The IMF

Mission: possible

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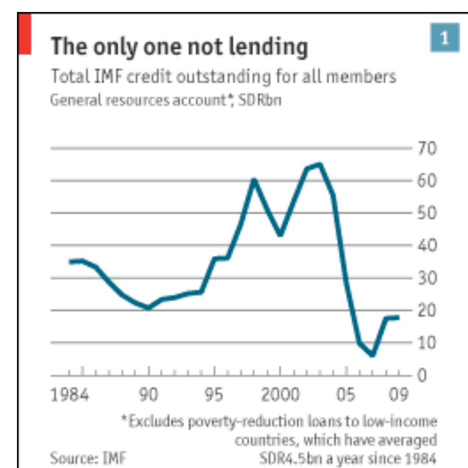
The IMF has been promised lots more money and has a new sense of purpose. But reform is still needed—especially if it is to win the trust of emerging economies

Illustration by Belle Mellor

AS RECENTLY as last October the International Monetary Fund seemed to be sliding towards terminal irrelevance. For several years, emerging economies had been making fewer and fewer demands on its rescue services (see chart 1). They were awash with private flows—and many of them had been building up vast reserves of their own for a rainy day. Even as the world sank into a financial crisis, there was scant demand for the roughly $250 billion in the fund's coffers. The talk at the fund's headquarters was less about its role in sorting out the global financial crisis than about whether it had one. Budget cuts forced it to persuade some staff to take early retirement.



The IMF is no longer at the margins. At a press conference in London after the G20 summit on April 2nd, its managing director, Dominique Strauss-Kahn, could barely contain his delight when he said of the meeting's communiqué that "each paragraph, or almost each paragraph—let's say the important ones—are in one way or another related to IMF work."

The leaders of the world's biggest rich and emerging economies decided in London that the IMF should both have more resources and play a broader role in the world economy than in the past. They said that the fund's resources were to be increased by $500 billion to $750 billion, and that it would be allowed to issue $250 billion-worth of its own quasi-currency, the Special Drawing Right (SDR), to ease liquidity in emerging and developing economies (see article). The G20 also expects the IMF to ensure "candid, even-handed, and independent surveillance" of big economies and their banks, of the impact of their policies on others and of risks facing the global economy.

Cynics will argue that the summiteers trumpeted the strengthening of the fund because this was the one substantive thing they were able to agree on. They made no new promises on co-ordinated budgetary stimulus, for example, and the details of what the G20 will do for trade finance remain uncertain (see article). Even so, it is indisputable that the G20 meeting confirmed a steady rise in the IMF's star in recent months. It has recently overhauled its lending schemes, along with the conditions attached to its loans, and already begun providing funding that looks more like crisis insurance than its usual loans for countries that have got into trouble. China and Russia have even talked about making it the issuer of a global reserve currency to replace the dollar.

But what matters for the world is not the fortunes of the institution itself so much as its ability to execute the tasks it has been assigned. For that the IMF must show intellectual leadership in debates about the global economy; it will need the right tools to tackle the problems it identifies; and it will have to acquire the legitimacy to ensure that its diagnoses and recommendations are taken seriously. Its ability to do all this will depend on what is done to address the root causes of the fund's former marginalisation. This means tackling still unresolved questions about the supply of resources to the IMF, the way it lends that money to governments in need, the demand for loans from emerging economies and the way the fund is governed.

Start with the fund's $500 billion of extra resources, the centrepiece of the G20's announcements. This is not entirely new, and where it will all come from is not clear. Only a $40 billion loan from China, still not confirmed by the Chinese government, was unknown before the summit. Another $200 billion comes from adding two lots of $100 billion already promised by Japan, whose government signed an agreement with the IMF in February, and the European Union. That leaves $260 billion to find. Some has been trickling in: Canada has offered $10 billion and Norway $4.5 billion. America is expected to provide $100 billion. Contributions from Saudi Arabia and other emerging economies are also expected.

Despite doubts about the extent and novelty of these new resources, the fact remains that the IMF has more money available. Even without it, the fund still had about $150 billion left to lend this year. So what explains the widespread agreement that the fund needed bulking up urgently?

Part of the reason that the IMF needs more money is the flight of private capital from emerging economies. The Institute of International Finance, a bankers' group, expects capital flows to emerging economies to be 80% lower than in 2007. This means that many more will have to turn to the IMF (or other official sources) to avoid drastic cuts in domestic spending. In addition, the fund wants to provide crisis insurance to large emerging economies suffering a temporary loss of liquidity but with basically sound policies.

Rather than negotiate a loan once a country is already in dire straits, the IMF would offer a contingent line of credit. This would have none of the policy strings attached to the usual IMF loans. The country would not have to draw down the line of credit unless it needed to; but the credit's existence would give investors confidence in its ability to ride out the storm.

