TO RESTORE ITS CREDIBILITY AMONG DEVELOPING COUNTRIES, THE IMF, SAYS ROBERT CHOTE, HAS TO SCALE DOWN THE INFLUENCE OF EUROPE AND THE US
Balance of power

IN JULY 1944, delegations from 44 countries gathered in the New Hampshire resort of Bretton Woods to lay the institutional foundations for the post-war economic order. The UK's John Maynard Keynes despaired of "committees and commissions numbering anything up to 200 people, in rooms with bad acoustics, shouting through microphones, with each wanting to get something on the record that would look well in the press at home". But somehow it delivered. And thus, next month, delegations from 184 countries will gather in Washington for the 60th annual meetings of the International Monetary Fund (IMF) and World Bank. Celebrations will, however, be muted. The past decade has not been a happy one for the Fund. A succession of financial crises in emerging market countries has undermined its reputation for promoting global economic stability. And with US interest rates heading up again, there may be more turbulence ahead.

The IMF has learned and applied many lessons from the past 10 years. But critics still question whether its methods, financing and governance are appropriate to a world very different from 1944. Ensuring that the Fund is "fit for purpose" is a challenge for its new managing director, former Spanish finance minister Rodrigo de Rato y Figerado. Since his appointment in May, de Rato has resisted the temptation to offer a detailed vision, but interestingly he has said that he regards the IMF as a "political" institution. This may have raised a few eyebrows, but de Rato is absolutely right.

Rigorous economic analysis may be central to the Fund's policy recommendations, but it remains, essentially, a political institution, run and financed by member governments. That is both a strength and weakness, and no reform agenda can ignore the fact.

Learning from the past

The IMF was created for both political and economic motives. The participants at Bretton Woods knew that the international community could not afford to recommit the mistakes of the Paris Peace Conference of 1919. That failed to put in place a framework for international economic co-

At a glance...

- The IMF's role of promoting world economic stability has been undermined by a number of crises in emerging countries.
- The Fund's tendency to bow down to pressure from its more powerful members, particularly the US, has led to calls for a new system of independent surveillance and programme negotiation.
- Critics have called for more transparency in IMF decisions and greater voting power to be given to developing countries.
operation after the First World War, leaving the way open for the beggar-thy-neighbour devaluations and trade barriers that contributed to the Great Depression and the political instability of the 1930s. Hence the determination to create rules and an institution that could promote growth and full employment by facilitating trade within a stable global financial system.

The IMF was structured as a credit union. Member countries deposited part of their foreign-exchange reserves with the Fund in amounts or “quotas” that roughly reflected their economic importance. This in turn determined their voting power when added to the “basic votes” that every country was allocated – irrespective of size.

These reserves were then available to be lent to members facing short-term balance of payments problems, giving them a breathing space to adjust their policies “without resorting to measures destructive of national or international prosperity”. The IMF’s Articles of Agreement specified that this would happen “under adequate safeguards”, implying that conditions could be attached to ensure the underlying balance of payments problem was addressed. The Fund also provided the machinery for “international monetary co-operation”, including – as spelled out in the 1970s – “surveillance” over the exchange-rate policies of its members.

This structure was shaped less by Keynes than by his US counterpart Harry Dexter White. This meant that the international monetary system was based on the dollar rather than a new global currency; that the lending power of the IMF was limited in size and scope; and that it was headquartered under the US Treasury’s watchful eye in Washington DC. All three factors have had an important influence on the way the Fund has behaved.

The biggest departure from Bretton Woods came in the early 1970s with the breakdown of the fixed exchange-rate regime among the major economies. When it became clear that floating rates were here to stay, the IMF took on the role of checking members’ policies to make sure they were consistent with strong growth, full employment, low inflation and a sustainable external position. Meanwhile loans were made available over longer periods and the conditions focused more on structural issues, such as labour market reform.

The Fund’s key role in helping resolve the debt crisis of the 1980s underlined the fact that it was by then lending exclusively to developing countries, rather than industrial ones. This episode gave the IMF the role of international crisis manager that it still “enjoys” today. It also marked an important change in its relationship with the private sector as the Fund refused to lend to victims of the debt crisis unless private creditors shouldered some of the burden by increasing their exposure, a principle to which it has tried to return in more recent crises. In its first half-century, therefore, the IMF had showed itself capable of adapting nimbly to changing circumstances. To be sure, the Fund’s role was controversial and its golden jubilee prompted a “50 Years Is Enough” campaign, by the US Network for Global Economic Justice. Criticism centred on a belief that the IMF’s loan conditions were too tough; that it should cancel the debts of the poorest countries; that it represented western corporate interests and was secretive and undemocratic.

