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How to Reform the IMF

RANDALL W. STONE

International governance—the broad set of rules, international organizations, and informal understandings that facilitate cooperation among states in the contemporary world—has reached a decisive moment. The world's essentially liberal international institutions, participatory but US-led, expanded rapidly after the end of the cold war. Now they face new challenges, as they will be forced to adapt to dramatic economic growth in emerging markets in Asia and Latin America. Under particularly heavy challenge is the role that the United States plays in international financial institutions, most notably the International Monetary Fund (IMF) and the World Bank, where America has traditionally exerted a degree of informal influence out of proportion to its formal voting rights.

The rapid expansion of international organizations has been one of the most striking developments in world politics since the cold war ended. Formal intergovernmental structures have proliferated in number. Indeed, it is hard to think of a problem of widespread international concern that is not now the focus of activity of some international institution. Meanwhile, membership in the major multilateral organizations has grown, such that few states in the world are not deeply engaged in international cooperation on numerous fronts.

The most important international economic organizations—the IMF, the World Bank, the World Trade Organization, and the European Union—have reinvented themselves several times in recent decades, extending their reach into intimate details of their members' domestic political economies. International law, too, has expanded in substantive scope, and the efficacy of its application has increased as the world has witnessed a proliferation of international courts and adjudicatory bodies. In general, international governance today is broader, deeper, and more comprehensive than at any previous point in history, and it shows signs of further extending and formalizing international cooperation in the future.

International organizations are useful to their member states because they lend legitimacy and credibility to cooperative undertakings. As the world economy becomes increasingly a single, global marketplace linked by speed-of-light financial transactions—a world where events in any location can produce systemic effects, and where local problems often have only international solutions—the demand for cooperation has grown. Yet cooperation is frequently impeded by domestic politics and by short-term incentives to pursue opportunistic policies. International organizations thus play a critical role in building trust.

In turn, multilateral institutions' ability to foster trust depends on overcoming two related incentive problems. First, trust is problematic because international organizations aggregate the interests of their member states, so a degree of conflict is to be expected between the international institutions and their individual member states in particular cases. Powerful states, especially, tend to have commitment problems because they enjoy attractive outside options; they often succumb to the temptation to break rules when their core interests are affected.

INFORMAL PRIVILEGE

This is particularly true of the United States. As a result, in order to promote US participation and investment, international organizations have developed informal channels that allow

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Washington to exert decisive influence when critical national interests are affected. In return, the United States has accepted weaker formal rights in international organizations than its share of the world economy would predict. I refer to this bargain as informal governance.

Informal governance resolves one incentive problem related to the distribution of power, but it creates another. Participation is attractive to weaker partners to the extent that the policies that international organizations generate are predictable and tolerably close to their own preferences most of the time. This requires that the leading state exercise a degree of self-restraint.

Yet, when pressing geopolitical or domestic political considerations loom larger in American calculations than the country's long-term interests in promoting cooperation, the United States tends to abuse its privileges—which undermines the credibility and legitimacy of international organizations. This happened in postcommunist countries in the 1990s, as US foreign policy objectives overwhelmed the agenda of market-oriented reform. It happened again in the Asian economic crisis of 1997, as US trade and investment objectives took priority over containing the spread of market panic.

Informal influence over the IMF is corrosive, as it undermines the organization's claims to being impartial and democratically governed.

The predictable consequence is declining participation by other states in international organizations. In extreme cases this problem can paralyze important institutions, as was beginning to happen to the IMF before the recent global financial crisis. Demand for IMF loans had declined so far by early 2008 that the international body was compelled to reduce its workforce by 10 percent, since it pays its expenses with the interest on its loans.

As the resources of emerging-market economies have expanded, calls to reform international financial institutions have intensified. In the case of the IMF, the global crisis of 2008 restored demand for its lending, and the leading financial powers—a club that now includes China, India, and Brazil—agreed to extend loans that tripled the IMF's resources. However, the price of that assistance will likely include a redistribution of formal voting rights in favor of developing countries, a gradual moderation of IMF efforts to liberalize markets, and an extension of recent moves to make IMF governance more transparent and to limit the scope for informal governance.

