April 8th: The Role of the IMF
The IMF is supposed to be the steward of global financial stability, but it is accused by its critics of aggravating financial crises.

Both sides argue that the Fund needs to reform itself. Some extreme critics, like George Shultz of Stanford University, have gone so far as to call for its abolition.

[Note that I ignore the other Bretton Woods twin – the World Bank – in part because I think the case for it is much harder to make in a world of active international financial markets.]
Over its history, the IMF has repeatedly reinvented itself

- It was created in 1944 as the steward of Bretton Woods System of pegged but adjustable exchange rates.
- When pegged but adjustable rates disappeared, it sought to become the orchestrator of policy coordination between the US, Europe and Japan in the 1970s.
- It turned to management and resolution of the Latin American debt crisis in 1980s.
- It focused on problems of transition in formerly planned economies in 1990s.
- It has now broadened its focus to a wide range of issues: multilateral surveillance, threats to financial stability, money laundering, underdevelopment in Africa, even the global fight against AIDS and malaria.

- A bureaucracy in search of a mission?
Understanding this evolution

- The IMF was created to oversee and support the operation of pegged but adjustable exchange rates.
- But more and more countries have moved away from this regime (Europe to EMU, developing countries to freer floats)
  - At right are emerging and developing countries.
  - Note the decline in the bars in the middle block of three.

Understanding this evolution

- The IMF was created to help coordinate exchange rate management in a world of low capital mobility.
- The recovery of capital mobility was integral to postwar normalization and growth, as we have seen.
- The advanced countries all have open capital markets. A growing share of developing countries do as well.
  - Note how the red bars are growing ever smaller.
These two trends are related, as we’ve seen

- With the rise of capital mobility, pegged exchange rates became a thing of the past.
- So the management of currency crises (attacks on pegged rates) gave way to management of financial crises more broadly defined.
But this created challenges for the Fund

- Old responsibilities evaporated.
- The amount of finance needed to deal with new ones increased as capital markets became more liquid.
  - (IMF lending as a share of world exports at right.)
- This created political challenges (who would pay?).
- It also created fear of moral hazard (the Fund as an “engine of bailouts”).
- Modern financial markets moving quickly, it was not clear that the IMF’s laborious decision making was up to the task.
- As financial systems were liberalized, officials charged with heading off and resolving crises necessarily became concerned with an exponentially expanding range of issues.
- But, unlike a domestic lender of last resort, the IMF had a limited capacity to mandate and enforce change. Conditionality necessarily became contentious.
These observations help us understand why IMF became so controversial in the 1990s

- The range of domestic policies with which the IMF gave advice and applied conditions expanded enormously (from exchange rate and macro policy to financial supervision, transparency, corruption, good governance, etc. etc.).
  - This was a response to the changing nature of the problem. High capital mobility erased the line between domestic and international financial markets. International stability therefore required domestic stability.
  - But the expansion of conditionality also had an element of “mission creep.” It made the Fund’s advice more invasive.
  - And didn’t warning of structural problems that are deeply embedded and hard to root out only threaten to precipitate the very crises of confidence that the IMF was seeking to prevent?
And, as already noted, the amount of money at stake escalated as old-fashioned current-account crises have given way to new-fangled capital-account crises.

- To the right we see IMF lending as a share of world exports.

- This excited the IMF’s critics in the creditor countries.
iClicker question: is there a rationale for the continued existence of the IMF?

A. Yes, the IMF can do a better job than national governments and rating agencies of warning of future crises.

B. Yes, it is desirable to have the IMF to provide emergency assistance to crisis countries.

C. Yes, the IMF can act as a fair broker in helping to coordinate the policies and adjust the exchange rates of big countries.

D. No.
Three contested rationales for the IMF in the 21st century

- **To signal early warnings**
  - But every generation of crises is different.
  - And can the IMF really predict the future on the basis of the past?
  - On the other hand, it may not have the conflicts of interest that hinder national officials and the rating agencies.

- **To provide emergency loans**
  - But no one seems to want to borrow at the moment (that’s why they are building up their reserves).
  - See the picture at right.

- **To coordinate macroeconomic and exchange rate policies.**
  - But how important is policy coordination, really?
  - And will the big countries listen?
What are the instruments with which the IMF carries out these tasks?

- **Surveillance** (involves identifying risks that might lead to crises with an eye toward correcting them in advance).