A traumatic decade
But the following decade was to prove even more traumatic, characterized by the rapid growth of financial flows into emerging market economies.

The IMF believed that flows of capital – like flows of trade – were a good thing, providing finance for countries with scarce domestic savings and offering higher returns to lenders. But it became clear in Mexico (1994–95), Asia (1997–98), Russia (1998), Brazil (1999), Turkey (2000) and Argentina (2001) that what flowed in could all too quickly flow out again, causing immense economic and social disruption.

The Fund’s surveillance and lending tools were not designed for the suddenness, frequency and ferocity of these capital-flow reversals. Improving crisis prevention and management has therefore been at the top of the IMF’s agenda for the past decade. Not surprisingly, the institution is now rather less gung-ho in its espousal of capital account liberalization, emphasizing the need for a country to phase it in cautiously and ensure that the domestic financial sector is strong and regulated to cope.

Recognition that crises can erupt suddenly when investors become alarmed by hitherto hidden vulnerabilities has prompted greater transparency in policymaking, mirrored by greater transparency in the workings of the Fund. There has been a proliferation of international standards and codes in different policy areas, with progress against them in individual countries summarized in IMF reports. And the markets seem to be paying attention; countries subscribing to the Fund’s statistical dissemination standard seem to be rewarded with better credit ratings and lower borrowing costs.

More countries are also accepting peer review of their financial systems, as part of the Fund-Bank Financial Sector Assessment Programme, and are allowing the Fund to publish the “Article IV” economic health checks it carries out in its surveillance. Drawing on lessons learned from the crises, the Fund now focuses much more on a country’s exchange-rate regime and the sustainability of its public and private debt when undertaking surveillance. In emerging market countries that have to borrow in foreign currencies, the two are often closely linked. As regards the
exchange rate, recent crises have been a painful reminder of the “impossible trinity”: that policymakers cannot simultaneously defend a currency peg, keep capital markets open and devote monetary policy to steering the domestic economy. With a few exceptions, most emerging markets have opted for formally flexible exchange rates. However, some still try to limit currency movements because concerns about foreign-currency debt burdens or worries about export demand instil a residual “fear of floating”. Several countries in Asia, for example, have limited the appreciation of their currencies by amassing very large foreign exchange reserves.

Negligent and complicit
The fact that some emerging market countries have continued to find exchange rate pegs useful to stabilize their economies has been an endless source of trouble for the IMF in recent years, as they tend to become part of the problem rather than the solution. As Agustín Carstens, deputy managing director of the IMF, explains: “More than once, the Fund has had serious concerns about the sustainability of a country’s exchange rate regime. Yet, out of concern for triggering the very sort of crisis it is our mandate to avoid, we were not forceful in expressing our views... In the event that a crisis did arise, the Fund was often seen as negligent in its duties, or even complicit in fomenting the crisis.”

In the case of Thailand, for example, the IMF repeatedly warned the authorities before the crisis broke in 1997 that the baht peg looked unsustainable, however, it did not go public with its concerns. Giving confidential Fund advice greater “traction” is an important goal of reform. One mooted possibility would be a “yellow card”, a threat to go public if a problem is not tackled within a given time. But would this ever be credible?

The Fund might be expected to have more leverage with a country to which it is lending. But the “when to blow the whistle” problem remains, because the key goal of a modern Fund programme is to restore private sector confidence and therefore “catalyze” the return of private capital. When Argentina fixed its exchange rate through a currency board in 1991, the Fund was sceptical. It warned that a tight fiscal policy and greater labour market flexibility would be necessary to sustain it, but then continued lending to Argentina when the authorities did not deliver – even when the country found itself facing a crisis.

The Fund’s Independent Evaluation Office in part blames weak and insufficiently forward-looking analysis of the exchange rate and debt for the crisis that hit Argentina: “The Fund lacked an objective basis to argue for a fundamental modification of the policy framework.”

However, it seems unlikely that more sophisticated analysis would have overcome political resistance in Argentina to sacrificing the currency board and seeking a debt restructuring. In any event, “the IMF’s culture discouraged questioning a member’s exchange rate regime”. Concerns were expressed within the Fund but “almost always, these dissenting views were overruled. Supporting a weak programme while maintaining influence was thought better than insisting on a strong programme that was unlikely to be implemented.”

