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The Agenda for IMF Reform

The world needs a strong and effective International Monetary Fund (IMF) as the principal multilateral institution responsible for international economic and financial stability. A consensus on the role of the Fund and the scope of its activities in the 21st century is needed to achieve this objective. However, such a consensus does not exist today in official circles or among private observers. In the view of many observers, the Fund has failed to effectively exercise its intended role as steward of the international monetary system. Consequently the IMF, once the preeminent institution of multilateral international financial cooperation, faces an identity crisis.

No single change by itself can restore the IMF to its prior position as a highly respected international monetary institution. Effective reform of the IMF must encompass many aspects of the IMF's activities—where it should become less as well as more involved. During the past decade, a large number of changes in the international financial architecture and in the IMF's operations have been put in place. Those reforms have not been sufficient to restore the IMF's luster at the center of today's international monetary and international financial system.

Successful reform of the IMF must engage the full spectrum of its members. The IMF should not focus primarily on its low-income members and the challenges of global poverty. It should not focus exclusively on international financial crises affecting a small group of vulnerable emerging-market economies. Instead, it must be engaged with each of its members on the full range of their economic and financial policies. However, the Fund should give priority attention to the policies of the 20 to 30 systemically important countries that impact the functioning of the global economy, including the policies of its wealthiest members that remain the prin-

Box 1.1 Managing Director de Rato's Report on the Fund's Medium-Term Strategy

On September 15, 2005, the IMF released Managing Director Rodrigo de Rato's Report on the Fund's Medium-Term Strategy (IMF 2005k). The report draws on preliminary discussions held at the time of the meeting of the International Monetary and Financial Committee (IMFC) in April 2005, the work of an internal committee, as well as inputs from the IMF's Executive Board. Its self-description is a strategy paper, not a five-year plan and not a reform agenda although that term has been used to describe the document. The report views IMF reform as requiring an evolution, not a revolution, at the Fund.

The report proposes globalization as its organizing principle: "Viewing the challenges through the lens of globalization holds the potential to prioritize the elements of the Fund's well defined mandate in the macroeconomic area and to address the criticisms of limited effectiveness, focus, and preparedness to face the future." It argues that 21st century globalization involving large cross-border capital movements and abrupt shifts in comparative advantage has exposed gaps in the work of the Fund with respect to surveillance, lending facilities, and governance.

The report lays out five key tasks responding to these new global conditions:

- make surveillance more effective,
- adapt to new challenges and needs in different member countries,
- help build institutions and capacity,

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cipal drivers of the world economy and, therefore, are the source of the greatest risk to global economic and financial stability.[1]

The Case for IMF Reform

Managing Director Rodrigo de Rato in his remarks to the Institute for International Economics conference on IMF reform (chapter 3 of the conference volume)[2] states that the IMF is the "central institution of global

1. The systemically important countries include primarily the Group of Twenty (G-20) countries: the United States, the European Union as a group, Japan, Canada, and possibly one or two other industrial countries; also Argentina, Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Nigeria, Russia, Saudi Arabia, South Africa, Turkey, and possibly a few other large emerging-market countries. See also footnote 3.

2. In several places, this policy analysis cites chapters in the forthcoming conference volume, *Reforming the IMF for the 21st Century*, ed. Edwin M. Truman (2006, Institute for International Economics).

Box 1.1 *(continued)*

- prioritize and reorganize IMF work within a prudent medium-term budget, and
- address the governance issue of fair quotas and voice (representation) in the Fund.

Against this background, the report discusses nine issues and proposes 31 actions or "deliverables" as next steps in the strategic review of the Fund by IMF management, the Executive Board, and member countries. Most proposed actions are process oriented, a few involve reoriented research efforts, and a larger number concern internal organization and management.

The report highlights four new proposals: intensified analysis of globalization, including a possible new report on the macroeconomics of globalization; a redesigned "contextually savvy" program of communication; a work program on issues surrounding capital account liberalization; and the assessment of the achievability of the Millennium Development Goals with available financing.

In keeping with the theme of a strategic review, the managing director's report suggests that these initiatives might be financed by scaling back the Fund's activities in five areas: a sharper delineation of the Fund's role in low-income countries; less time spent, in particular by the management and Executive Board, on procedures and documentation; less work on standards and codes; less research in other (unspecified) areas; and less spending on overhead and support activities, including the possibility of more offshoring of information technology services.

monetary cooperation." He suggests that the Fund can rest on its 60-year history of accomplishments, but he also acknowledges the need for changes. In fact, a few days earlier the IMF released a report by de Rato on the Fund's medium-term strategy (IMF 2005k; also box 1.1). In the report, de Rato argues that the Fund is being pulled in too many directions and accumulating new mandates: "The question [is] whether the Fund is fully prepared to meet the great macroeconomic challenges that lie ahead." On the other hand, he argues that the IMF's principal power in meeting the challenges of the 21st century is the soft power of persuasion. He implicitly dismisses proposals that the Fund should use or develop other instruments to carry out its mission. One detects little sense of urgency in his remarks.

Remarks by US Under Secretary of the Treasury for International Affairs Timothy Adams (chapter 4) convey a greater sense of potential institutional crisis than those of the IMF managing director. Adams declares he is a "believer in the IMF . . . as a facilitator of international monetary cooperation" but notes "the IMF now faces fresh, tough questions about its relevance" to the industrialized countries and to emerging-market economies. The risk is that the IMF is becoming a development institution focused primarily on its low-income members. To strengthen the Fund's relevance, Adams argues that it should concentrate on its core mission, "international financial stability and balance of payments adjustment." The IMF needs to be "far more ambitious in its surveillance of exchange rates" and by implication other macroeconomic policies. Noting that exchange rate surveillance is politically difficult, he states, "Nevertheless, the perception that the IMF is asleep at the wheel on its most fundamental responsibility—exchange rate surveillance—is very unhealthy for the institution and the international monetary system." Adams concludes that the medium-term strategy paper of the managing director represents activity but adds that what the Fund needs is achievement and, "To achieve, the IMF needs to refocus and deliver."