The first such arrangement, of $47 billion, has been requested by Mexico under a new IMF programme, the Flexible Credit Line (FCL). Although it is not yet known how popular the scheme will prove, it is clear that the fund could not credibly claim to want to support other countries on such a scale unless it had much more money. The Mexican package, if drawn down, would take one-third of what the fund had left to lend this year.

Even more important, the creation of a beefier but gentler IMF will give emerging economies a credible alternative to the practice of building up enormous foreign-exchange reserves. Many countries have done this in the past decade to protect themselves against fluctuations in capital flows or commodity prices. Given the opportunity to insure with the IMF, countries should have less need to insure themselves with vast reserves or to arrange large bilateral swap lines. When emerging economies have reserves worth several hundred billion dollars each, the IMF could not possibly have provided a credible alternative to self-insurance with a kitty of no more than $250 billion.

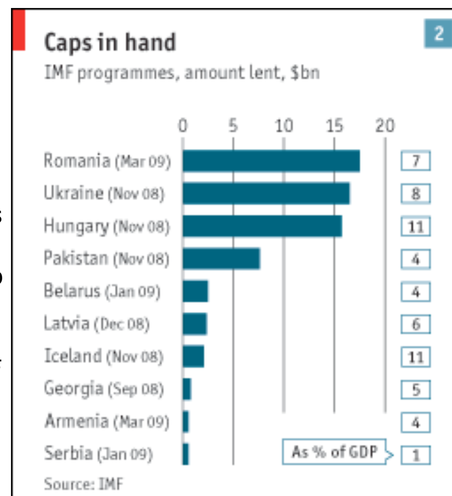
Supply and demand

In essence, the approach of the past few months has been to address the supply side of the IMF's problems by ensuring that lack of funds will not hold it back. But tackling the demand side is just as important—and governments have been understandably reluctant to ask for help.

Because countries usually approach the IMF only when they are in deep trouble, the fund attaches demanding

conditions to its loans. These typically include cuts in budget deficits, often by slashing public expenditure, or increases in interest rates. An IMF loan has thus become shorthand for austerity, making politicians who turn to it (and the fund itself) unpopular. Markets, too, tend to treat even a rumour of an imminent call on the IMF as a sign that matters have spun out of control. As a consequence, countries avoid the fund until they have run out of options. This was much in evidence with Pakistan, one of the early borrowers from the fund in the current crisis (for the full list, see chart 2). The country scrambled to arrange bilateral bail-outs, approaching China and Saudi Arabia before finally turning to the fund.

None of this means that the fund should avoid imposing conditions when mismanagement has led a country into crisis, or that it is about to stop doing so. But the political and market stigma attached to the very name of the fund could hinder its ability to act as an insurer. Governments are unlikely to want crisis insurance from the IMF if they believe that voters and investors will desert them.



The IMF's awareness of this problem is clear from the careful design of its new insurance instrument, the FCL, which replaced the Short-Term Liquidity Facility introduced by the fund last October. That attempt to help well-run countries found no takers. According to Alejandro Werner, Mexico's deputy finance minister, his country was attracted not just by the flexibility and size of the new facility, but also by the fact that the IMF consulted emerging economies while designing the programme to ensure that it met their needs.

Although Mexico's response to the FCL is a good sign, the stigma of borrowing from the IMF remains a concern. Asked about his country's interest in the programme, Brazil's president, Luiz Inácio Lula da Silva, replied "with a lot of pride…that Brazil needs no money from the IMF." Asian economies are particularly wary of the fund after what many consider to be its botched rescues in the crisis of 1997-98. The governor of Indonesia's central bank said on April 6th that political considerations are likely to preclude an approach to the IMF under the new scheme.

The shame of borrowing from the IMF may also make it harder for the fund to develop its new job as insurer in order to reduce global imbalances. Eswar Prasad, a former head of the IMF's China unit now at the Brookings Institution, a Washington think-tank, has an ambitious idea that would see the fund charge premiums for supplying crisis insurance. Mr Prasad proposes premiums that vary according to countries' economic policies. Countries following policies that drove up global risks (either by running huge surpluses or deficits) would have to pay more, much as premiums for car insurance depend on a driver's past safety record. This would allow the IMF to use its insurance function explicitly to tackle global imbalances.

Yet this, too, is a hostage to the fund's reputation. An almost visceral dread of having to approach the IMF, especially after the Asian crisis, was at least partly responsible for the enormous build-up of reserves to begin with. Mr Prasad acknowledges this, saying that "the main emerging markets are going to remain wary of relying on the IMF for emergency financial support until they are convinced that the leopard has really changed its spots."