THE REDISTRIBUTION OF RISK

The IMF has come to symbolize the efforts of advanced industrial countries to link the financial assistance that they provide to developing countries with a broad agenda of macroeconomic policy adjustment, trade and financial liberalization, and structural reform; indeed, the IMF has been at the forefront of all of these efforts. Debt rescheduling is linked to IMF-backed programs of sweeping liberal reforms, as is crisis lending to emerging-market economies and prolonged assistance to the impoverished countries of sub-Saharan Africa.

It was not always so, however. The IMF that was envisioned by the economist John Maynard Keynes (who represented Great Britain in negotiations over postwar financial architecture) and that was codified in the Bretton Woods agreement of 1944 was a different institution, with profoundly different purposes. Gradual changes in conditionality, the IMF's treatment of capital controls, and the size of IMF resources relative to the world economy have over time shifted more and more risk to developing countries.

The Bretton Woods agreement envisioned a system of fixed exchange rates, and both Keynes and his American negotiating partner, Harry Dexter White, recognized that fixed exchange rates would only be consistent with economic demand management and full employment objectives if they coexisted with illiberal measures to restrain flows of capital. The IMF Articles of Agreement consequently specified that members were free to impose capital controls at their sole discretion, and insisted only that countries should move steadily toward eliminating controls on payments for current transactions—controls, for example, that amounted to restraints of trade.

Furthermore, the IMF did not initially attach conditionality, or demands for policy reform, to its loans. Keynes in particular thought that access to IMF resources should be made automatic in order to alleviate countries' needs to hold foreign currency reserves. These policies changed only gradually, and in response to American initiatives. The United States, when it was the Fund's primary net creditor, insisted on the introduction of policy conditionality. Indeed Washington, until its demands were met, either blocked new lending or circumvented the IMF with bilateral lending that was loaded with policy conditions.

Conditional lending was gradually formalized in the 1950s, and loans were broken into phased tranches that were disbursed as policy reform targets were met. Controversy over conditionality raged between the United States and its allies during the 1960s, with Washington pushing for more rigorous reforms across the board and linking IMF-backed reforms to its bilateral foreign aid. At the same time, the United States used its informal influence over IMF management to push for softer conditions for strategically placed client states. These conflicts came to a head when Britain's Labor government was driven into a last, humiliating IMF program in 1976 that compelled it to drop long-standing social democratic policy commitments.

By the 1980s, however, the United States and its closest allies were reading from the same script and calling on developing countries to implement economic reforms. The administration of Ronald Reagan intensified the degree of conditionality in IMF loans by the simple expedient of slowing the growth of IMF resources. Higher levels of conditionality were established as a country's debt to the Fund increased as a proportion of its quota, or share in the Fund's capital. By keeping quotas low while inflation and debt levels rose, the IMF pushed countries into higher levels of conditionality, until conditional lending gradually became universal.

Powerful states often succumb to the temptation to break rules when their core interests are affected.

The Latin American debt crisis in the early 1980s gave the Fund leverage to demand substantial policy reforms, and in subsequent years the complexity of the postcommunist transition added structural conditionality to the mix. The Asian crisis in the late 1990s added a new priority for financial sector liberalization. Conditionality as a result became much more comprehensive—and much more politically sensitive—than the IMF's designers had ever imagined.

Meanwhile, the IMF gradually abandoned its acceptance of capital controls. The United States suspended convertibility of the dollar into gold in 1971, thereby undermining the Bretton Woods system of fixed exchange rates, and in 1973 the major currencies began to float against each other. This meant that capital controls were no longer a necessary part of the international system of finance. The administration of Richard Nixon immediately pushed for their abolition, but was rebuffed by the Europeans and Japanese. Over the next two decades, however, Europe and then Japan became convinced, first, that capital controls were ineffective, and eventually, that they were pernicious.

The European Community abolished capital controls along the way to creating the single market, and the Organization for Economic Cooperation and Development adopted the requirement that new members eliminate capital controls. The IMF began to use its policy conditionality to liberalize capital flows in the 1980s, and expanded this agenda in the 1990s.

THE RUSH TO SELF-INSURE

As IMF policy conditionality became more demanding, and as developing countries were encouraged to liberalize their financial markets, the size of IMF loans decreased relative to private capital flows. IMF resources have been expanded in a series of infrequent quota adjustments, but the adjusted quotas have not kept up with inflation. By the late 1990s they had become much less significant than they had been at the end of World War II as a share of world output, world trade, or particularly world capital flows.