**IMF: QUOTAS, VOTES AND DECISION-MAKING**

**Quota:** Quota subscriptions generate most of the IMF’s financial resources. On joining, each member is assigned a quota subscription, based on its relative size in the world economy.

**SDR:** The Special Drawing Right (SDR) is the IMF’s unit of account.

**Governor/Alternate:** The Board of Governors is the IMF’s highest decision-making body. Each member has a governor and an alternate governor.

**THAILAND**
- Quota: 1,081.9 million SDRs.
- Percentage of total quota: 0.51.
- Governor: Pridiyathorn Devakula.
- Alternate: Bandit Nijathawon.
- Votes: 11,069.
- Percentage of total votes: 0.51.

**MEXICO**
- Quota: 2,585.8 million SDRs.
- Percentage of total quota: 1.22.
- Governor: Francisco Gil Díaz.
- Alternate: Guillermo Ortiz.
- Votes: 26,108.
- Percentage of total votes: 1.20.

**ARGENTINA**
- Quota: 2,117.1 million SDRs.
- Percentage of total quota: 0.99.
- Governor: Roberto Lavagna.
- Alternate: Alfonso de Prat-Gay.
- Votes: 21,421.
- Percentage of total votes: 0.99.

**RUSSIA**
- Quota: 5,945.4 million SDRs.
- Percentage of total quota: 2.79.
- Governor: Aleksei Kudrin.
- Alternate: Tatyana Paramonova.
- Votes: 59,704.
- Percentage of total votes: 2.75.

**TURKEY**
- Quota: 964 million SDRs.
- Percentage of total quota: 0.45.
- Governor: Ali Babacan.
- Alternate: Süreyya Serdengecti.
- Votes: 9,890.
- Percentage of total votes: 0.46.

**BRAZIL**
- Quota: 3,036.1 million SDRs.
- Percentage of total quota: 1.43.
- Governor: Antonio Palocci.
- Alternate: H de Campos Meirelles.
- Votes: 30,611.
- Percentage of total votes: 1.41.
Such tensions have prompted the UK Treasury to argue that there is an inherent conflict of interest between honest surveillance and decisions on when to lend: “The Fund, as the subsequent monitor of performance, may face pressures and incentives that prevent it from stepping back to provide a candid assessment of the sustainability of the programme framework.”

The Treasury would like “to make the IMF as credible and independent from political influence in its surveillance of economies as an independent central bank should be in the operation of domestic monetary policy”. Some academics have gone further and argued that lending decisions should be insulated from politics by replacing the 24 member-government representatives who sit on the Fund’s Executive Board with independent members, as occurs on the Bank of England’s monetary policy committee. However, placing a Chinese wall between surveillance and programme negotiations or trying to take both activities outside the political arena risks using a sledgehammer to crack the wrong nut.

Taking the political temperature
When negotiating a new programme or the continuation of an existing one, the IMF’s staff and management know that the terms will eventually have to be acceptable both to the country concerned and to the Fund’s members, which in practice means the US and other powerful G7 countries. Typically, Fund management consult informally with the G7, take the political temperature, and present a programme proposal to the Board once they are confident it will be accepted.

The so-called “transitional” programme negotiated with Argentina in December 2002 was an extreme example in which the US pressed the then managing director of the Fund, Horst Köhler, to recommend a programme that the staff bluntly told the Board “contains insufficient steps to give confidence to restoring medium-term sustainability”. This judgment was not made public, although for the cognoscenti, Köhler damned the proposed programme with faint praise by declaring: “I have decided to recommend the approval of this arrangement as a demonstration of a good-faith effort of the international community in favour of the people of Argentina.” In the event, the Board approved it, albeit with abstentions. This, and subsequent support for Argentina given the continued weakness of its policies, has harmed the IMF’s credibility in the eyes of many.

This unedifying episode suggests that disentangling surveillance from programme negotiations may be less helpful than disentangling the political decisions of IMF members on the Board. However, the fact remains that it is the member governments who finance the Fund, who represent the international community and who should decide what a fellow government could be expected to deliver in terms of policy. If they want to overrule the technical judgments of IMF bureaucrats they should certainly feel free to do so, but the credibility of the institution and of the international community might be better served if such decisions were transparent and accountable.

