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The International Monetary Fund: Reform and role in crisis prevention

by Alex Cobham

DEBATING THE IMF

There is currently much discussion of of the ways in which the International Monetary Fund could play a more positive role in the prevention of financial crises, and the extent to which a new delineation of responsibilities between the Fund and the World Bank might contribute. This Analysis sets out some of the context for these discussions, and suggests a number of choices face the Fund's stakeholders.

The first section explains the four main reasons for current calls for IMF reform – concerning the allocation of voting shares, the failure effectively to tackle important global issues, a perceived lack of independence and legitimacy and the collapse in its income. The second section considers a range of actual and possible

MAIN POINTS
This Analysis was prepared as an Issues Note for the International Policy Workshop: How can Financial Crises be Prevented? held at the German Federal Ministry for Economic Cooperation and Development, October 2006. The IMF is facing renewed calls for reform, and its role in crisis prevention is the subject of debate.

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roles for the Fund, including in financial liberalisation and crisis prevention, and the implied reforms that would be necessary to make the institution effective. A final section considers where we stand, and what decisions are required.

CALLS FOR IMF REFORM

Not for the first time, demands for IMF reform are at the top of the international economic agenda. With changing economic and political conditions since its inception, its articles have been significantly amended three times – in 1969 (effective 1969), 1976 (1978) and 1990 (1992).

Four different but complementary impulses have contributed to the current demands for reform. Three of these map closely on to the gifts for the Bretton Woods twins ('Miss Fund' and 'Miss Bank') that John Maynard Keynes offered in his speech to the first meeting of the Fund in 1946:

i. a multicoloured coat, 'as a perpetual reminder that they belong to the whole world';

ii. vitamins, to give them 'energy and a fearless spirit' in order to welcome and solve difficult issues; and

iii. 'a spirit of wisdom' to ensure that 'their approach to every problem is absolutely objective'. [Politicisation of the Fund would leave only one option – euthanasia, 'an eternal slumber'.]

The first issue is the most widely shared concern of external observers (e.g. Bretton Woods Project, 2006; Phillips, 2006; Woods, 2006) and of the involved parties (frequently reflected in statements by European countries, the USA and the G24). Outdated and unbalanced voting rights, in a system that requires an 85% majority of the total voting rights for action, means that almost all of the world's countries are by definition excluded from effective ownership of the Fund. Some limited progress has been made with the announcement in September 2006 of small increases in the quotas of China, Mexico, South Korea and Turkey (but a reduction for India).

A commitment to wholesale reforms by 2008, if met, offers the possibility for the Fund to finally try on that multicoloured coat. The G24 has produced analysis of how voting rights would change if the allocation was made on alternative bases. First, if GDP (in PPP terms) is the sole factor taken into account, the share of developing countries increases from 39% to 48%. The shares of different regions are ill-balanced however; Asia's share more than doubles to 26%, while there are reductions for Africa, the Middle East and transition countries. The analysis then introduces a weight for the impact of volatility in exports and capital flows. If this is set at 0.4 with GDP weight falling correspondingly to 0.6, then small, open countries (especially in Africa) see their shares rise significantly. The overall effect is to raise the developing country share of votes to 52%.

The second charge is that the IMF has not confronted the major problems that face it, and in particular the one that concerns us here – specifically, that it has not had the 'energy and fearlessness' to take concrete steps to reduce the prospects for international financial crises. Bank of England Governor Mervyn King (2006) identifies three tasks in relation to the international monetary system: surveillance of country balance sheets in rich as well as poorer countries, giving rise to analysis of the risks to the world economy as a whole; encouraging countries to stick to commitments about national policy transparency, since 'by making their national policy frameworks sufficiently transparent, countries will be making it possible for the IMF to hold them to account and to fulfil its role as an umpire'; and providing a forum for national policymakers to discuss global economic risks, where an expert secretariat can facilitate the sharing of confidences about policy reaction functions.

