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COMMENTARY

A Blueprint for IMF Reform: More than just a Lender*

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I. Introduction

The International Monetary Fund (IMF) is in the throes of an existential crisis. Emerging markets have accumulated international reserves several times the Greenspan–Guidotti benchmark of the value of short-term foreign debt in order to guarantee that they will never again have to procure assistance from the Fund.[1] The ASEAN+3 countries have committed to transforming the Chiang Mai Initiative of bilateral swaps and credits into a regional reserve pool to ensure that if Asian countries again require financial

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[1]Greenspan (1999) and Guidotti (1999) suggested holding foreign reserves equal to foreign debt coming due within one year. To be sure, other goals have also motivated the observed accumulation of reserves, notably the desire to enhance the international competitiveness of exports by using foreign exchange market intervention to limit currency appreciation (Aizenman and Lee 2005).

Table 1: Ratio of Reserves to Imports of Goods and Services*

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Emerging markets and developing countries	46.3	44.7	49.5	55.3	60.5	62.7	66.4	71.4	75.1	79.1
Regional groups										
Africa	31.2	39.1	45.5	46.9	48.3	53.6	57.2	63.6	67.4	74.7
Sub-Sahara	28.7	33.6	33.2	31.2	28.0	34.7	38.0	42.1	45.5	51.7
Excluding Nigeria and South Africa	30.2	33.2	31.0	35.3	34.4	34.0	31.1	34.8	35.4	39.0
Central and eastern Europe	38.8	34.6	34.8	41.1	39.3	34.8	35.2	31.9	29.3	28.9
Commonwealth of Independent States†	17.6	30.5	34.4	41.0	52.1	64.3	75.7	96.0	109.1	120.0
Russia	17.2	40.6	44.6	52.9	71.5	92.7	107.2	135.2	152.7	170.5
Developing Asia	58.6	49.2	58.4	68.1	74.6	79.6	81.9	87.9	93.9	98.5
China	83.3	67.4	79.7	89.0	91.1	101.5	115.5	124.3	132.2	137.4
India	52.9	52.6	65.0	90.0	107.1	97.0	72.5	70.4	68.6	67.3
Middle East	64.0	75.5	78.7	74.3	78.5	77.9	90.5	98.3	97.9	99.6
Western Hemisphere	38.0	35.9	37.3	40.5	47.6	44.8	43.8	44.0	46.2	46.8
Brazil	37.6	43.5	49.2	61.1	77.2	65.9	54.8	71.3	86.2	88.6
Mexico	20.4	18.6	24.2	27.3	31.4	29.8	30.5	26.2	25.9	26.1

Source: IMF *World Economic Outlook* (April 2007).
Note: *Reserves at year-end in per cent of imports of goods and services for the year indicated.
†Mongolia, which is not a member of the Commonwealth of Independent States, is included in this group for reasons of geography and similarities in economic structure.

assistance, they can obtain it locally.[2] Reserve accumulation has been slower in Latin America (see Table 1), but there too countries are running current account surpluses, paying down foreign currency-denominated debt, building up foreign assets and retiring obligations to the IMF. China's rapid growth (which is stimulating the exports of countries supplying it with components and raw materials), high prices for primary commodities (especially energy) and historically low spreads have all encouraged emerging markets to declare their independence from the multilaterals. Venezuela, which has declared the intention of withdrawing from the IMF and the World Bank, is an extreme case, but the independence movement is general.[3]

[2]Discussions of multilateralizing the Chiang Mai Initiative took place on the sidelines of the Spring 2007 meetings of the Asian Development Bank (see China Economic Net 2007).

[3]At the time of writing, press reports differ on how seriously to take this Venezuelan threat. The country's leader, Hugo Chavez, has also proposed the creation of a 'Bank of the South' as a regional alternative to the Bretton Woods institutions. Asian readers will be reminded of the Japanese government's proposal in 1998 for the creation of an Asian Monetary Fund.

Table 2: Total Fund Credit and Loans Outstanding to the Ten Largest Borrowers (in Millions of SDRs; as of 22 March 2007)

Member	Non-concessional	Concessional (PRGF, SAF, and trust fund loans)	Total: Outstanding amount	Total: In per cent of quota
Turkey	5,624.0	0.0	5,624.0	472.1
Pakistan	33.2	933.4	966.6	93.5
Democratic Republic of Congo	0.0	553.5	553.5	103.8
Ukraine	517.6	0.0	517.6	37.7
Sudan*	271.6	59.2	330.8	194.9
Dominican Republic	327.5	0.0	327.5	149.6
Bangladesh	0.0	316.7	316.7	59.4
Iraq	297.1	0.0	297.1	25.0
Liberia*	200.2	22.9	223.1	312.8
Bulgaria	213.6	0.0	213.6	33.4
Total	7,484.7	1,885.8	9,370.5	–
Memo				
All fund members	8,009.5	3,874.4	11,883.9	–

Source: Report of the Managing Director to the International Monetary and Financial Committee (April 2007).
Note: *Member is in arrears on its total outstanding Fund credit (which excludes any overdue interest and other charges).
PRGF, Poverty Reduction and Growth Facility.

As of the spring of 2007, IMF credit outstanding to emerging market borrowers was less than SDR 12 billion (the equivalent of US$18 billion), down from SDR 65 billion as recently as 2003, with a single country, Turkey, accounting for half of the total (see Table 2). A side-effect has been, deliciously for the Fund's critics, a budget squeeze in which the institution's income, which derives largely from its lending activities, is inadequate to meet its expenses.

