

Reforming the IMF: Back to the Drawing Board

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The International Monetary Fund (IMF), in order to operate as a useful and truly multilateral institution for all countries, rather than as an instrument for some, needs genuine reform and redirection with regard to its mandate, operational modalities, and governance structure.

**The best reformers the world
has ever seen are those who
commence on themselves.**

George Bernard Shaw

I. Why Reform?

There have been widespread misgivings about international economic cooperation in recent years even as the need for global collective action has grown because of recurrent financial crises in emerging markets, the increased gap between the rich and the poor, and the persistence of extreme poverty in many countries in the developing world. Perhaps more than any other international organization the IMF has been the focus of these misgivings. Several observers including former Treasury Secretaries of the United States, a Nobel Prize economist and many NGOs have called for its abolition on grounds that it is no longer needed, or that its interventions in emerging market crises are not only wasteful but also harmful for international economic stabil-

ity, or that its adjustment programs in poor countries aggravate rather than alleviate poverty. Others want the IMF to be merged into the World Bank because they see them as doing pretty much the same thing with the same clientele. Many who still wish to keep the Fund as an independent institution with a distinct mission call for reform of both what it has been doing and how it has been doing it. All these groups include individuals across a wide spectrum of political opinion, ranging from conservative free marketers to anti-globalizers.

Because of inherent instability of international financial markets and the tendency of governments to pursue beggar-thy-neighbour exchange rate and macroeconomic policies, there is a strong rationale for an institution to safeguard international monetary and financial stability. Such concerns in fact underlined the creation of the IMF towards the end of the Second World War. But the Fund is no longer performing the tasks it was originally created for. It started out as an institution to promote global stability through multilateral discipline over exchange rate policies, control over capital flows and provision of short-term liquid-

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ity for trade financing. It has ended up focusing, on the one hand, on development issues, providing long-term financing on concessional terms and, on the other hand, on the management of capital-account crises associated with instability of capital flows, allocating a large proportion of its resources for financing capital outflows. Originally all members of the Fund had equal *de jure* and *de facto* obligations for maintaining stable exchange rates and orderly macroeconomic conditions. With the breakdown of the Bretton Woods system in the early 1970s, the establishment of universal convertibility of key currencies, and the emergence of international financial markets as a main source of liquidity for advanced economies, the Fund's policy oversight has been confined to its poorer members who need to draw on its resources.

The Fund needs reforming in order to retain or, rather, restore its relevance and credibility. The Western European countries, including the smallest and the least prosperous, walked out of the Fund almost three decades ago with the establishment of intra-European monetary cooperation. Eastern Europe has now also come under the EU discipline. The most important developing countries in Asia also appear to have left the Fund not only because the likelihood of them being hit by another crisis is low, but also because they are unlikely to go back even under austere external financial conditions given their treatment during the 1997-1998 crisis. Almost all other emerging markets, except Turkey, have also exited from Fund supervision, leaving only the poorest countries as its only regular clientele — barely a strong rationale for an institution established to secure international economic stability. Besides, this situation poses the question of financial viability of the Fund since it relies on lending to emerging markets to generate some \$800 million per annum to meet its administrative expenses.

Thus, the Fund would need to reinvent itself. There is no sound rationale for it to be involved in development matters, including long-term lending. This is also true for several areas of policy closely connected to development, most notably trade policy which is a matter for multilateral negotiations elsewhere in the global system. On the other hand, while the management and resolution of financial crises in emerging markets constitute a key area of interest to the Fund in the context of its broad objective of securing international monetary and financial stability, there is

little rationale for financial bailout operations that have so far been the main instrument of the Fund's interventions in such crises. The original considerations that precluded IMF lending to finance capital outflows continue to be equally valid today.

By contrast the Fund should pay much greater attention to two areas in which its existence carries a stronger rationale; namely, short-term, counter-cyclical current account financing, and effective surveillance over national macroeconomic and financial policies, particularly of countries which have a disproportionately large impact on international monetary and financial stability. In other words, a genuine reform of the Fund would require as much a redirection of its activities as improvements in its policies and operational modalities. However, none of these would be possible without addressing shortcomings in its governance structure.