Table 1: IMF voting shares by group (% of total vote)

	Current	GDP(1)	GDP+vol(2)
Total Developed	**60.8%**	**51.6%**	**47.3%**
- G7 countries	45.3%	43.3%	39.0%
- Other developed	15.5%	8.4%	8.3%
Total Developing	**39.2%**	**48.4%**	**52.7%**
- Africa	5.7%	3.9%	6.7%
- Asia	10.5%	26.3%	24.9%
- Middle East	7.7%	3.9%	5.0%
- Latin America/Caribbean	7.7%	7.8%	8.4%
- Transition Economies	7.7%	6.5%	7.8%

Source: G24, 2006, quoted in Phillips (2006). Note: 'Current' indicates current representation, (1) is an allocation based on GDP in PPP terms, (2) is based on GDP (PPP terms) weighted at 0.6 and a 10% volatility metric weighted at 0.4.

The third criticism, made prominently by King but also by a range of developing country policymakers, academics, NGOs and civil society, is that the Fund lacks independence and legitimacy. For King this demands (in addition to a deal on voting rights) that patterns of responsibility for decisions are simplified and made transparent, and he cites a report by the Independent Evaluation Office identifying 'the difficulty of knowing who was responsible for those decisions: management, the Board, or the national shareholders'. For Wood (2006) the real issue of legitimacy is that Fund (and World Bank) advice is not seen as impartial by developing country recipients, and this requires improved IFI knowledge of those economies coupled with genuine domestic policy ownership.

The final problem facing the IMF – and arguably the only one not suggested by Keynes – is the collapse in its income. Loan repayment income has fallen to the lowest level for 25 years. This stems from a combination of greater private flows to developing countries, due to high global liquidity and low interest rates, and disenchantment with Fund conditionality (especially in Asia, following the heavily-criticised IMF response to the 1997-8 crises). The result is a predicted deficit of SDR59m ($88m) for the fiscal year to end-April 2007, and of SDR104m and SDR189m for each of the following years.

These four issues cover the main issues and criticisms facing the Fund. The appropriate responses – insofar as responses are in fact required – depend on the role that is desired.

THE IMF AND CRISIS PREVENTION

Ever since the pre-inception discussions of the Bretton Woods institutions, there have been disagreements over their ideal form. From Harry Dexter White's disagreements with Keynes, through John Williamson's (1977) disenchantment with the 'failure' of the 1970s reforms, to the current widespread criticisms, one element stands out. Exacerbated by changing economic and political conditions, criticisms of the Fund stem overwhelmingly from differing views of its role in the world economy.

Its failings are therefore not attributable to individuals or indeed even to particular institutional characteristics; but rather to the absence of stakeholder agreement on its role. As such, any reform – and at this time of flux, important reforms seem likely to be forthcoming – risks being appropriate to a role that is envisaged by only a minority of stakeholders.

Agreement on that role should therefore be a first priority for stakeholders.

It is then useful here to consider some of the range of roles that have been, or could be, played by the IMF. The original purpose of the IMF can be taken to be that expressed in its Articles of Agreement. As these demonstrate (see Appendix I), the envisaged role was two-fold:

- to improve international monetary outcomes through providing an institutional framework for cooperation, through better exchange arrangements and a multilateral payments system (I.i, I.iii, I.iv); and

- to promote international economic stability through providing adjustment finance for balance of payments imbalances, and working to reduce the length and depth of such disequilibria (I.v, I.vi).

The underlying goal is arguably captured in purpose I.ii: 'To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.'

The current operations of the Fund involve roles at the country level and internationally. At the country level, lending is coupled with policy advice and conditionality. It is widely noted that only borrowing countries are responsive to Fund advice. That is, that – notwithstanding common perceptions (e.g. Wood, 2006) and substantial evidence (surveyed in Joyce, 2005) that conditionality has failed – it is only those countries whose relationship with the IMF is conditional where policy is typically affected by the latter. Policy advice for borrowing countries has typically included domestic financial and capital account liberalisation, along with codes and standards of transparency and institutional reporting and conduct in monetary policy, coupled with fiscal restraint.

Internationally, some of the goals of the Articles remain – but, to paraphrase King (2006) quoting Keynes, these are not pursued with sufficient 'energy and fearlessness'. Accusations of exchange rate manipulation are common, while harmonised actions are rare and short-lived. Current grave concerns over the possibility of a large negative shock to the global economy have not yielded any significant response. Illustrating the continuing discontent, it is possible to find similar concerns throughout the postwar period – Stewart and FitzGerald (1996), for example, concluded that 'the Fund has not performed the two major roles required of a global monetary institution – that of lender-of-last-resort or prudential regulator of international capital' (p.23).