Running (from) the fund

Emerging economies may dread the IMF; developed ones disdain it. Rich countries have never been receptive to its criticisms of their policies or responsive to its suggestions. The attitudes of both rich and poor are influenced by who runs the fund and for whom it speaks.

Emerging economies do not trust the IMF because they do not think they have enough say in it. Rich countries, which have the bulk of power within the institution, do not take it seriously. And the fund, ever aware of who holds the purse strings, is "excessively hesitant in talking to rich countries about faults in their policies," according to Raghuram Rajan, a former chief economist of the IMF and a professor at the University of Chicago Booth School of Business (and author of this week's Economics focus).

The balance of power in the IMF is reflected in the votes of its member countries. These are broadly aligned with countries' "quotas" or shareholdings, which after several rounds of reform are still largely a legacy of the global

distribution of economic might at the end of the second world war. Even after the proposed change to vote shares, Brazil, with 1.72% of the votes, will have less weight than Belgium, with 1.86% (see table 3). Together, European countries will still have more than 30% of the votes and America will have nearly 17%. The G20 wants the IMF to implement the most recently agreed quota changes by October, and to bring the next round of quota reform, scheduled for 2013, forward to January 2011. But a more ambitious quota reform, to bring about a significant change in power, will involve arduous negotiations: larger shares of the votes for big emerging economies will mean smaller shares for rich ones. Without such a shift or some creative thinking, it is hard to see the fund winning more legitimacy among emerging economies.

One idea, which would be relatively easy to put into practice, would be to loosen Europe's grip on the appointment of the IMF's managing director. (The head of the fund's sister institution, the World Bank, is by convention an American.) The G20's commitment to ensure that "the heads and senior leadership of the international financial institutions should be appointed through an open, transparent, and merit-based selection process" is clearly a nod in this direction. This is not the same as choosing the bosses "irrespective of nationality", as demanded by the finance ministers of Brazil, China, India and Russia when they met last month. But Mr Rajan says that even the weaker commitment by the G20 leaders makes him "fairly certain that the next selection process will not be a closed one." The IMF, he says, will have to try fairly hard to give the appearance of change. At the very least, non-European candidates will have to be seen to be seriously in the running, even if a European ends up with the job.

Unfair? 3

IMF votes

	Share, %	
	existing	proposed
United States	16.77	16.73
Japan	6.02	6.23
Britain	4.86	4.29
France	4.86	4.29
China	3.66	3.81
Russia	2.69	2.39
Belgium	2.09	1.86
India	1.89	2.34
South Korea	1.38	1.36
Brazil	1.38	1.72

Source: IMF

There is no shortage of ideas for reforming the fund's governance. An IMF-appointed committee headed by South Africa's finance minister, Trevor Manuel, reported to the fund on March 24th. It recommended a cut in the percentage of votes needed for the fund's most important decisions from 85% to 70-75%. The existing threshold amounts to a veto for America, with its 17% share. Reducing it to 70% would have removed another source of emerging-country discomfort. The G20's communiqué did not mention the idea.

Nor did the G20 refer explicitly to another idea from Mr Manuel's committee: to create a supervisory IMF council consisting of finance ministers and central-bank governors, which would provide a forum for co-ordination and strategic decisions crucial to global stability. According to Mr Rajan, this would take strategic decisions out of the hands of bureaucrats and entrust them to people with greater political legitimacy. He also argues that the importance of repeated and regular interaction at a high political level should not be minimised. It would make it easier for emerging and rich countries to discuss policy more openly and frankly than they can now. But the G20 did not go beyond an oblique reference to the need for "greater involvement of the fund's governors in providing strategic direction to the IMf."

Votes for all

Even quota reform, hard though it is, need not be impossible. Mr Prasad has an innovative idea about how quotas could be adjusted to the realities of the global economy. He suggests shrinking all existing quotas by 20%, so that a country that at the moment has 10% of the votes would have 8%. Then the 20% of quotas freed up could be auctioned, with an upper limit (say 14.9%) on any country's share. In effect, this would give more voice in the IMF to those who want it most, giving them a greater stake in its success.

All these ideas recognise the importance of making the IMF an institution that reflects the changes over the years in the global economy. It will soon have the necessary firepower to act credibly both as a lender in a crisis and a provider of insurance against one. It has shown some nimbleness by rethinking the way it lends in order to meet the needs of large emerging economies better.

Nevertheless, there is still a long way to go before the fund becomes an institution that is both trusted by the emerging world and respected by the rich, and is therefore a venue for effective multilateral financial co-operation. Without further changes to the way it functions and is run, it may find itself beset by some of the same underlying problems that were pushing it to the margins before the crisis brought it back. And it may be unable, in spite of its much fuller coffers, to make a serious dent in the problems of the global economy.

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