Reforming the IMF: Some Initial Proposals*

by
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The recent events in Argentina raise, once again, serious questions about the current approach to crisis management in emerging markets, the chief characteristic of which seems to be large-scale improvisation and impromptu arrangements with costly social and political repercussions. The IMF has found itself in the middle of each of these debacles, and questions about its effectiveness have been raised every time; indeed some have argued that the organization is no longer needed in an environment of largely floating exchange rates. It is clear, however, that because today's world is one of closely integrated markets and in which linkages are becoming evermore complex, an institution that will have sufficient resources to deal with occasional episodes of financial instability and that will help cushion or prevent the effects of future crises is indispensable. Some ideas follow on the sort of reforms that could make the world's only "financial peacekeeper" a more effective crisis manager.

As presently structured, the IMF falls far short of the role played by central banks in national economies. Like a national central bank, it can create international liquidity through its lending operations and the occasional allocations to its members of Special Drawing Rights (SDRs), its composite currency. Thus, as Richard Cooper has pointed out, the IMF already is, in a limited sense, a small international bank of issue. As seen during much of the past decade, beginning with the Mexican crisis in 1994/5, the Fund can also play the role of "lender of last resort" for an economy experiencing debt-servicing difficulties. But the amount of support it can provide has traditionally been limited by the size of the country's membership quota and there is obviously an upper limit on total available resources; at the end of November 2001 this amounted to some $100 billion, a relatively small sum, equivalent to about 1% of cross-border claims of BIS reporting banks.

In addition to the paucity of resources, which do not allow the Fund to respond to more than a handful of crises in a few medium-sized countries, there are other serious structural flaws in its lender of last resort functions. To begin with, its regulatory functions are extremely rudimentary. Its members are sovereign nations that are bound, in theory, by the Fund's Articles of Agreement, but the institution has no real enforcing authority, other than some limited functions through the "conditionality" it applies to those countries using its resources. In particular, the Fund has no authority to enforce changes in policies when countries are engaged in misguided or unsustainable policy paths but are otherwise not borrowing from the Fund—this was the case with the Asian countries in 1997. What little enforcement authority the IMF does have is sometimes eroded when the country in question has a powerful patron, who may try to persuade the Fund and its managers to exercise leniency or "turn a blind eye" if policies appear to be going awry. Contrast this situation with that of a typical national central bank, which has enormous leverage vis-à-vis the commercial banks under its jurisdiction when making resources available to them, particularly in

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the midst of a crisis. The IMF simply does not have an analogous authority at the international level vis-à-vis the countries that are eligible to use its resources.

There are a number of possible ways to deal with these shortcomings. One proposal is to create an International Financial Stability Fund, to supplement IMF resources. This would be a facility that could be financed by an annual fee on the stock of cross-border investment; a 0.1% tax could generate, according to Edwin Truman, a former Assistant Secretary at the U.S. Treasury, some $25-30 billion per year, which could then be used over time to create a $300 billion facility. This would deal with the relative scarcity of IMF resources and would partially delink its lender of last resort functions from the periodic allocations of national currencies that currently form the basis of IMF liquidity growth. An alternative proposal would give the Fund the authority to create SDRs as needed, as a national central bank can in theory, to meet calls on it by would-be borrowers.

When this idea was first put forward, in the early 1980s, concerns were raised about the possibly inflationary implications of such liquidity injections, but international inflation was a serious problem then in ways that it is clearly not one today and measures could be introduced to safeguard against this. This, of course, would involve giving the Fund considerably more leverage vis-à-vis the policies of those countries willing to have much larger potential access to its resources. Nobody questions the right of central banks to have a major say over the prudential and regulatory environment underlying the activities of the commercial banks under their jurisdiction; it is seen as a legitimate counterpart of its lender of last resort functions. A much richer Fund would, likewise, have to have much stronger leverage and independence.

The above says nothing about the kinds of policies which the IMF advocates and whether these are generally welfare enhancing or not. The recent crisis in Argentina, as well as earlier devastating episodes in Russia and Asia, have generated heated debates as to whether the IMF is part of the problem, part of the solution, or a bit of both. Whatever be the justice of these respective positions, it is clear that giving the Fund potential access to a much larger volume of resources would have to be accompanied by significant internal reforms, both in terms of the content of the policies it advocates, as well as its internal management. Both areas have received scant attention in the past decade, with the focus having largely been on the type of facilities through which resources are made available and the bureaucratic underpinnings of each.