Do more extensive self-insurance, regional co-insurance and better economic and financial policies in emerging markets mean that the IMF should radically overhaul its business model? Should its very existence be questioned? These issues are hotly debated, not for the first time in the history of the institution. But the fact that IMF management has come forth with a 'Medium-Term Strategy' for repositioning the Fund in the market-place for ideas and policies suggests that the urgency of these questions is now recognized within the corridors of the organization itself (see IMF 2005a).

Answers to these questions are not simple because the issues are complex. They are not likely to be of the form 'the IMF should get out of the lending business' or 'there is no longer a role for IMF policy advice since policy makers in emerging markets are just as skilled and know their economies better'. But neither do they suggest as wide-ranging and inclusive a set of tasks as enumerated in the managing director's 'Medium-Term Strategy', which is informed by an ambition to expand, or at a minimum to maintain, the institution's role.

II. Crisis Lending

Reasonable people can disagree about the IMF's future as a crisis lender. Sceptics observe that emerging markets' own reserves are now a multiple of the IMF's lending capacity and that the incidence of emerging market crises has declined. They point to a veritable revolution in emerging market finance: borrowing is by the private rather than the public sector, debts are increasingly denominated in local currencies and emerging markets have actually become net lenders. Others caution that weak policies, even if less pervasive, are by no means a thing of the past and that financial vulnerabilities remain. Both positions have a logic, and it is yet to be seen which will stand the test of time. But this very uncertainty means that there is a case for retaining the IMF's capacity to provide emergency financial assistance. Countries do not disband their armies as soon as peace breaks out; rather, they maintain the military force required to provide for contingencies.

The fact that short-term foreign-currency debt is less than in the 1990s and that in many cases it is only a fraction of foreign reserves means that, in the short run, crises will differ from the canonical crisis in South Korea in 1997, when foreign creditors' reluctance to renew maturing obligations pushed the banks and their implicit guarantor, the government, to the brink of default. Debt ratios have declined, maturities have lengthened and a growing share of debt to foreigners is denominated in local currencies. Even if a sudden reluctance on the part of foreign investors to renew their maturing claims creates financial problems for banks and firms, the national authorities can provide the resources needed for repayment, using their international reserves to pay off foreign currency-denominated obligations and printing money to supply the liquidity needed by banks and firms to meet their domestic currency-denominated obligations. That is, they can act as lenders-of-last-resort. To the extent that emerging markets have adopted more flexible currency regimes, the authorities are not prevented from intervening by a commitment to defend a currency peg. Because currency mismatches have been reduced, the decline in the exchange rate will not have such adverse balance-sheet effects.

To be sure, these are arguments for why future crises will differ from their predecessors, not for why no financial crises will take place. In an environment of asymmetric information, there can still be a disorderly decline in asset prices, leading to distress among financial institutions severe enough to disrupt the credit-allocation function (this being what economists mean by 'financial crises'). The question is whether stabilizing intervention will require assistance by an outside body or whether emerging markets, like the industrial countries, are now capable of resolving such problems on their own.

One answer is that resolving such problems unilaterally requires more than just ample reserves. Given the more limited policy credibility of central banks and governments in emerging markets and the limited depth, liquidity and stability of their domestic financial systems, purely domestic intervention not backstopped by the foreign exchange, credibility and expertise of the IMF or an analogous entity may fail to restore confidence; to the contrary, it may only undermine it further. Even if the authorities provide extensive liquidity assistance, local banks will grow more cautious about lending. Equity and real estate prices will decline, reflecting greater uncertainty about the future. The greater the severity of the resulting recession, the more serious the deterioration in bank and corporate balance sheets, and the more severe will be the consequent recession. Where support for market-friendly reforms is tenuous, a political backlash may follow, compounding the confidence problem. In addition, the more serious the deterioration in balance sheets, the more emergency liquidity will have to be supplied by the central bank. If investors expect the result to be more inflation and currency depreciation, their expectations may prove self-fulfilling.[4] In too many emerging markets, a *de facto* or *de jure* currency peg remains the anchor of policy. Large liquidity injections will require abandoning that peg, undermining confidence in the policy regime. In the absence of policy credibility, it may only provoke additional capital flight rather than stemming it, and cause the further collapse of the currency rather than stabilizing it. Ultimately, the authorities may be forced into an Argentine-style bank holiday and a debt moratorium, followed by a not-so-painless restructuring. Given how emerging markets are linked, economically, financially and in the minds of investors, the crisis may spill over to other countries. It is the nature of emerging markets that these problems are

[4]The reluctance of emerging markets to see their exchange rates move suggests that they are aware of these risks. See e.g. Calvo (2006).

more severe and the resulting vulnerabilities are greater than in mature economies.

External support may be critically important under such circumstances. By replenishing depleted reserves, it will allow the authorities to engage in stabilizing intervention without pushing down the exchange rate and destabilizing expectations. By requiring stabilizing policy commitments, it may help to calm overly excited markets.