- **Adjustment lending** (involves supporting efforts to eliminate those problems by extending temporary financial assistance)
  - Recall the case of the EPU.

- **Conditionality** (making the provision of assistance conditional on the adoption of specific policy adjustments and reforms by the member)
  - Recall we saw its origins when we discussed the Marshall Plan.

- We will consider the controversies surrounding each of them.
Forms of IMF surveillance

IMF Surveillance

- **WEO GFSR**
- **Multilateral Surveillance**
- **Bilateral Surveillance**
- **Article IV Consultation**

**Overseeing the international monetary system as a whole**

**Assessing member countries’ economic policies**

**Exchange Rates**

*2007 Decision on Surveillance over Exchange Rates*

*Consultative Group on Exchange Rate Issues (CGER)*
1. Surveillance

- Official view: the integration of domestic and international capital markets means that any shortcomings of domestic regulation can have international consequences. Domestic regulatory weaknesses can now interact destructively with international capital flows.
  - In a country where the banks borrow in dollars for example, a creditor panic that causes its funding to evaporate cannot be offset by the central bank unless the latter is also flush with dollars.
  - Where corporate governance is week, firms will borrow excessively offshore in hopes of being bailed out (recall our discussion of the Asian crisis, last time)

- Preventing crises thus requires policies to upgrade auditing, accounting, bankruptcy procedures, corporate governance, etc, etc. (and IMF surveillance of the same).

- Thus, IMF surveillance has been extended from monetary and fiscal policies to a host of new issues: prudential supervision and regulation, accounting, auditing, corporate governance, and financial transparency.
But the Fund lacks expertise in these new issue areas

- According to its critics*, the Fund should focus on monetary, fiscal and exchange rate policy; lacks competency in other areas.
  - Therefore needs to figure out how to “contract out” the process.
- There is also a problem of staff overload
  - Especially, given the institution’s own budget deficit and staff cutbacks.
- It needs to focus its surveillance on problem countries rather than visiting every member every year.
  - It has taken some early steps in this direction but can go further.

Exchange rate surveillance

- The IMF’s official line is that a country can adopt any exchange rate regime it wishes so long as domestic policies are consistent with its maintenance.
- But this ignores overwhelming evidence that regimes of limited flexibility are crisis prone risky. IMF should be more forthright in criticizing them and urging countries to move away from them.
- IMF has also been reluctant to criticize rates as significantly over- or undervalued.
  - Case in point: China’s renminbi (whose exchange rate policies we will discuss next time).
New exchange rate decision

- In the summer of 2007 its Board adopted a new Exchange Rate Surveillance Decision, authorizing staff and management to analyze problems of over and undervaluation and be more forceful in their criticism.
- China dissented from this decision.
- It is yet to be seen whether the institution will significantly modify its actions and issue more forceful advice and statements concerning exchange rates.
- And it is yet to be seen whether countries (especially big countries like the US and China) will listen.
Surveillance of capital account policies

- In 1997 the IMF’s Managing Director announced his intention of amending the Articles of Agreement to make capital account convertibility an “obligation” of Fund members.

- Subsequently stepped back from that policy, which many critics thought was premature and dangerous.

- Fund has now adopted a more cautious view of capital account liberalization.
  - This has been evident in its advice to China.
  - Thus, it does appear that the IMF is a learning institution.

- One can read statements like (by IMF chief economist):
  “these days, everyone agrees that a more eclectic approach to capital account liberalization is required...[but] hard work remains to be done on capital account liberalization and its sequencing with other policies to find the point at which the benefits to further capital market integration stop exceeding the costs.”

- But this recognition was late in coming.
What about problems that require coordinated adjustments by multiple countries to head off threats to stability (like “the correction of global imbalances”)?

Threats to systemic stability that no single country can eliminate by itself (or that no single country has an incentive to address unilaterally) are exactly why the IMF exists.

Yet it has traditionally lacked mechanisms for addressing these issues.