It is becoming increasingly clear, however, that at least some of the instances of unsuccessful intervention by the IMF in recent years (that of Russia springs most readily to mind, though Paul Krugman thinks Argentina qualifies as well) may reflect less lack of resources and more old fashioned policy mistakes, arising from the Fund's own intellectual biases, its particular views as to what makes for good economic policy, and the vagaries of its internal decision-making processes, which suffer from a number of serious flaws. In Russia the IMF disbursed some $22 billion of debt between 1992 and 1998 but, clearly, without eliciting much in the way of policy reforms in return. Indeed, six years of IMF involvement collapsed in August of 1998 and, along the way, with the cognisance of the IMF, the government was allowed to give away its best assets under extremely corrupt privatisation schemes. Simultaneously, the Russian population endured a more pronounced decline in living standards than was warranted by the elimination of some of the distortions of the central plan, greatly undermining public support for market-oriented reforms. During a visit to Moscow last year a senior IMF official characterised the 1995 standby arrangement as “very successful” and “a key achievement” because inflation came down. The consensus in Moscow, however, remains that the 1995 programme was an “unmitigated disaster;” for what virtue could there be in bringing inflation down (temporarily, it came back with a vengeance after the collapse of the ruble in 1998) if this is at the cost of the state building up massive wage and pension arrears, thereby signalling to tax payers that, since the state fails to fulfil its own obligations, others may legitimately follow suit?

So, if the Fund is to be given more of the functions of a lender of last resort to the likes of Argentina, Turkey, and Russia, then it needs a new philosophy, bringing into the centre of its programs (and its conditionality) the kinds of concerns and policies which, so far, it has only tended to espouse in theory. In their public speeches the Fund’s top managers speak of transparency, social protection, good governance, and “high quality growth,” but they have not yet managed to incorporate these laudable aims into IMF program design. Indeed, it is becoming increasingly evident (as the crisis in Argentina has dramatically demonstrated) that only programs perceived as meeting actual needs and as being just and equitable in their objectives can hope to engage the commitment of the people, upon whom successful implementation ultimately depends. By this yardstick, most IMF programs yield distressingly disappointing results. Not surprisingly, the Fund finds itself increasingly at the centre of ineffective programs, blamed for the failure of its policy prescriptions.

Easing the task of evolving new paradigms of intervention, a wealth of illuminating material already exists in the field. A perusal of Amartya Sen’s Development As Freedom provides a compelling list of the ingredients of a successful approach to economic development, soon bearing home upon the reader that fiscal austerity is not the sole remedy available. Indeed, as UK Chancellor of the Exchequer Gordon Brown recently noted, the assumption that “just by liberalising, deregulating, privatising and simply getting prices right, growth and employment would inevitably follow” has “proved inadequate to meet the emerging challenges of globalisation.”

A broadening of the policy content of Fund programs, to meet the challenges of Sen’s much wider vision of successful development, to be credible, would need to be accompanied by a structural reorganization, whereby the Fund’s shareholders assigned it a greater measure of intellectual independence, making it at the same time more accountable for the consequences of its decisions. It would seem desirable to separate the Fund’s surveillance activities from its decisions in respect of lending, so that glaring conflicts of interest might be avoided. Gordon Brown’s call for a “more transparent, more independent and, therefore, more authoritative” Fund is certainly a step in the right direction, as is his call for new approaches to sovereign debt restructuring and the implementation of code standards for fiscal, monetary and other policies, to diminish the likelihood of future crises. In these discussions the focus should overwhelmingly shift to crisis prevention rather than crisis resolution.