A second answer to the question of why outside intervention is still relevant is that the favourable financial and policy trends that have reduced the risk of traditional emerging-market financial crises will not last forever. Voters hungry for growth will want to see higher levels of investment, and their demands for additional consumption will limit saving rates. There is no guarantee that the high commodity and energy prices that have supported the international accounts of emerging markets will be a permanent feature of the international economic landscape. All this is to say that they will not run current account surpluses forever. Foreign reserves will not rise indefinitely: governments will find it hard to ignore the opportunity costs of ever-larger reserves, and sooner or later market forces and political pressures will require them to allow undervalued currencies to rise. Although the new generation of populist leaders in Latin America has displayed macroeconomic restraint (Venezuela to the contrary notwithstanding), nothing guarantees that they will continue to do so. The prospect of more limited reserves and less admirable policies, superimposed on the financial fragility that is the defining feature of emerging markets, means that old-fashioned financial crises may be back. Although there is some evidence that contagion has declined with improvements in the information environment, there is still the tendency for investors in markets rendered illiquid by financial difficulties to sell their more liquid claims on other countries in order to raise cash. For all these reasons, it is premature to argue that the IMF can be closed down because a multilateral organization to act as a quasi-lender-of-last-resort is now redundant.[5]

It is still necessary to make the case for the IMF as the logical source of financial support. The alternative is help from one's neighbours, this being what the Chiang Mai Initiative and its less prominent Latin American counterpart, the *Fondo Latinoamericano de Reservas* (FLAR), are designed to provide. But the regional option has limitations. It assumes that the principal regional lenders – say, China in the Asian context, or Venezuela in the Latin American setting – will not themselves suffer a shock that depletes

[5]A true lender-of-last-resort would be able to provide unlimited liquidity, hence the qualifier 'quasi' and the related practice of referring to the Fund as a lender of 'final' resort (Mussa 2006).

their now ample reserves. It assumes that shocks to the regional partners will not be closely correlated – that countries will be able to loan reserves to one another because they do not all need them at the same time. National reserves have tended to co-vary strongly within both Latin America and East Asia.[6] In Latin America, this reflects the common dependence of countries on primary commodity prices and on the US market for both exports and finance. In East Asia, it reflects the growth of regional supply chains and production networks. In both cases, it reflects the pronounced regional component of financial spillovers and contagion.[7] These are arguments for why reserve pooling is more effective when organized globally – in other words, through an entity like the IMF.

A further argument for organizing the provision of assistance globally is the greater capacity of a multilateral like the IMF to apply conditionality. Countries will not loan reserves without a reasonable prospect of getting them back. To ensure this, they will expect policy adjustments. That is to say, they will want to attach conditions to their support. But conditionality is difficult to negotiate between neighbours with complex political relations. This is particularly true in Asia, with its tradition of non-intervention in the affairs of neighbouring countries (see Manzano 2001).[8] The result is a reluctance to actually activate regional supports.[9] In Asia, this problem has been solved by making the extension of currency swaps contingent on a country first negotiating an IMF programme.[10] IMF conditionality may be politically sensitive, but it is less sensitive than conditions imposed by one national neighbour on another. This is another reason why regional entities are unlikely to supplant the Fund as a quasi-lender-of-last-resort.

The problem historically has been that those responsible for IMF conditionality do not know when to stop. Rather than focusing on the restoration of macroeconomic stability, they use the Letter of Intent as an opportunity to apply more pressure for structural reform. This can overload

[6]The Latin American evidence is in Eichengreen (2006), while that for Asia is presented by Dayaratna-Banda and Whalley (2007).

[7]Evidence of the regional component of contagion is in Glick and Rose (1998).

[8]This strongly held tradition, sometimes referred to as the 'Asian way', can be understood as a legacy of Japanese and Western colonialism in the first half of the 20th century.

[9]Revealingly, the Chiang Mai Initiative was not activated when Indonesia suffered problems due to the disequilibrium level of fuel prices in the summer of 2005 or when Thailand had a confidence crisis due to the awkward imposition of capital-account restrictions at the end of 2006.

[10]Under the initial CMI design, only the first 10% of the credit line could be disbursed without the recipient first negotiating an IMF programme. Subsequently, the 'Fund-free' share has been raised several times.

a political system with limited adjustment capacity and do more to undermine confidence than restore it.[11] It can delay agreement. Compliance is weak, which tarnishes the credibility both of the IMF and its client. This encourages the Fund to dribble out assistance in response to signs that its conditionality is being met, where a large down-payment may be needed for confidence.

The observations have motivated discussion, in conjunction with the Medium-Term Strategy, of creating of a new lending window through which countries with strong policies will be provided large loans that are front-loaded, quickly disbursed and lightly conditioned. These discussions echo the recommendation of the International Financial Institution Advisory Commission (2000) that the IMF should concentrate on lending to countries with strong policies that can be identified in advance, prequalified for assistance and require little if any conditionality. The appeal of large loans disbursed quickly is heightened by the enormous liquidity of private capital markets. And, for better or worse, the idea of a 'liquidity facility' where countries are not subjected to onerous conditionality appeals to the IMF as a way of attracting back clients who might otherwise be inclined to invest further in self-insurance.

But it is unrealistic to imagine that the Fund can draw a line in the sand between countries with strong and weak policies, in advance of their need for assistance. A small number of criteria that actually work across countries and over time are hard to concoct, because circumstances change, along with the structure of the world economy. Prequalifying some countries will send an adverse signal about the others.[12] Disqualifying a previously prequalified country because its policies deteriorate, as would be necessary if access for the prequalified was automatic, would almost certainly precipitate a crisis.[13] Executive Directors, who are constantly reminded of their obligation to safeguard Fund resources, will refuse to continue lending without conditions the first time a country has difficulty paying the money back.