As a consequence, the IMF's lending was generally inadequate to fill the financing gaps facing most of its borrowers. Inadequate financing made IMF-induced economic reform programs riskier and compelled countries to assume more of the responsibility for closing their financing gaps by cutting their fiscal deficits, devaluing their currencies, and raising interest rates.

Each of these measures in turn amplified the pain of financial crises and increased the attendant political risks. IMF conditionality, meanwhile, had moved well beyond its initial blueprint of macroeconomic policy corrections intended to restore equilibrium to the balance of payments. Conditionality had come to embrace numerous supply-side reform measures aimed at promoting long-term growth, but which in some cases worsened the short-term outlook. Furthermore, the new IMF agenda of liberalizing capital flows increased the volatility of international business cycles.

All of these changes added up to a profound redistribution of the risks of globalization to developing countries. The Asian crisis of 1997 and subsequent capital account crises in Russia (1998), Brazil (1999), and Argentina (2001) convinced the leaders of emerging-market countries that the IMF no longer provided adequate insurance against financial crises, and that the United States exercised too much informal influence over the IMF.

As a result, these countries sharply changed their macroeconomic policies. Emerging-market economies withdrew from participation in IMF programs and turned instead to self-insurance: They devalued their currencies and steadily built up immense war chests of dollars and dollar-denominated assets. In the past 10 years, foreign investors accumulated over $4 trillion of US Treasury securities and hundreds of billions of dollars in cash and various US assets. China accumulated $2.5 trillion in official foreign reserves, 70 percent of which was in dollars. Japan, South Korea, Taiwan, and Russia pursued similar policies on a smaller scale.

Paradoxically, the rush to self-insurance fueled the financial imbalances that led to the global financial crisis of 2008. Immense purchases of US currency and assets drove up the value of the dollar and swelled the size of the American trade deficit with the rest of the world, and particularly with China. The attendant capital inflows inflated an asset bubble in the United States, in which the stock market was driven to record highs and real estate prices soared. The volume of outstanding mortgages in the United States rose from $5 trillion in 2000 to $11 trillion by 2008. In the subsequent collapse of the housing bubble, prices dropped by one-third on average.

US policy mistakes, including a fiscal expansion and an extended period of low interest rates, contributed to the bubble. US regulatory failures turned it into a systemic financial problem rather than a localized real estate crisis. The international dimension of the crisis also was important, however. The foreign currency purchases that fueled the bubble economy emerged as a response to the risks that were shifted onto emerging market economies in the 1990s.

THE DOLLAR RULES

A sea change has occurred in the international economy during the past 10 years, and this will have a profound impact on international governance. In 2000, correcting for differences in purchasing power, the emerging and developing economies accounted for 37 percent of the global economy, and the advanced economies accounted for the other 63 percent. Today the emerging and developing economies are 47 percent of the world economy, and by 2013 they are projected to reach parity with the developed world.

The Group of 7 leading industrial countries' share of world output has declined since 2000 from 49 percent to 40 percent. As a result, the cozy Western club that shaped economic policy by consensus has been largely eclipsed by the more fractious Group of 20. Today, China alone represents over 13 percent of global output, and the developing-country members of the G-20 comprise over 30 percent of the world economy.

As significant as these developments are, it would be a mistake to conclude that the global crisis has upset the monetary order premised on the central role of the US dollar, or that it has fundamentally undermined American preeminence in international finance. Consequently, we can expect the existing modes of international economic governance to be adjusted at the margins, rather than fundamentally overturned.

The US dollar remains the world's reserve currency. Eighty-eight percent of foreign currency transactions involve dollars, and in fact it is impractical to convert most of the world's currencies to each other without first converting to dollars. Sixty percent of official currency reserves are held in dollars. Most commodity trade is conducted in dollars, and dollars are the preferred vehicle for international lending, borrowing, and investment.

Partly as a result of the privileged position of the dollar, the financial crisis of 2008 had very different consequences from those that might have been expected of a similar banking crisis originating in some other country. Indeed, the American economy showed strengths during the crisis that only a crisis could reveal.

In a typical country, a banking crisis provokes a run on the currency and on the sovereign debt of the national authorities, because banks are typically leveraged in foreign currency. Bank runs lead to rapid capital outflows, which drive down the value of the currency and depreciate the value of government debt issued in the domestic currency. This leads to more capital outflows as bondholders try to convert their balances to foreign currency. The currency depreciation further undermines the banking system, which has borrowed in foreign currency and lent in domestic currency, and the systemic nature of the crisis undermines the ability of the government to act as a lender of last resort.

