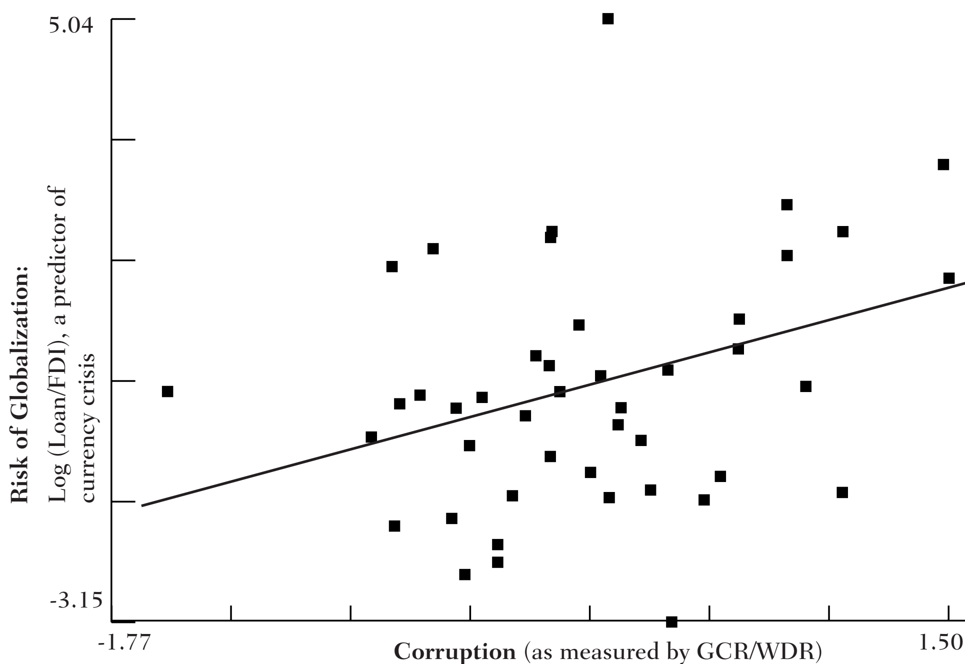
Corruption may hinder a country's ability to absorb the benefits of globalization, which the IMF was set up to promote.

While different types of capital inflow imply a different risk level for the recipient country, the level of corruption has an important impact on the composition of capital inflows, tilting them away from the more stable FDI and towards less stable bank borrowing. There are two reasons why this is the case: First, since international direct investors are more likely to have repeated interactions with local officials (for permits, taxes, health inspections, etc.) than international banks, one would expect local corruption to be more detrimental to FDI than to other forms of capital flows. Along the same lines, direct investment involves greater sunk costs than bank loans or portfolio investment. Once an investment is made, corrupt local officials, knowing that it cannot easily be withdrawn, may threaten to raise obstacles to that investment's success unless they are bribed. Hence, direct investors can find themselves in a weaker bargaining position than international banks. This subsequent disadvantage of FDI would tend to make international direct investors more cautious before entering a corrupt host country than international banks.

A second reason why local corruption might deter international direct investment more than it does international bank credit arises from the fact that, under the current arrangement, international creditors are more likely than international direct investors to be bailed out in times of crisis. For example, during the 1994-95 currency crisis in Mexico and other Latin American countries (the "tequila crisis") and the more recent Asian currency crises, the International Monetary Fund, the World Bank, and the Group of Seven countries mobilized a large amount of funds for the affected countries, to prevent or minimize potentially massive defaults on bank loans. So an international bailout of bank loans in the event of a severe crisis has by now been embedded in market expectations

(although the IMF's refusal to rescue the creditors in Ecuador in 1999 has preserved some semblance of market discipline). In addition, many governments in developing countries implicitly or explicitly guarantee loans to the country's private sector. There have been no comparable examples of international assistance packages for the recovery of nationalized or extorted assets of foreign direct investors, except for an insignificant amount of insurance from the World Bank Group's Multilateral Investment Guarantee Agency, which is often expensive to acquire. This difference makes banks more willing than direct investors to do business with corrupt countries, further distorting the composition of capital flows.

Figure 2: Corruption Increases the Likelihood of a Currency Crisis



Note: partial correlation based on a regression of log (Loan/FDI) on corruption, tax rate, log (GDP), Log (GDP per capita), and exchange rate volatility.

Source: Author's calculation.

Consider some concrete examples to illustrate the point. New Zealand and Singapore have both a relatively low level of corruption and also a relatively low ratio of loans to foreign direct investment. On the other hand, Uruguay and Thailand have both a relatively high level of corruption and also a relatively high loan to FDI ratio. These examples are consistent with the notion that local corruption is associated with a higher foreign borrowing-to-FDI ratio.

More formal statistical analyses confirm this hypothesis on a more systematic basis: More corrupt countries tend to rely on the types of capital inflows (e.g., foreign bank borrowing) that are more volatile than FDI and are more likely to be reversed in the event of unfavorable news about the country in question or even unfavorable news about another developing country.

Moreover, the research on currency crises in developing countries has identified a higher foreign borrowing-to-FDI ratio as one of the (few) indications of a currency or financial crisis. Therefore, severe corruption in a country makes a financial crisis more likely by distorting the structure of its capital inflows away from the more stable FDI and towards the more volatile bank borrowing. Of course, corruption also encourages misallocation of

resources to less efficient users and accumulation of bad loans in the domestic banking sector, which can become another source of a financial crisis. In other words, while corruption may not predict the exact timing of a currency crisis, it does significantly raise the likelihood of a future crisis.