II. Reversing the Mission Creep into Development

Recent debate on the role of the IMF in development has focussed on three issues. First, there has been widespread criticism of rapid deregulation and liberalization promoted by the Fund in developing countries because of their adverse impact on economic growth and poverty. Second, the conditions attached to Fund lending have been under constant fire on grounds that, *inter alia*, they interfere with the proper jurisdiction of a sovereign government and leave little room for manoeuvre to national policy makers. Finally, there is a broad consensus that financing provided in support of such programs, including in debt relief, is highly inadequate.

There has been less emphasis on whether the Fund should really be involved in development finance and policy, particularly given that there are other multilateral institutions exclusively focussing on these issues, including multilateral development banks and various UN technical assistance agencies. There are indeed no compelling reasons why the IMF should deal with structural problems in developing countries. The Fund moved towards developing countries in large part because it was no longer needed by industrial countries as a source of liquidity and it lost leverage over exchange rate and macroeconomic policies of these countries. Sticking to its original mandate for facilitating payments adjust-

ment through provision of liquidity to meet temporary current account deficits would not have generated much business for the Fund in developing countries given that their balance of payments difficulties were structural and durable, rather than cyclical and temporary. This, together with the expansion of IMF membership in Africa, was the main reason why the Fund introduced long-term facilities and concessional lending. In doing so, however, it has gone right into the domain of development since overcoming structural payments deficits calls for reducing both savings and foreign exchange gaps, including chronic public sector deficits, which, in turn, depends on structural and institutional changes and economic growth, rather than demand management. But these are exactly the kind of issues dealt with by multilateral development banks.

That external disequilibrium in developing countries is structural does not justify the Fund going into long-term balance-of-payments support because this is exactly what the World Bank has been doing since the early 1980s when it shifted its lending from project financing to structural adjustment loans. Furthermore, the Bank is doing this for all developing countries while such long-term support in the Fund is limited to low-income countries. This is an ad hoc arrangement without a sound rationale, since there are many middle-income countries with chronic payments deficits and excessive dependence on foreign capital, notably in Latin America, in need of long-term support to strengthen domestic savings and export capacity. This inconsistency should be addressed not by bringing them under the IMF, but by taking the others out to the Bank.

There is also considerable doubt that the Fund has the necessary competence and experience in complex developmental issues. There are serious risks in entrusting development matters to an organization preoccupied with short-term financial outcomes and susceptible to strong influences from sudden shifts in market sentiments about the economies of its borrowers. What the IMF does or should be doing for promoting stability has consequences for development, but this does not provide a rationale for the Fund to work in these areas. Such interdependencies would call for coordination not duplication.

While it is often argued that the Fund and the Bank should be merged because they are effectively doing the same thing, they should in fact remain separate institutions doing different

things. In fact there are many areas in which their activities do not and should not overlap. Crisis management and resolution, surveillance over macroeconomic and exchange rate policies, and provision of international liquidity are areas where the Fund should have a distinct role and competence. By contrast, the Fund should transfer development-related activities and facilities to the Bank. This would not lead to a significant retrenchment of Fund lending. The legal difficulties that might be involved in transferring the resources currently located in the Fund could be overcome once the principle is accepted.

III. Financial Bailouts Versus Orderly Debt Workouts

There is a consensus that crises in emerging markets will continue to occur and that the IMF should be involved in their management and resolution. However, there is considerable controversy over how the Fund should intervene. Until recently the Fund's intervention in financial crises in emerging markets involved ad hoc financial bailout operations designed to keep countries current on their debt payments to private international creditors and maintain capital account convertibility. Crisis lending was combined with monetary and fiscal tightening in order to restore confidence, but this often failed to prevent sharp drops in the currency and hikes in interest rates, thereby deepening economic contraction.

There have also been suggestions to turn the Fund into an international lender of last resort with a view to helping prevent crises. It is argued that if the IMF stands ready to provide liquidity to countries with sound policies, they would be protected from contagion and financial panic so that a lender of last resort facility would have a preventive role. There are many difficulties in transforming the IMF into a genuine international lender of last resort. But the most serious problem is that rescue packages tend to aggravate market failures and financial instability by creating moral hazard, particularly on the side of creditors. They undermine market discipline and encourage imprudent lending since private creditors are not made to bear the consequences of the risks they take.