But even an updated set of policy prescriptions is unlikely to suffice without corresponding reforms in the internal workings of the organization. As a preliminary measure, the international community might finally break with the convention adhered to ever since the IMF’s creation, which establishes that its managing director must be an EU citizen. (A similar recommendation applies to the World Bank, whose president has traditionally been an U.S. citizen). The organization is too important and its mistakes too socially costly for the nationality of the candidate for Managing Director to be the determining factor in assessing suitability for the job. The unseemly negotiating process that is entered into every few years as efforts are once more set in train to locate the most suitable candidate from a specific country is inherently offensive to the peoples of those countries who have to endure the rigors of IMF austerity; not to mention that it exemplifies that very inefficiency which IMF officials are quick to condemn in dealings with the Fund's member countries. (Doubtless the practice could not be sustained under present-day judicial codes, embodying as it does the particular conceptions of a world recently emerged from the trauma of world war). Another desirable reform along these lines would be to accord the managing director a non-renewable fixed term of service, thereby freeing him from the conflict that may otherwise result between the interests of those who hold his appointment in their hands, and the countries which it is his mission to serve: in this way, he may never feel himself under pressure to forgo his principles by reconciling these divergent stances.

On this question of the controlling interest in the organization, it may be noted that the salaries of the Fund's managing director and of its entire staff (as well as other administrative expenditures) are financed precisely by the interest paid by tax-payers in Argentina, Turkey, Russia and other users of Fund resources. Whereas IMF lending operations have no budgetary implications for members such as the US and the EU; (indeed they earn a return on their SDR reserve assets); a country such as Russia, by contrast, has paid, since August 1998, over $3 billion in interest charges on previous Fund loans. Such a circumstance alone, one would think, might go some way to counter the existing notion that, because the large shareholders "contribute" more to the organization, they are in some manner entitled to oversee its operation as well, particularly since they have already the largest voting shares at the IMF Board.

This raises a second observation: namely, that increasingly there is a tendency for the markets, borrowers and other economic agents to view the Fund as subservient to its main shareholders, a proxy of G7 foreign policy or, worse, as Paul Krugman recently expressed it, "a branch of the US treasury." Such a perception is deeply damaging to the organization's ability to act effectively. It encourages countries to gauge their relationship with the IMF in terms of short-term political advantage rather than of lasting economic gain. In Russia, for instance, in the mid-1990s, the government realised that "the money was coming in any event"; the will for policy reforms died at about the same time. A similar calculation may be underway in Turkey at the moment, as the country amasses a mountain of debt to the IMF at a vertiginous pace, breaking and confounding all previous historical parameters that linked the amount of external funding to the scale of the policy adjustment, and destroying the long-respected Fund principle of equality of treatment across its member countries. (To put things in perspective, consider the following statistic. Were Argentina later this year to return to the Fund with a coherent economic program and ask for levels of access to IMF resources broadly similar to those granted to Turkey, it could qualify for a $50 billion loan, equivalent to about 50% of total net uncommitted usable IMF resources. Nobody thinks that Argentina would ever be given a credit of this magnitude, no matter how ambitious and comprehensive its program. However, by end-2002 Turkey could well account for 35-40% of the total debt of the entire IMF membership, an impressive achievement for a relatively small country.)

The present organizational structure has implications too for the Fund staff, who cannot under the present regime be held accountable for policy miscalculations.

Deprived of full freedom to make intellectually independent assessments, inasmuch as the controlling influence rests with the large shareholders, who, as indicated, may be answerable to various "strategic," meaning political, interests of their own, they are constrained to represent themselves merely as executors – not a role calculated to enhance their standing with their counterparts in the Fund's member countries. And to the extent that they be viewed by the countries concerned as mere functionaries, their ability to act more generally as advocates for change will be impaired.

Emerging from the 1944 Bretton Woods conference at which both the IMF and the World Bank were created, John Maynard Keynes expressed the view: "As an experiment in international cooperation, the conference has been an outstanding success." The world has changed beyond recognition in the meantime, and, with the emergence of one global economy, the case for an institution that will help further the cause of international cooperation and be identified with the promotion of economic policies supportive of improved efficiency and equity has only become stronger. Conditions seem now propitious for the convocation of a global conference of heads of state to consult upon the policy and institutional requirements for a more stable world financial system in the era of globalization. How to promote better ownership of programs, and how to engage more effectively in the decision-making process the countries most affected by such crises are clearly two central questions that would need to be addressed. Indeed, the time may be fast approaching for a new Bretton Woods conference aimed at turning our two premier development organizations into more flexible and effective instruments for the promotion of global welfare.