- For years, the main vehicles for multilateral surveillance (that is, for warning of these threats and suggesting corrective action) were its biannual reports, the *World Economic Outlook* and *Global Financial Stability Report*.
- There was also scope for talking about these matters in the Board, but a board of 24 chairs representing 180 countries was unwieldy for this purpose.
To address problems like this, 2006 the Fund established a Multilateral Consultations Initiative

- This is designed to bring together key countries on an ad hoc basis.
- First bilateral consultations with each and the Fund, then multilateral consultations.
- First round was concerned with global imbalances and brought together US, euro area, Japan, Saudi Arabia, Japan and China.
- But this was largely a consciousness raising exercise.
- Nothing but agreement to do what countries were doing anyway came out of this.
- A problem is that the Fund lacks an enforcement mechanism in this context.
- Is it realistic to think that it might acquire one?
Lending and conditionality

- IMF has few customers currently
  - The only middle-income country that is borrowing is Turkey.

- Disbursement procedures are laborious.
  - Long decision making process.
  - IMF assistance is “tranchéd” (disbursed in a long series of small increments).

- Conditions are viewed as onerous and as doing more to undermine confidence than restore it.
Is the solution a new quick-disbursing facility?

- There is a perceived need to provide more up-front assistance, quickly, to countries suffering capital-account crises for reasons not of their own making.
- Hence the desire to prequalify countries.
  - Such countries have strong policies, so they can be prequalified without the need for onerous conditionality.
- Contingent Credit Line, established in 1999, was first attempt.
  - No one applied. (Groucho Marx problem…)
- Now the IMF proposes to try again; this time it will unilaterally decide what countries are prequalified.
  - But here the problem is that previously-prequalified countries will have to be un-prequalified if their policies deteriorate.
  - Won’t this open the IMF up to the criticism that it is precipitating crises?
- Only solution is probably more business as usual, but in streamlined fashion.
Governance problem

- Rising economic powers have not been given votes or influence over decision making in the Fund commensurate with their role in the economy.
- This is specific instance of the general problem of governing globalization.
- It also should remind us of how inability to accommodate rising powers at the beginning of the 21st century helped set the stage for the first globalization backlash and World War I.
How the Fund operates

- Executive Board: 24 members, some representing individual countries, others representing groups of countries ("constituencies").
- Directors take instructions from national governments and oversee day-to-day decisions.
- Voting shares proportional to quotas, which are supposed to be determined by a complex formula involving country size, openness, and export variability, but in practice reflect historical considerations (incumbents being reluctant to give up their dominance).
- Notice the dominance of the US, France, Germany, Japan (dominant economic powers in the third and fourth quarters of the 20th century) and how countries like China and India are far down the list.

(see next slide)
## Voting Shares

<table>
<thead>
<tr>
<th>Country</th>
<th>Vote share 1999</th>
<th>GNP (PPP) share 1997</th>
<th>Trade share 1997</th>
<th>Over (+) or Under (-) representation</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>17.5</td>
<td>20.8</td>
<td>13.7</td>
<td>1.1</td>
</tr>
<tr>
<td>Japan</td>
<td>6.3</td>
<td>8.0</td>
<td>6.9</td>
<td>-1.1</td>
</tr>
<tr>
<td>Germany</td>
<td>6.1</td>
<td>4.7</td>
<td>8.9</td>
<td>-1.4</td>
</tr>
<tr>
<td>France</td>
<td>5.1</td>
<td>3.5</td>
<td>5.3</td>
<td>0.4</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>5.1</td>
<td>3.3</td>
<td>5.2</td>
<td>0.5</td>
</tr>
<tr>
<td>Italy</td>
<td>3.3</td>
<td>3.1</td>
<td>4.4</td>
<td>-0.6</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>3.3</td>
<td>0.3</td>
<td>0.8</td>
<td>2.7</td>
</tr>
<tr>
<td>Canada</td>
<td>3.0</td>
<td>1.8</td>
<td>3.4</td>
<td>0.2</td>
</tr>
<tr>
<td>Russia</td>
<td>2.8</td>
<td>1.7</td>
<td>1.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.4</td>
<td>0.2</td>
<td>3.2</td>
<td>0.3</td>
</tr>
<tr>
<td>China</td>
<td>2.2</td>
<td>11.9</td>
<td>2.5</td>
<td>-1.6</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.2</td>
<td>0.6</td>
<td>2.8</td>
<td>0.1</td>
</tr>
<tr>
<td>India</td>
<td>2.0</td>
<td>4.3</td>
<td>0.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1.6</td>
<td>0.5</td>
<td>1.7</td>
<td>0.3</td>
</tr>
<tr>
<td>Australia</td>
<td>1.5</td>
<td>1.0</td>
<td>1.2</td>
<td>0.4</td>
</tr>
<tr>
<td>Spain</td>
<td>1.4</td>
<td>1.7</td>
<td>2.2</td>
<td>-0.6</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.4</td>
<td>2.8</td>
<td>0.9</td>
<td>0.1</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1.3</td>
<td>0.5</td>
<td>0.3</td>
<td>0.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>1.2</td>
<td>2.1</td>
<td>1.6</td>
<td>-0.4</td>
</tr>
<tr>
<td>Sweden</td>
<td>1.1</td>
<td>0.5</td>
<td>1.4</td>
<td>0.0</td>
</tr>
</tbody>
</table>
Is this a problem? Answer depends on what you think governance is designed to achieve