[11]As arguably happened in Asia in 1997–98 (although in some cases, like Indonesia, it was the local authorities and not the Fund that pushed for a long list of conditions). Acknowledging the general problem, the IMF adopted new guidelines for streamlining conditionality in 2002, and the Executive Board reviewed experience with those guidelines in 2005 (IMF 2005b).

[12]This will be true even if the Fund unilaterally prequalifies countries rather than waiting for them to apply. And waiting for them to apply may be futile, as they may worry that doing so sends an adverse signal to the markets – which is why no country applied to access the Contingent Credit Line (established in 1999 and allowed to expire in 2003).

[13]IMF management has asserted awareness of this problem (de Rato 2006), but it has not devised an adequate solution.

For two years now, there has been discussion in the Fund of creating an automatic, high-access, quick-disbursing, minimally conditioned facility dubbed the Reserve Augmentation Line (RAL) (see IMF 2006). That these proposals have not been adopted is unsurprising. Automaticity and a simple binary decision of who prequalifies are not feasible. Moving away from a small set of preconditions and adopting a more continuous signal – e.g. access limits that vary with assessments of the ex ante quality of a country's policies – is more likely to work, but the result will inevitably resemble existing lending windows more than the Meltzer Commission's proposal for prequalification based on a few simple criteria. The discretion and judgement of IMF staff, management and the board will unavoidably remain the basis for decisions to provide financial assistance, and if so how much to provide.[14] Conditions will still have to be associated with these loans.

None of this is to question the need to update the way the IMF goes about its lending. Stronger policies and reserve accumulation mean that the days of regular mega-bailouts are over; actual disbursements will be fewer and further between. The IMF will have to learn to lend more selectively. Dramatic changes in the structure of emerging market finance – with private borrowing replacing public borrowing, local markets replacing international markets and liquidity expanding almost unbelievably – mean that future crises will differ from past crises. Faster-moving, more liquid markets create the need to speed decision making and front-load assistance. They heighten the need for focused conditionality targeted at key vulnerabilities and designed to signal credible policy commitments, because the size and liquidity of private markets mean that the IMF will not be able to solve problems simply through the provision of money.[15]

But this updating of IMF lending will have to be carried out in the context of existing lending procedures – including high-access precautionary arrangements, where countries arrange for credits but do not draw – rather than by creating a trendy new facility. Even if the Fund creates a new lending

[14]Thus, schemes for strictly limiting the amount of financial assistance (say, to 300% of quota) are not likely to be viable, for similar reasons.

[15]These points explain the otherwise troubling observation that governments find it difficult to negotiate commercial credit lines providing protection against volatility and contagion – credit lines that would obviate the need for the IMF to act as a lender-of-final-resort. That governments find such loans prohibitively expensive or impossible to secure reflects worries on the part of the lenders that policies might deteriorate, perhaps in response to the crisis, and that a credit line negotiated in advance may not be repaid, hence the (continued) need for IMF conditionality. Thus, arguing both that IMF loans to countries currently running strong policies can be free of conditions and that IMF loans to such countries are needed (because they cannot negotiate commercial insurance at reasonable rates) is logically inconsistent.

window that pays official obeisance to precommitment and automaticity, it will differ from existing windows only in its details. The RAL is dead. Long live the RAL.

III. Surveillance

Questions should also be raised about IMF surveillance, given that this activity absorbs the lion's share of the Fund's operating budget in a period when the institution is running a sizeable deficit. Like members in deficit, should the IMF itself be forced to undergo a structural adjustment, downsizing and cutting back its surveillance, given the growing sophistication of developing-country policy makers and the capacity of rating agencies, investment banks and mutual funds to assemble information on their policies?[16]

The idea that markets and national officials know better, rendering the IMF's data gathering, data dissemination and policy-analysis-and-advice functions redundant, has been around for years – along with compelling counterarguments. Some information has the character of a public good: it is non-excludable, limiting the incentive for individual market participants to invest in assembling it because the returns are incompletely appropriable.[17] Governments may be reluctant to divulge it, given uncomfortable economic and political consequences. Through its Data Dissemination Standard, its Special Data Dissemination System and its Code for Fiscal Transparency, the IMF can help to promulgate international standards for transparency and apply peer pressure to comply.

Article IV consultations are similarly an opportunity to convey information about international best practice regarding the making of fiscal policy, the conduct of monetary policy and regulation of the banking and financial system. Countries learn from the experience of other countries through multiple channels, but Article IV consultations are one of these. Staff reports and Executive Board discussions can ratchet up the pressure for policy

[16]Space does not permit systematic analysis of the IMF's budgetary situation. Management has cleverly charged an independent committee with proposing schemes for augmenting the Fund's financial resources while asking it to leave aside questions about the expenditure side. (For its report, see Committee to Study Sustainable Long-Term Financing of the IMF 2007.) The result has been to focus discussion on alternative sources of revenue to the neglect of curtailing expenditure.

[17]It is revealing in this connection that the rating agencies, which are private purveyors of information, rely heavily on published IMF reports. The point applies not just to information gathering but also to the Fund's economic analysis, especially of small countries, in which the rating agencies invest limited analytical resources.

adjustments that governments might otherwise resist for political reasons. And site visits are a way for IMF staff to learn about the situation in a member country, enabling the institution to make informed lending decisions.