There has been growing agreement that orderly debt workout procedures drawing on certain principles of national bankruptcy laws, notably chapters 9 and 11 of the United States law, including temporary debt standstills, provide a viable

alternative to bailout operations. The Fund appeared to be moving in this direction at the end of the 1990s with rising opposition to bailout operations from European and some other governments and the increased frequency of crises in emerging markets. The IMF Board recognized that "in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally", and that since "there could be a risk that this action would trigger capital outflows ... a member would need to consider whether it might be necessary to resort to the introduction of more comprehensive exchange or capital controls." The Fund secretariat prepared a proposal for Sovereign Debt Restructuring Mechanism (SDRM) along these lines. However, the provision for statutory protection to debtors in the form of a stay on litigation has subsequently been dropped and many others have been added in favour of creditors because of opposition from financial markets and the United States government.

Even the watered down version of the SDRM proposal could not elicit adequate political support and has been put on the backburner. The impetus for reform has generally been lost because of widespread complacency associated with the recovery of capital flows to emerging markets, driven by a combination of highly favourable conditions including historically low interest rates, high levels of international liquidity, oil surpluses, strong commodity prices and buoyant international trade. However, as noted by several observers including the Institute of International Finance, the international financial system is becoming more fragile once again and a combination of tightened liquidity, rising interest rates, slowing growth and persistent trade imbalances can reverse the boom in capital flows to emerging markets. Under these conditions if the recent consensus against large-scale bailouts is adhered to, countries that may be facing rapid exit of capital could be forced into unilateral standstills, creating considerable uncertainties and confusion in the international financial system. If not, we will be back to square one.

IV. Restructuring IMF Lending

The Fund should thus no longer be engaged in development finance or bailout operations. It should return to its original mandate. There is still a strong rationale for the Fund to have a role

in providing liquidity because of pro-cyclical behaviour of financial markets and increased volatility of global economic environment.

Such financing should be made available in order to support trade and economic activity in countries facing sharp declines or reversals of private capital flows, or temporary shortfalls in external payments as a result of trade shocks. To ensure that it does not amount to bailouts for private creditors, there should be strict limits to IMF crisis lending. Exceptional current account financing may be needed at times of a sharp contraction in world trade and growth, and the Fund's regular resources may not be adequate for dealing with such cases. This can be handled by a global countercyclical facility based on reversible SDR allocations.

IMF quotas have considerably lagged behind the growth of global output and trade and they need to be adjusted. However, an across-the-board increase in the size of the Fund may not address the problems faced by many developing countries even if quota allocations are reformed to reflect the relative economic size of its members. This problem could be tackled through a differential treatment of poorer countries in the determination of their drawing rights, based on the principles of vulnerability and need.

V. Ineffectiveness and Asymmetry of Fund Surveillance

The architects of the Bretton Woods system recognized the role of surveillance over national policies for international economic stability. But it was only after the collapse of the fixed exchange rate system and the expansion of capital markets that IMF surveillance gained critical importance. The Fund was charged to exercise firm surveillance over members' policies at the same time as members were allowed the right to choose their own exchange rate arrangements. Its objective was originally limited to surveillance over the sustainability of exchange rates and external payments positions, but its scope and coverage have expanded over time into structural policies, the financial sector and a number of other areas such as trade. Various codes and standards established for macroeconomic policy, institutional and market structure, and financial regulation and supervision have become important components of the surveillance process.

However, the Fund's intensive bilateral surveillance of developing countries' policies has not been effective in crisis prevention in large part because it has failed to diagnose and act on the root causes of the problem. Experience shows that preventing unsustainable surges in private capital inflows, excessive currency appreciations and current account deficits holds the key to avoiding financial crises in emerging markets, but none of the standard policy measures recommended by the Fund for this purpose, including countercyclical monetary and fiscal policy and exchange rate flexibility, is a panacea.

Measures of control over short-term capital inflows that go beyond prudential regulations may be necessary to prevent build up of financial fragility. It is true that the Fund has little leverage over policies in emerging market economies enjoying surges in capital inflows. But it has also been ambivalent even towards market-based measures adopted by countries such as Chile for slowing short-term capital inflows. Moreover it refrains from requesting policy changes and effective capital account measures to slowdown speculative capital inflows even in countries under standby agreements. This was certainly the case in the 1990s when it supported exchange-based stabilization programs relying on short-term capital inflows. More recently Turkey has also been going through a similar process under its oversight.