This is what happened, for example, in Iceland in 2008. In the United States, however, because the dollar is the world's reserve currency, exactly the opposite occurred—a run on financial institutions worse than anything seen since 1929 caused the US dollar to appreciate and government bond yields to drop.

The reason was a flight to quality. Foreign investors reasoned that if the American financial system were truly threatened, the consequences would be worse in their own country than in the United States. For the most part they were correct. Losses due to the US housing bubble were as threatening to European financial institutions as they were to American ones. American financial institutions were not vulnerable to a decline in the dollar, because they do not borrow in foreign currencies; they have preferential access to credit in dollars, so they have no incentive to do so.

As a result, there was no self-reinforcing banking and exchange-rate crisis. Money flowed into the American bond market as international investors hurried to reach safe harbors. The US Federal Reserve, instead of husbanding its resources, expanded its lines of credit to other countries even before the financial crisis began to spread, correctly judging that the problem would be a shortage of dollars, not a surplus. As long as the international financial system remains dependent on the dollar, the United States will enjoy unique privileges and an unparalleled degree of financial influence.

WHAT'S THE ALTERNATIVE?

The central role of the dollar cannot be threatened unless a credible substitute arises. To be more attractive than the dollar, an alternative currency would have to be legal tender in a similarly large economy. It would have to displace the dollar as a medium of exchange in trade and finance, so as to overcome the lower costs of conducting transactions in the accepted currency. It would have to overcome a great deal of inertia in order to accomplish this.

In addition, an alternative currency would have to represent financial markets for debt and other securities of similar depth and breadth to those of the United States, and these markets would have to be comparably resilient, comprehensive, and innovative. Finally, such a currency would have to be backed by a similarly credible government.

The euro comes closest to challenging the position of the dollar, but it has a long way to go to overcome the dollar's cost advantage. (Euros are involved in about 30 percent of currency transactions.) European financial markets remain segmented and are not as flexible as American markets. Demographic and budget trends in Europe are more unfavorable than in the United States. Furthermore, the double-dip European financial crisis of 2010 has revealed the depth of Europe's financial governance problems. The EU failed to prevent member countries from amassing debts that destabilized the financial system and led to months of costly paralysis as the crisis in Greece spread this year to Portugal, Spain, Ireland, and Italy.

The yen was once seen as a challenger to the dollar, but years of economic stagnation in Japan have dulled its luster. The Chinese renminbi is no challenger, in spite of the dynamism of the Chinese economy, because it is not fully convertible and Chinese financial institutions are shielded from international competition.

The primary challenge that China will pose to the international financial system will be that of coping with the consequences of China's inevitably slowing growth rate. According to the IMF, China's economy is projected to grow at the astounding rate of 9.5 percent in 2010. This is not sustainable, however, if only because the rest of the world economy is not large enough to sustain the trade deficits that China would need to continue running its huge trade surplus.

China's growth has been export-led. Thirty-seven percent of China's gross domestic product comes from exports, and it maintains this level of exports by running a current account surplus of 10 percent of GDP. Beijing's policy of maintaining a weak renminbi—thereby increasing the price competitiveness of its exports—has provoked controversy with the United States. China in response has allowed a slight appreciation of the currency. But meanwhile the inflationary consequences of the weak-currency policy have driven up Chinese costs and wages.

On top of this, the People's Republic faces severe demographic challenges. China is expected to witness the most rapid urbanization in history over the next two decades, and there will be a surge in the proportion of the elderly population as the Cultural Revolution generation retires.

The Chinese press frequently refers to a belief that annual growth of 8 percent is the minimum requirement for maintaining "social stability" in the face of rapid internal migration and rising aspirations, but it seems unlikely that this level of growth can be sustained.

DEMANDS FOR REFORM

The need to reform the IMF, however, does not come primarily in response to China's rise, and a slowing of Chinese growth will not solve the IMF's underlying problems. The shift of global economic power to emerging markets is a much wider phenomenon. In terms of purchasing power, India's economy is rapidly approaching the size of Japan's, and the major Latin American countries are catching up with the major European economies.

Demands for broader influence over global economic governance are, as a result, widespread. And these demands coincide with a deep disenchantment with international financial institutions, particularly the IMF. Even Fund insiders and sympathetic observers have been calling for reform for the past decade.