This is not to question that the Article IV process and surveillance generally should be updated for the 21st century. Visiting every country every year is expensive and time consuming; the Fund should better target its resources at systemically significant countries with visible vulnerabilities.[18] Not even an organization of nearly a thousand PhD economists has in-house expertise on the entire range of relevant issues. It should therefore co-opt more outside experts for its Article IV missions and Financial Sector Assessment Programs. Surveillance of capital markets should pay more attention to how the characteristics of its financial liabilities expose a country to fire-sale liquidation by investors who see a decline in the value and liquidity of their claims on other emerging markets, and not simply compute indices of debt sustainability and mismatch.[19] The institution's ability to apply pressure for pre-emptive policy adjustments would be enhanced by a decision to make obligatory the publication of staff reports and board discussions of Article IV reviews.

An increasingly controversial aspect of surveillance is the exchange rate. This issue has a long history as well. The breakdown of the Bretton Woods System of pegged but adjustable rates forced the IMF to re-think its oversight of exchange rate policies. This led to the second amendment to the Articles of Agreement, which obliged members to avoid manipulating their currencies and recognized exchange rate policies as a legitimate subject for surveillance. The Argentine, Brazilian, Mexican and, especially, the Asian crises then strengthened the argument that the Fund should be pushing harder for more flexible exchange rates (as in Eichengreen 1999). The traditional interpretation of the Articles of Agreement is that a country can adopt the exchange rate regime it prefers; its responsibility and that of the Fund are to ensure that domestic policies are consistent with that choice.

[18]Some preliminary steps have been taken: consultations with a few countries have been streamlined by limiting every second visit to a narrower range of issues and by limiting actual visits, in a few cases, to every second year. But the effort has not been systematized.

[19]Because they use positions in more liquid markets to hedge stakes in less liquid markets, if an adverse shock to the relatively illiquid markets materializes they then have the option of selling holdings of more liquid instruments to reduce the net loss from the portfolio. This creates a tendency for volatility to spill across countries, as we saw when tiny Iceland had problems in 2006.

Recent experience suggests that the IMF needs to stake out a stronger position. Regimes of limited flexibility are dangerous both for the countries running them and for the international system.[20] The Fund needs to push harder for the abandonment of crisis-prone regimes and of policies designed to sustain unsustainable rates. But the 1977 decision of the Executive Board, which provides management and staff guidance on the surveillance of exchange rates, gives them little leeway for greater assertiveness.[21] On 18 June 2007, the Fund announced that its Executive Board had agreed to new exchange rate surveillance guidelines, but at the time of writing no details had been released.[22]

The elephant in this room is, of course, the Chinese renminbi. This is not the place to explain why a renminbi tightly linked to the dollar is bad for China and a problem for the world economy. But those who regard it as such argue that the IMF should be more forceful in demanding its adjustment. Goldstein (2006) argues that the IMF should draw up a code of conduct for acceptable exchange rate policy that rules out practices, like extensive one-way intervention in foreign exchange markets, indicative of efforts to maintain the exchange rate at disequilibrium levels, and that it should embed that code in new surveillance guidelines. Country surveillance is one context in which to identify disequilibrium rates; another could be a regular semi-annual report on the exchange rate policies of all members. Where there is evidence of a disequilibrium rate, the managing director could call loudly for changes. He could initiate an ad hoc consultation, as he is in fact authorized to do by existing surveillance guidelines.[23]

Common objections to these proposals – that a more assertive stance would conflict with the IMF's status as a trusted advisor of governments, that exchange rate policy is too delicate a national prerogative for the Fund to interfere, that the choice of exchange rate is a domestic matter without

[20]To be sure, countries with strict controls on international capital flows have more scope for safely limiting flexibility. Even for those with open capital accounts, greater flexibility need not mean free floating. For a limited subset of countries, unilateral dollarization or membership in a regional monetary union are viable options. But I have long argued that these caveats do not change the general point.

[21]The board reviewed exchange rate surveillance in 1993 and 1999 but failed to address the key problems.

[22]Press reports suggests that guidelines for identifying misaligned rates will include persistent one-way intervention, large-scale reserve accumulation and 'fundamental misalignment' (Guha 2007).

[23]Such ad hoc consultations have been conducted only twice, with Sweden in 1982 and South Korea in 1987, despite a 1993 decision of surveillance guidelines designed to encourage their greater use.

implications for the international system – are unconvincing or simply wrong. But there are two important obstacles. First, identifying disequilibrium exchange rates is not easy. Some, like Williamson (2006), propose a relatively mechanical procedure where staff computes the equilibrium exchange rate – perhaps using Williamson's own model. Minor deviations from reference rates would be allowed, but significant deviations would trigger special consultations. But there is no consensus on how to compute the equilibrium or reference exchange rate. There are alternative conceptual frameworks, alternative empirical models, and – unavoidably – a range of estimates. Computing and publishing a single set of reference rates would give the process a spurious sense of precision and undermine its credibility.

It would be better to compute a range of estimates based on a variety of analytical frameworks, empirical models and forecasts of macroeconomic developments. The Fund has taken a step in this direction by reviving its staff Consultative Group on Exchange Rates (CGER), extending its coverage to the major emerging markets and encouraging it to provide a range of estimates. Similarly, staff's judgement of how serious a threat to domestic and international financial stability is posed by a potential deviation will have to inform the decision of whether to make an issue of it.

Second, the IMF will still have limited ability to encourage the abandonment of disequilibrium rates, especially in cases of undervaluation. So long as a country is willing to bear the cost of sterilizing the associated capital inflows, the Fund cannot force the issue. The message from the bully pulpit will be heard, but it will not always make converts.