- Governance is a mechanism for ensuring the accountability, representativeness, efficiency, and effectiveness of an agency.

  - **Accountability** means that it is answerable to its ultimate constituency for its actions.
  - **Representativeness** means that different constituencies have appropriate voice.
  - **Efficiency** means that no other policy it pursued could make some better off without making others worse off.
  - **Effectiveness** means (in this context) that decisions are reached without undue delay.
But moving from principle to practice is difficult (the devil is in the details)

- Consider for example the problem of ensuring that the IMF is adequately accountable to its members.
  - But accountable to whom?
  - One country, one vote would give each Marshall Islander 3,000 the weight of each citizen of the USA. Is this fair?
  - Stronger representation of program countries (which, in practice, means developing countries) would mean more “ownership” of programs but let the fox into the henhouse.
Still, there is a sense that voting shares in the IMF no longer reflect reality, in particular the much increased weight of rapidly growing emerging markets (Asian countries especially) in the world economy.

Hence there was agreement at the September 2006 annual meetings of the IMF to undertake a comprehensive quota revision.

Now (as of March) there is agreement on a new quota formula (still to be ratified by 85 per cent of member governments).
The New Quota Formula

- The new quota formula includes four quota variables (GDP, openness, variability and reserves), expressed in shares of global totals, with the variables assigned weights totaling to 1.0.
- The new formula is:

$$CQS = (0.5*Y + 0.3*O + 0.15*V + 0.05*R )$$

Where CQS = calculated quota share;
- Y = a blend of GDP converted at market rates and PPP exchange rates averaged over a three year period. The weights of market-based and PPP GDP are 0.60 and 0.40, respectively;
- O = the annual average of the sum of current payments and current receipts (goods, services, income, and transfers) for a five year period;
- V = variability of current receipts and net capital flows (measured as a standard deviation from the centered three-year trend over a thirteen year period);
- R = twelve month average over a year of official reserves (foreign exchange, SDR holdings, reserve position in the Fund, and monetary gold)
Winners and Losers

- **Increases:**
  - China’s quota share in the Fund will rise from 3% to 4%
  - Korea’s will rise from 0.8% to 1.4%
  - India’s from 1.85% to 2.45%
  - Brazil’s from 1.45% to 1.85%

- **Reductions**
  - UK’s will fall from 5.0% to 4.5%
  - France’s will fall from 5.9% to 4.5%
  - Canada’s will fall from 2.7% to 2.4%

- This is progress, but nominal progress…
Shares versus chairs

- Of course, all this assumes that influence in the institution flows from voting shares.
- But in practice countries rarely vote – only on fundamental reforms (“constitutional amendments”) requiring an 85 per cent supermajority.
- Other decisions are reached in the board by consensus.
- In this view, what matters is who has a seat at the board table.
- Recall that large shareholders (US, Japan, China, Saudi Arabia) have their own seats, others are formed into constituencies.
- Problem here is that European countries have as many as 9 of the 24 seats (largely for historical reasons). At the other extreme, African countries have only two.
- Making the board bigger would be counterproductive from the viewpoint of efficiency.
- Consolidating EU (EMU?) representation would be key to freeing up board seats for underrepresented regions.
Other mechanisms for accountability

- Transparency (but this is more difficult than in the case of a national central bank owing to the much more complex mandate of the IMF).
- Independent Evaluation Office (but how independent can it really be?)
- More independence for staff surveillance and assessment to prevent management from making caving into to political pressures (But is UK Treasury proposal feasible?)
- Pressure from NGOs? (Yet how effective has this been?)
Conclusion: IMF governance is a work in progress. It epitomizes the problems of global governance generally.