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The IMF has in fact undertaken a number of reforms in recent years. Historically, it has been one of the most impenetrable of international organizations, with a deep-seated aversion to public scrutiny and an extensive system of controls to preserve secrecy. The secrecy surrounding IMF decision making has been the subject of intense criticism, particularly in the wake of the Asian economic crisis of 1997, and governments, academic experts, and nongovernmental organizations have called for increased transparency.

In response, the Fund has begun posting on the internet the letters of intent that it negotiates with program participants. It has created an Independent Evaluation Office—independent of IMF management—to assess the institution's policies and activities. It has opened to researchers its archives of documents older than five years. In the past year it has begun providing online access to its database of conditionality and compliance.

At the same time, there have been widespread calls to reduce the intrusiveness of conditionality. New conditionality guidelines promulgated in 2002 in response to the Asian crisis focused on streamlining conditionality, making it less intrusive, and achieving local ownership of economic reform programs. It is not clear that the new guidelines actually had the effect of reducing conditionality before the global financial crisis of 2008, but as part of the agreement to expand access to IMF resources, in 2009 the IMF significantly reduced the number and rigor of its conditions.

CREDIBILITY PROBLEMS

These changes, even in combination, fall short of changing the IMF governance structure. The fundamental issue with the Fund's governance is that formal control rests with a weak executive board, which acts as a rubber stamp for proposals made by the managing director. This means that informal influence is privileged in the organization, because whoever influences the managing director controls policy.

Increased external transparency does not fundamentally change the terms of informal governance, because members of the executive board have always had access to the information now being disseminated more widely. The critical factors that marginalize the board are the number of the executive directors and the relatively low level of the officials appointed to fill these positions.

The frequency of meetings (several per week) and the large number of highly detailed decisions that form the board's agenda ensure that executive board members are relatively junior; thus, members do not have the political authority to make major policy decisions. Instead, they receive instructions from their countries' finance ministries and central banks.

In addition, the executive board, because of its large size—with 24 directors and an equal number of deputy directors who often represent different countries—has proved repeatedly that it cannot maintain confidentiality, so it cannot be the effective locus of control. Major decisions have to be made elsewhere, where the rules of engagement do not involve voting.

These institutional features favor the countries that are best positioned to exert informal influence. In practice, the United States is usually the sole informal participant in the process of program development outside of Africa, where France and occasionally Britain still play important roles. Germany played the critical role in influencing the extensive conditionality applied to Greece in 2010, because domestic politics in Germany made it costly for Chancellor Angela Merkel to extend loans to the Greek government.

This kind of informal influence over the IMF is corrosive, as it undermines the organization's claims to being impartial and democratically governed (albeit with weighted voting according to contributions). Furthermore, informal influence makes the IMF's policies inconsistent and, in politically or systemically important cases, it undermines the credibility of the loans-for-reforms contract at the heart of IMF conditional lending.

These credibility problems, which became obvious in the cases of Russia in the 1990s and Argentina in 2001, have crippled the Fund's ability to help manage financial crises in countries with systemic importance. In short, informal governance comes at the cost of legitimacy and credibility. The IMF can neither improve its effectiveness nor increase its acceptability in the developing world without addressing this issue.

From this point of view, the ongoing shift in the distribution of global financial power could come just in time to revitalize the IMF and other major international financial institutions. In response to the global crisis of 2008, the IMF applied to its members in 2009 for drastically increased lines of credit to support crisis lending. In a break with precedent, the decision to roughly triple IMF resources was made in the G-20 rather than the G-7, reflecting the fact that emerging-market countries now have substantial financial reserves. Ten percent of the new resources came from China; another 8 percent came from South Korea, Russia, India, and Brazil.

These resources came in the form of loans, not contributions to IMF capital, so they do not yet come with voting rights attached. But voting rights are set to be revised again in 2011 to reflect the redistribution of resources. It is to be expected that the shift to greater control by emerging-market countries will lead to a gradual moderation of the IMF's stance on financial reforms and to a streamlining of conditionality.

It could also lead to deeper institutional reforms that would increase the IMF's credibility as a lender of last resort and as a monitoring agent for the global economy. In addition to boosting the effectiveness of international economic governance, such reforms would bolster the IMF's legitimacy, which is essential to promoting widely shared cooperation. ■