To be sure, buying as well as selling attacks on disequilibrium exchange rates are possible.[24] By publishing the results of its CGER exercise (something that individual members have been able to resist, even when the Article IV report is published, in the absence of a decision by the Executive Board), the Fund can ratchet up the pressure. By declaring in no uncertain terms that a currency is undervalued and that it will have to appreciate in short order, the Fund can encourage the capital inflows that will force the issue. To be sure, when this country has capital controls and can force-feed sterilization bonds with low interest rates to the domestic banking system, this mechanism is relatively feeble. As in China's case, the problem of limited leverage remains. Trade sanctions would be a more formidable weapon.[25] But for those concerned with the stability of what is already a fragile global trading

[24]The classic model is Grilli (1986).

[25]Authorizing them would require governments to file a case against China's currency policy as a 'frustration of trade commitments' with the World Trade Organization, as part of which they would cite the Fund's exchange rate report. The WTO route is discussed by Bergsten (2007).

system, the costs of this 'nuclear option' would almost certainly exceed the benefits.

The choice of exchange rate regime is, of course, only one of a constellation of policies affecting internal and external balance, which also includes the monetary policy operating strategy, the stance of fiscal policy and the nuts and bolts of debt management. In the case of a large country, that choice and those related policies will affect not just the domestic economy but also the rest of the world – and conversely. When the result is large international imbalances, it is conceivable that these may unwind in a disorderly fashion, placing the stability of the world economy and its financial system at risk. Boiled down to a couple of sentences, this is the rationale for establishing the new Multilateral Consultations Initiative in 2006 and making global imbalances the subject of the first consultation. A group of policy makers from systemically important countries and regions (in this case, the United States, China, Japan, Saudi Arabia and the euro area) are brought together, first for bilateral discussions with the Fund and then for multilateral consultations under its chairmanship. The result, hopefully, is a mutually beneficial set of policy adjustments that would not occur in the absence of reciprocity.

The initiative in general and the focus on global imbalances in particular are heavily criticized. They are seen as the IMF stepping into an arena where it does not belong and identifying a problem that does not exist. To be sure, that national policies have cross-border spillovers is uncontroversial.[26] The analytical literature shows that the non-cooperative equilibrium that results when national policy makers fail to internalize those externalities is Pareto inferior to its cooperative counterpart.[27] But it has been argued that such inefficiencies are of second-order importance and that giving them undue attention distracts policy makers from more important matters.[28] In the current context, it is argued that global imbalances simply reflect the optimizing decision of agents (the desire for high savings in Asia, the

[26]This observation has long been recognized as a valid rationale for IMF activities. The Fund regularly conducts simulations of a multi-country model and not infrequently publishes the results in its biannual *World Economic Outlook* (*WEO*). The *WEO*, together with the institution's other flagship publication, the *Global Financial Stability Report*, are exercises in multilateral surveillance predicated on the fact that bilateral surveillance organized on an individual-country basis does not adequately address the combined effect of national policies on the global economy, its financial system and risks to systemic stability.

[27]Two summaries of this literature are Canzoneri et al. (2001) and Meyer et al. (2002).

[28]Like many other IMF-related controversies, this one is not new. It arose in the 1980s when the Fund sought to expand its role in promoting the international coordination of macroeconomic policies and was criticized in, *inter alia*, Feldstein (1988).

attractiveness of investment in the United States) and that any risk to the stability of the global economy is negligible. Rather than being fixated on international imbalances, policy makers should attend to the monetary, fiscal and financial fundamentals. From this point of view, it is not surprising that governments are unwilling to concede major policy adjustments when brought together by the IMF.

The counterargument is that observed imbalances reflect misguided policies resulting in excessive fiscal deficits and inadequate household savings in the United States and the continued commitment to an unsustainable exchange rate in China, and that the longer these are unchanged the greater the risk of a disorderly correction. But even if there is only a small chance of a large disruption, there is still a justification for consultations designed to achieve modest policy adjustments to head it off.

A second criticism is that the very limited results of the first multilateral consultation end up discrediting the process and damaging its sponsor. Following almost a year of consultations, in the spring of 2007 the IMF released a statement by the countries participating in the first consultation (see IMF 2007b). The US government acknowledged, as it had in the past, the desirability of cutting its budget deficit and raising household savings but without committing to any new policies to do so. China acknowledged the desirability of greater exchange rate flexibility, as it had in the past, without committing to any actual changes in policy. If this was supposed to be a demonstration of the ability of the IMF to coordinate mutually beneficial policy adjustments, then it was not effective.

The counterargument is that the exchange of views that took place during the course of this consciousness-raising exercise – for that was all that it was – may yield results down the road. Fund staff will refer to these commitments in future Article IV consultations and call countries to task for failure to show progress. Governments will feel more pressure than otherwise to follow through on their commitments, however limited these may be and even if they were announced before the actual Multilateral Consultation. This longer view is appropriate, it is argued, because global imbalances are a medium-term problem that needs to be addressed in the medium term; sharp policy adjustments now would be counterproductive. Alternatively, it could be that these medium-term commitments are quickly forgotten. And if the unwinding of global imbalances comes soon and proves disruptive, failure to take concerted action in the short term will have been an opportunity missed.