If staff knew these assessments would be made public they would have an incentive to ensure they were as rigorous and defensible as possible. Staff might also present their projections in a more probabilistic fashion, underlining the uncertainties that the Board would then need to take into account in deciding whether to support the particular policy programme. Voters and investors could then decide for themselves if they thought the decision economically well-founded or politically motivated.

The financial and political stakes in lending decisions have been raised by the fact that it is much more expensive to help a country cope with a catastrophic capital outflow than a gap in its current account. This has forced the IMF repeatedly to lend far more than the 300 per cent of quota that countries have traditionally been able to borrow. In recent years, for example, Korea and Turkey have been offered at least 1,500 per cent.

One outcome has been that the Fund’s lending portfolio has become heavily concentrated, with about $61bn (£33bn) of the $86bn (£47bn) in credit outstanding at end-July accounted for just by Brazil, Argentina and Turkey. Officials are nervous about the consequences if one or two of them were to default. An Argentine default looks manageable, but if Brazil followed suit the Fund’s credit union-style financial structure might not be sustainable.

“The fact remains that it is the member countries that finance the Fund”
Impudent lending and increased anxiety

The fact that huge loans have allowed some private sector creditors to be repaid and thereby escape the full consequences of imprudent lending has also been a source of anxiety. In response the Board has agreed a set of tough criteria that must be met before "exceptional" access to IMF resources is allowed. However, it has not withdrawn existing exceptional support for Brazil or Argentina even though neither meets those criteria. It remains to be seen whether it will be tougher when new cases come along.

The concern to ensure that private sector creditors play their part is particularly acute when a country is suffering a solvency, rather than a liquidity crisis - in other words when the burden of government debt has become unsustainable. In the domestic context we have bankruptcy regimes to achieve an orderly resolution of private sector insolvency. In 2001 Anne Krueger, the Fund's first deputy managing director, proposed an analogous mechanism for government debt, noting that much of it was now in the form of diffuse bond holdings and therefore harder to reschedule than bank debt in the 1980s.

However, the US balked at the idea and attention turned to encouraging the use of collective action clauses in new sovereign bonds, which help limit the ability of minority creditors to frustrate an otherwise widely supported restructuring of the debt. Krueger proposed the more overarching mechanism in part because such clauses would not help coordinate restructuring across a range of different debt instruments. If and when Argentina decides to engage in serious negotiations with its private sector creditors, it will be interesting to see if this problem emerges and Krueger's scheme resurfaces.

So de Rato has arrived at an IMF much transformed. As its official historian observes: "Much of the volume of its lending has become crisis-driven and the Fund's involvement in crisis prevention and resolution has correspondingly intensified. It has effectively become divided into groups of creditor and debtor countries whose membership changes little over long periods of time. The breadth of its involvement in policymaking in member countries, especially borrowing countries, has vastly increased." An important consequence is that the governments who call the shots at the IMF are much less likely than in the early days to come to it for financial help and submit to the policy conditions it demands.

All this underlines the importance of ensuring that the Fund's decisions and governance are as far as possible seen as a legitimate expression of the international community's will and not simply that of its most powerful members. This cause was not helped by de Rato's own appointment, which followed the discredited convention that Europe gets to pick the head of the Fund, and the US the head of the World Bank. Neither has it been helped by the perception that the US talks tough on the need to lend only in support of good policies, but then demands support for weak ones whenever politically expedient.

Barry Eichengreen, professor of economics and political science at the University of California (Berkeley), says: "Fast-growing countries like those of Asia, whose stake in the operation of the international financial system is growing rapidly, and smaller underdeveloped countries like those of Africa, which tend to be the subject of IMF programmes, both have a reason to feel they are inadequately represented in the Fund, and as a consequence exhibit inadequate ownership of its programmes." A solution, Eichengreen suggests, is to increase the votes of these countries and reduce the number of European executive directors on the Board (currently nine out of 24).

Yet we have to be realistic. In his book Why Globalization Works, Martin Wolf argues that "the trick of making multilateral institutions work is to recognize the realities of power, without succumbing entirely to them... Can we create an all-wise, self-disciplined, transparent and democratic IMF? The answer is an unambiguous no. But we can do better." Whatever its faults, the IMF plays an indispensable role in the governance of the global economy. But its decisions are ultimately the responsibility of its political masters, and if more could be done to make them accountable that would be no bad thing.

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