Anti-corruption reform, therefore, is not just another good thing in life, but one that the IMF can choose to ignore. Controlling corruption should be as much of a priority as controlling inflation and fiscal deficits, as it directly affects the macroeconomic stability in the countries even if its effect is not immediately apparent. Since the IMF is in charge of managing international macroeconomic stability, advising or cajoling its member countries to control corruption is central to its core business.

But is anti-corruption reform, in the words of its critics, consistent with the IMF's "core competence"? I believe it is. The broad principles of corruption control—greater transparency and greater accountability—are clear, and the IMF can insist on them even without the knowledge of, say, a particular piece of legal reform. Moreover, "core competence" is not set in stone. The IMF is currently in the process of creating a new department that deals with capital markets for the express purpose of enhancing its competence in an area that it views as unsatisfactory. If additional expertise is needed on anti-corruption measures that are consistent with the IMF's central mission, it can set out to acquire it.

Anti-Corruption Reform: Where to Start?

Fighting corruption is not easy. Anti-corruption campaigns are more often limited to rhetoric, and are only rarely sustained. Moreover, political leaders in some countries are either unable or unwilling to pursue bold reforms because of the political risks. Many prime ministers and finance ministers lose their jobs over less controversial issues, such as reforming price subsidies.

Comprehensive reforms can also be expensive, and many cash-strapped national coffers in developing countries cannot even afford to pay civil servants a decent salary. Political leaders may also be concerned that applying models that work in other countries may not fit their local tradition and social norms. However, there are steps countries can take on their own—without prodding from the IMF—to address the problem.

Special Governance Zones

Countries with leaders willing to do something about corruption should consider starting a "special governance zone," or SGZ—a city or a region within a country in which bold and comprehensive reforms can be implemented. Like a free-trade zone, which is common among developing countries, an SGZ minimizes the political risk for the leaders since the experiment is initially geographically contained and reversible. It also reduces the cost, since even a poor country can afford to pay decent salaries to civil servants in one area. Furthermore, because it is experimental, international practices can be tested, refined, and "domesticated" before they are applied to the rest of the country.

The special governance zones can pay for themselves. As levels of corruption come down, economic growth should pick up, while the tax base expands and tax revenues surge. A special governance zone is not just good economics, it is also good politics. Popular support should increase not only because of the greater government efficiency but also because of a corresponding decline in bureaucratic corruption.

This is not a utopian idea. Three years ago, in the small city of Campo Elias, Venezuela, a country with widespread corruption and widespread public cynicism toward government-sponsored anti-corruption programs, a dynamic mayor with assistance from the World Bank initiated an anti-corruption campaign. Even without much support from the central government in Caracas, the mayor built a reformist coalition of activists, citizens, journalists, business managers, and civil servants that pushed for more transparency and accountability in government operations. The city has since turned around, with better public services and increased citizen satisfaction, attracting admiration from the rest of the country.

Even in countries as corrupt as Russia, one can still find bright spots. Obninsk, a small city not far from Moscow, launched anti-corruption reforms without much help from the federal government, emphasizing the same sort of transparency and accountability as Campo Elias. While the experiments in Russia and Venezuela are too new to allow for detailed data, the early results are promising enough to make the idea an attractive one for other countries.

Transferring the lessons of special governance zones to a nationwide reform effort poses new challenges. Nonetheless, a successful special governance zone substantially raises the likelihood of success. First, a working special governance zone can serve as a model for the rest of the country. Second and more importantly, because bureaucrats often use tradition or culture as an excuse to stifle anti-corruption reforms, a successful SGZ in a place with identical tradition and culture undermines this excuse and can provide new impetus for reforms in other parts of the country. In addition, as capital and talent start to move into the SGZ from parts of the country still marred by corruption, pressures increase for real change in these local governments. The beneficial spillover can go to the central government level as well. An initial success in a locality provides lessons, removes excuses, and exerts pressure for the center to start increasing transparency and accountability.

What International Institutions Can Do

The IMF, the World Bank, and other international development organizations can play a valuable role in fighting corruption. There is an initial cost in setting up a special governance zone. Currently, the World Bank has funds for municipal reforms and community development programs. If funds are spread across twenty cities in a country, they are unlikely to make enough of a dent in any one place to be effective. International agencies can, however, focus their resources on one or two special governance zones in a particular country. Once reform is under way there, the increased investment and tax revenue will be the "anti-corruption dividend." Part of it can be paid back to the international lending

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agencies and be rolled over to support the next special governance zone. This can be a truly virtuous cycle, and special governance zones can be a win-win strategy.

Corruption significantly raises the likelihood of macroeconomic instability, in addition to reducing economic growth. This is particularly true in a globalizing world economy. The gap is widening between those countries that can manage to control corruption and those that cannot. More benefits of globalization will go to the first group of countries. At the same time, the risks of globalization—manifested in the volatility of international capital flows and the recurrence of currency crises—will pose a greater threat to the second group. Since promoting macroeconomic stability and economic growth is central to the IMF's mission, the Fund can and should help countries that borrow its funds to undertake anti-corruption reforms. Overcoming the obstacles to the reforms is not easy, but special governance zones are a good start.

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