The more general case for the initiative is that there is no other venue for a systematic exchange of views, in the presence of an impartial mediator, by the relevant countries. The G-7 is no longer appropriately configured. The G-20 is too large. There needs to be a mechanism for constituting a flexible grouping tailored to the issue at hand, whose members are chosen by an impartial body. While the first multilateral consultation may have failed to produce anything of substance, the IMF should not abandon this new part of its business model. But to avoid discrediting the exercise, it should avoid creating unrealistic expectations and claiming too much after the fact.

IV. Governance

An additional reason why emerging markets are disenchanted with the IMF is that the quota formula that determines voting shares and country representation on the 24-member Executive Board that oversees management and staff on a day-to-day basis have not been updated to reflect their rapid growth.[29] They suspect that the IMF is simply a mechanism for US and European foreign policy by other means. Mr Chavez may be posturing when he dismisses the Fund as an instrument of American imperialism, but the broader dissatisfaction is real. It is intensely felt in Asia, where it is believed that the IMF misdiagnosed the region's financial crisis partly because Asian countries were inadequately represented in the institution. This feeling raises questions about the legitimacy of the Fund and in turn about its policy advice, which do nothing to enhance their respective effectiveness.[30]

The argument against more seats and votes for emerging markets is, to put it impolitely, that this would allow the inmates to run the asylum. Banks and lenders cannot be run by the borrowers; the moral hazard would be too great. The flaw in this argument is that the IMF has never been exclusively a lending institution and, as the preceding sections show, it is likely to focus even less exclusively on lending in the future. In so far as its role is to encourage the adoption of codes and standards for data dissemination, fiscal transparency and exchange rate policy, the Fund's effectiveness will require adequate voice and representation for all its members, whether historically borrowers or lenders. In so far as the IMF orchestrates multilateral consultations, it similarly must be seen as answering to all its members.

At the annual Bank–Fund meetings in Singapore in September 2006, the members agreed to conclude a comprehensive quota revision within two

[29]Quotas also determine the members' obligation to provide financial resources to the Fund and provide a loose metric of how much they can borrow from the institution.

[30]Doubts about the representativeness and competence of the board are thus another reason why emerging markets are attracted to the idea of the RAL (described in Section II), as prequalification on the basis of specified criteria would free them from the misjudgement of directors when they apply for assistance. Real governance reform could thus eliminate the problems with an RAL by eliminating the need for it.

years. A down-payment was made in the form of increases amounting to 1.8% of total current quotas for four underrepresented emerging markets, China, South Korea, Turkey and Mexico, and more staff resources were committed to the two Executive Board chairs representing African countries, with the heaviest work loads.[31] But there is little evidence of progress on comprehensive quota reform sufficient to meet the two-year deadline or of concrete steps to reform of Executive Board representation.

Predictably, while every country wants an increase in its voting share, none welcomes a reduction, and there is no magic formula for achieving both equity and efficiency. Leverage in reform discussions reflecting current quotas, new quotas tend to be only minor changes on old ones. These facts become problematic when change in the world economy is rapid and cumulative. Politicized negotiations become more difficult in a more multi-polar world. The resulting incremental changes in voting shares do little to enhance legitimacy and restore trust in the institution. If, after labouring on quota reform for two additional years, the IMF only produces a mouse, its credibility will have been tarnished further.

One solution would be to delegate the design of a new quota formula to an independent panel of experts. Such committees have been constituted before, of course: Richard Cooper of Harvard University chaired one at the beginning of the decade (see IMF 2000). But its recommendations, which did not meet with the satisfaction of many members, were not adopted.[32] For delegation to work, it would be necessary for governments to commit, by a binding vote, to accept the committee's determination under the veil of ignorance – that is, before its release.

Whether they would be willing to do so depends in part on how much faith they have in the management and board that would presumably oversee the appointment of that committee. This brings us to the other place in the Fund's corridors where history casts a long shadow. European countries have eight members on the Fund's 24-person Executive Board (nine when Spain periodically chairs its predominantly Latin American constituency) because a set of small European countries had a head start on industrial and financial development and figured disproportionately in

[31] In addition, the resolution adopted in Singapore agreed to increase the basic votes received by every member (additional votes being proportional to quotas), as quotas had been increased a number of times but basic votes had not been raised.

[32] The committee recommended a simple formula, with a two-thirds weight on GDP at market prices and exchange rates and a one-third weight on the variability of current receipts and long-term capital flows. The problem, as many members saw it, was that adoption of this simplified formula would have further increased the quota shares of the advanced countries as a group.

international trade and financial transactions when the Fund was established, and because convention is slow to change. Their presence on the board is out of proportion to their current weight in the world economy. The members of the euro area have only one monetary and exchange rate policy, creating a logic for why they should function as a single entity in the IMF. That the euro area was one of the five parties in the first Multilateral Consultation underscores the point.[33]

Consolidating euro area countries in a single chair would free up seats on the Executive Board for emerging markets complaining of inadequate voice.[34] This is more urgent than revising the quota formula, as board representation is more severely out of line, and as most important decisions in the Fund are reached through discussion in the board leading to consensus, and not by formal votes.

But small European countries accustomed to seats at the table are reluctant to give them up.[35] Arrangements where they chair constituencies dominated by emerging markets are the one surviving reminder of imperial grandeur and global influence now past. But attempting to perpetuate this is short-sighted: European countries can be more effective in achieving their goals in the Fund if they speak with one voice instead of each having to modulate their views in different ways as a result of representing mixed constituencies.[36] To the extent that they value the institution, European governments should recognize that their overrepresentation on the board poses a threat to its legitimacy. IMF management, which was too polite to broach the issue in its 'Interim Strategy', must now force it.