Current arrangements do not give the Fund clear jurisdiction over capital account regimes. The issue now faced is how to include capital account measures to the arsenal of policy tools for effective management of international capital flows. As noted, temporary restrictions over capital outflows should become legitimate tools of policy at times of rapid exit of capital. Guidelines for IMF surveillance should also specify circumstances in which the Fund should actually recommend the imposition or strengthening of capital controls over inflows. It should develop new techniques and mechanisms designed to separate capital account from current account transactions, to distinguish among different types of capital flows from the point of view of their sustainability and economic impact, and to provide policy advice and technical assistance to countries at times when such measures are needed.

The failure of IMF surveillance in preventing international financial crises also reflects the unbalanced nature of the procedures which give too

little recognition to shortcomings in the institutions and policies in major industrial countries with large impact on global economic conditions. Its surveillance of the policies of the most important players in the global system has lost any real meaning. Little attention has been given to the role played by policies and institutions in major developed countries in triggering international financial crises. Standards and codes have been designed primarily to discipline debtor developing countries on the presumption that the cause of crises rests primarily with policy and institutional weaknesses in these countries. No attention has been paid to how instability of capital flows on the supply side could be reduced through regulatory measures targeted at institutional investors or how transparency could be increased for institutions engaged in destabilizing transactions such as the hedge funds.

It has been suggested that separation of surveillance from decisions about program lending could address problems regarding the quality, effectiveness and evenhandedness of surveillance. Surveillance should thus rest with authorities who are independent of their governments and who are not involved in lending decisions. Such a step could help improve the quality of surveillance, but it may not secure evenhandedness between program and non-program countries, since there would be no mechanism to encourage non-program countries to heed the policy advice emerging from surveillance. Such a step needs to be supplemented by reforms of governance.

VI. Making the Fund a Genuinely Multilateral Institution

The debate over governance of the IMF has focussed mainly on issues raised by exercise of power by its major shareholders, particularly the United States. The most frequently debated areas of reform include the procedures for the choice of the Managing Director and the distribution of voting rights. Shortcomings in transparency and accountability are also closely related to democratic deficit within the governance structure of the Fund resulting from the quota regime.

The postwar bargain struck between the United States and Europe for the distribution of the heads of the Bretton Woods institutions between the two shores of the Atlantic has survived widespread public criticism and initiatives taken by developing countries. The latest selection of the Manag-

ing Director was again business as usual despite the apparent consensus reached during the previous round by the Board that the decision for selection would be based on a wide and open discussion involving all members of the Fund.

There is a consensus that the present distribution of voting rights lacks legitimacy not only because it does not meet the minimum standards for equity due to erosion of “basic votes”, but also because it no longer reflects the relative economic importance of the members of the Fund. The proposals for reform for reducing the democratic deficit fall into two categories. First, changes could be made to special majority requirements in order to remove the veto power of the Fund’s major shareholders over key decisions. Second, voting rights could be reallocated so as to increase the voice of developing countries.

A reform along these lines would constitute an important step in improving the Fund’s governance. It would rectify anomalies such as Canada holding the same number of votes as China, the Netherlands holding more votes than India or Brazil, or Turkey sitting behind Belgium and Austria. Nevertheless, it is unlikely to make a significant impact on the political leverage of its major shareholders or reduce the imbalance between its creditors and debtors. The problems of governance and lack of uniformity of treatment across members cannot be resolved as long as Fund resources depend on the discretion of a small number of its shareholders.

In trade, bilateralism is often seen as a threat to multilateralism. In finance, they are seen as complementary. The Fund’s interventions in emerging market crises were combined with bilateral contributions from industrial countries; official debt reduction initiatives combine bilateral and multilateral debt in the initiative for Highly Indebted Poor Countries; and bilateral lenders often insist that any talks in the Paris club should be preceded by a formal IMF program. Such arrangements subvert the governance of the Fund further and enhance the scope to make it

an instrument for major industrial countries to pursue their national interests.

A reform that would translate the Fund into a truly multilateral institution with equal rights and obligations of all its members, de facto as well as de jure, would call for an international agreement on sources of finance that do not depend on a handful of countries as well as a clear separation of multilateral financial arrangements from bilateral creditor-debtor relations. An appropriate source of funding is the SDR. The Fund should be allowed to issue SDR to itself up to a certain limit and the SDR should be promoted as a universal means of payment. The case for creating SDRs to provide funding for the IMF for current account financing is much stronger than the case for using them to back up financial bailout operations advocated by some observers. Such a step, if supplemented by the kind of reforms regarding its mandate, operational modalities and governance structure noted above, would give the Fund a chance to operate as a useful institution for all countries, rather than as an instrument for some.

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