To take a more effective role as the prudential regulator of international capital, it seems likely that the Fund will be further removed from a lender-of-last-resort role. As noted, borrowers have shied away in recent years due to improved private capital flows and growing discontent with Fund conditionality and policy approach. The preferred approach for those countries that can afford it has been to build own reserves, rather than rely on outside funding during downturn or crisis. Provision of such funding, following its Article I.v, will remain an important Fund activity for more fragile lower income countries – but is unlikely, at least without grand governance and accountability reforms, to return to previous highs.

The diminution of this role does not guarantee the expansion of any other, however. The Fund's multiple roles in international capital markets and surveillance, while overlapping, do not necessarily follow a clear logic reflecting agreed priorities. As a result, the division of costs and control is not clear either.

It may be informative to speculate briefly about the role of the Fund in an ideal world. A body designed today to operate primarily at country level would be expected to do so to the benefit of its stakeholders, not only tailoring lending margins according to conditions but also responding to borrower requirements and serving as a key conduit for best practice. Costs would be borne through lending spreads by the beneficiary countries, and as the body's income would depend on these, control would evidently rest with them also.

In contrast, a body designed today to enhance the functioning of capital markets internationally would seek not only to reduce the cost of capital for users but also to increase the stability of flows and of access for stakeholder countries, and to address the control of non-state users to the benefit of the latter (i.e. to act against tax evasion, regulatory evasion and terrorist financing). Costs would be borne by those beneficiary countries for the latter role (in proportion to e.g. government revenues and international financial market access), and by the users of the financial system (most likely through a user levy, e.g. a fixed percentage of transaction values), and control would rest with beneficiary countries.

The IMF can take credit for its role in the process of financial globalisation that has characterised the post-war period, not least through its role in international monetary developments and through individual country steps where its policy advice and conditionality have been important. The measurable effects of financial globalisation can therefore be considered as a part of the assessment of Fund contribution to the global economy. At the international level, there is evidence of benefits. Hardouvelis, Malliaropoulos and Priestley (2004) and Stulz (1999) find a falling cost of capital as financial markets become more efficient, transparent and closely linked. Superior capital allocation and hence lower costs result from freer markets and information flows.

At the country-level, the evidence on capital account liberalisation continues to disappoint. Earlier work (Cobham, 1999) surveyed the econometric literature on growth effects and found no compelling pattern. Subsequent work has confirmed these findings and tended to urge caution (e.g. Prasad, Rogoff, Wei & Kose, 2004). The pronounced tendency for crises to follow liberalisation has yet to be satisfactorily addressed, and the absence of systematic growth benefits militates against the type of uniform policy support that was once the norm. Considerable econometric evidence confirms the tendency for greater variance of country output after liberalisation (e.g. Demirguc-Kunt and Detragiache, 2001; Honohan, 2001).

WHERE DO WE STAND?

Realistically, three things are required:

(i) agreement on the central role(s) of the Fund;

(ii) recognition that sustainability requires the stakeholders – as determined by the chosen role(s) – to have some non-trivial voice in decision-making; and

(iii) sustainable income streams that meet the costs of fulfilling the chosen role(s), with allocations of costs more closely following the benefits of operation.

If a key role is to be in crisis prevention, then progress towards this must be financed by those who stand to benefit – rather than those lower-income borrowers least involved in the international system, whose best way to avoid crisis (though not necessarily optimal policy) may be capital controls. The G24 analysis (see Table 1) suggests a practical way forward to allow voting rights (and hence ownership and control of the Fund) to reflect exposure to features of the world economy, including risks of international financial crisis, and for costs to be allocated accordingly.

Spreading the IMF's income base as is being explored by the Committee of Eminent Persons will assist, but may not provide a sustainable source of funds without genuine political commitment. That commitment will depend on the accepted definition of the Fund's role; and the current discussions on the work of the External Review Committee on IMF-World Bank Collaboration may have an important bearing on this.

APPENDIX: ARTICLE I OF THE IMF

The purposes of the International Monetary Fund are:

i. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

ii. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

iii. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

iv. To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

v. To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

vi. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund shall be guided in all its policies and decisions by the purposes set forth in this Article.

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