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[33]Moreover, staff already drafts a regional report on the euro area, which is then discussed by the board. More generally, there being no scope for currency crises within the euro area, there is no more logic for considering the trade and financial flows between them in an updated quota formula than there is in considering flows between different Federal Reserve Districts.

[34]It would also permit the board to be downsized, which would cut costs and speed decision making, as argued by Linn and Bradford (2006) and Truman (2006). To conserve space, this discussion avoids complex issues about whether European, European Union or euro area representation should be consolidated and if so how in how many chairs. These issues are the subject of Ahearne and Eichengreen (2007).

[35]See for example the report of Swann and Louis (2006).

[36]Bini-Smaghi (2006) and Leech and Leech (2006) show that a unified euro area would become a swing voter on many issues. In fact, the EU has already made progress in coordinating national policies in the Fund by creating SCIMF, a Subcommittee on IMF-related issues in the Economic and Financial Committee, for which Directorate General EcFin (DG2) of the European Commission acts as secretariat, and EURIMF, an informal committee of EU countries' representatives in the IMF.

A final step toward enhancing legitimacy and trust in the institution, as well as potentially increasing its efficiency, is reforming management selection. The convention by which the United States selects the president of the World Bank and European governments nominate the managing director of the IMF is an archaic inheritance. The absence of open process in which all members can nominate candidates, who then campaign publicly for the position, suppresses competition in the marketplace for ideas. The case of Paul Wolfowitz at the World Bank may be extreme, but it illustrates how collusion in management selection between the United States and Europe undermines trust in the Bretton Woods institutions.

The preceding position is not exactly controversial. (We can at least thank Wolfowitz for this.) The harder question is how to engineer meaningful change. Simply announcing that the head of the IMF no longer needs to be a European (and the head of the World Bank no longer needs to be a citizen of the United States) does not guarantee the selection of a more competent CEO. Given the way electoral campaigns are run in many countries (not least my own), having nominees campaign actively for the position is no guarantee of a high-quality intellectual debate.

This is not to deny that the reform of leadership selection is important symbolically. The same can be said of quota reform, which is also probably more important for symbolic than practical reasons. But symbolism matters. Quota shares and leadership selection matter because countries think they matter. And what countries think is important for an institution seeking to maintain and enhance its legitimacy.

V. Conclusion

Formulas for IMF reform are not simple because the economic and political environment in which the Fund operates is complex. I have argued that the need for a quasi-lender-of-last-resort has not evaporated. When global economic and financial conditions become less favourable, that need will be back. Reserve pooling and crisis lending are more cost effective and politically tractable through the Fund than through regional arrangements. The growth of global financial markets means that the institution will have to respond more quickly and front-load its assistance. But in practice this will mean streamlining its existing procedures, not establishing some mechanical new procedure or lending without conditions.

Continuing the lending function implies continuing surveillance. The compliance of members with standards and codes for fiscal and financial transparency should be closely monitored. The focus on financial vulnerabilities and on exchange rate policy, which are connected, should increase further. As the world is becoming more multilateral, surveillance must become more multilateral. Notwithstanding the very limited results of the first Multilateral Consultation, the general initiative should continue.

But the Fund can effectively execute these functions only if it enjoys legitimacy and trust. This is why governance reform is needed to reflect changes in the weight of countries in the global economy. This is why the issue of leadership selection needs to be addressed urgently and decisively.

A comprehensive agenda would feature still other items – including important ones that tend to be missing from the institution's own Medium-Term Strategy. The IMF should get out of the business of combating terrorist financing, which is tangential to its mission and in which it has no special expertise. The Poverty Reduction and Growth Facility should be transferred to the World Bank, which is a more suitable institution for providing development assistance. The fact that many of the Fund's stakeholders are developing countries means that it may not succeed in getting out of the development-lending business, but it should try.[37] Much of the IMF's work on financial development should also move to the Bank; the Fund should concentrate on the development of markets and instruments, such as contingent securities that pay off under unfavourable financial circumstances, most directly relevant to its crisis-prevention efforts.[38] Larger global financial markets imply the need for more loanable funds, which implies the need either for significant quota increases or authorization for the Fund to access capital markets.[39] At the same time, the institution needs to put its own operations on a sustainable financial basis, partly by downsizing and restructuring. Thought should be given to more far-reaching changes in the Fund's own management structure to bring it into line with modern corporate governance standards.[40] One could go on, but this is already enough to induce a sense of reform fatigue. The fundamentals of crisis lending, surveillance and governance should be the focus in the short run.

[37]This was the (admittedly carefully couched) message of the Malan Report on Bank–Fund collaboration (IMF 2007c).

[38]The role of the official community in encouraging the incorporation of collective-action clauses into international loan contracts is an example of how it can promote the development of innovative instruments with attractive risk-sharing characteristics.

[39]Alternatively, one can imagine emerging markets allocating some share of their reserves to a pool for emergency lending to be administered on their behalf by the Fund. This would get around some of the problems of suboptimal risk-sharing properties and political problems with regional arrangements, but it would be tantamount to an increase in emerging markets' financial commitments to the Fund without a commensurate increase in their voting rights, which would not be viewed as attractive.

[40]As argued by Santor (2006). Specific proposals for doing so include De Gregorio et al. (1999), Kenen (2006) and King (2006).

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