Four international experts on the wrap-up panel at the Institute conference expressed an even greater urgency for IMF reform. Barry Eichengreen (chapter 25) describes the Fund "as a rudderless ship adrift on a sea of liquidity. On none of the key issues does the institution or its principal shareholders have a clear, or a clearly articulated, position." Mohamed El-Erian (chapter 26) chooses different words but comes out in the same place: The IMF is losing relevance, there is no simple solution, and what it needs is a critical mass of reforms. Tommaso Padoa-Schioppa (chapter 27) argues that the Fund has drifted from its core mission of ensuring stability and has lost leverage because for many countries international liquidity is no longer scarce. Finally, Yu Yongding (chapter 28), while more reserved than the others, nevertheless agrees with C. Fred Bergsten (chapter 13) that the Fund has become weak and ineffective.

The Content of IMF Reform

On the content of IMF reform, the managing director's strategy document (IMF 2005k) is frequently eloquent in its diagnosis of the issues. In arguing for more effective surveillance, he calls for improvements in focus and context, "less cover-the-waterfront reporting on economies, more incisive analysis of specific weaknesses and distortions that risk crises and contagion or hinder adjustment to globalization, and more active Fund engagement in policy debates that shape public opinion and policy choices," including a revitalization of the IMF's International Monetary and Financial Committee (IMFC), which meets twice a year at the ministerial level and provides nonbinding guidance on IMF policies and activities.

On capital account liberalization, the managing director's report perceptively observes, "Financial globalization has both caused and been caused by the liberalization of the capital account." With respect to the Fund's role in addressing the many problems and challenges faced by low-income countries, he acknowledges "a consensus that the Fund should remain engaged in these areas" but asks "how best to do so, and to what degree?" Finally, with respect to governance, IMF quotas, and voice in the institution, he notes, "The current allocation puts this legitimacy [of the Fund as a universal institution] at risk in many regions. . . . In the view of too many, governance and ownership imbalances in the Fund now rival global current account imbalances. Neither imbalance is sustainable." However, on none of these issues does Managing Director de Rato put forward, or promise to put forward, concrete proposals. This lack of leadership is most notable in the area of IMF governance, where there is widespread agreement that actions are needed but no consensus about their content.

The communiqués of the IMFC, the Group of Seven (G-7), the Group of Ten (G-10), and the Group of Twenty-Four (G-24) issued at the time of the September 2005 IMF–World Bank annual meetings as well as the communiqué of the Group of Twenty (G-20) issued in mid-October all welcome the managing director's report and look forward to specific proposals.[3]

Almost all individual pronouncements in September 2005 by IMF governors and members of the IMFC emphasized the salience of the governance issues without suggesting any degree of consensus on appropriate solutions. There is a similar lack of consensus on IMF policies with respect to emerging-market economies. In addition, the managing director's report calls for a sharper delineation of the IMF's involvement with the Fund's low-income members, implying a substantial reorientation and scaling back of the financial and organizational resources devoted to the Fund's activities in this area, but the statements by finance ministers and central bank governors suggest less than full comprehension of his implication. In support of a more expansive vision of the IMF's role in low-income countries is the report's advocacy of intensified IMF involvement in the building of institutions and capacity in low-income countries. Such an increased emphasis would be likely to move the Fund into activities beyond its traditional core competencies on fiscal, monetary, exchange rate, and financial-sector policies; and IMF members may also underappreciate the implications of this suggestion.

The managing director's strategy document barely mentions exchange rates and omits entirely any discussion of the IMF's responsibilities in

3. The G-7 comprises Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. The G-10 grouping comprises the G-7 countries and also Belgium, the Netherlands, Sweden, and Switzerland. The G-24—formally the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development—comprises representatives of 24 Asian, African, Latin American, and Middle Eastern countries plus observers. The industrial-country members of the G-20 are the G-7 countries, Australia, and the country holding the EU presidency when not a European G-7 country; the nonindustrial-country members are Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, and Turkey.

this area; officials noted this omission in a number of statements at the time of the IMF–World Bank annual meetings. With respect to reports on "surveillance-only cases" of advanced and/or systemically important countries, the strategy document advocates discussing reasons why the Fund's advice is not accepted and what adaptations might deal with such concerns. A number of official commentators noted that this approach might usefully be applied to all members. A few also noted the omission of a broad treatment in the report of the IMF's lending activities aside from the mention of a few proposals that are under discussion and the controversial issue of the IMF's role in crisis resolution. Finally, although most officials have welcomed and praised the managing director's report, a few have commented that it lacks ambition or fails to recognize what one finance minister identifies as a need for organizational and cultural change in the institution.

Michel Camdessus (2005) evoked several noteworthy contrasts when he delivered the Per Jacobsson Foundation lecture two days after the Institute conference on IMF reform. Perhaps because he was liberated from the constraints of his former position as managing director, Camdessus presented a more comprehensive and provocative reform agenda covering the IMF's mission, its human and financial resources, and its governance; see box 1.2. He went beyond de Rato's strategy paper in arguing that the Fund should propose a bold initiative in the area of global imbalances such as organizing a new Plaza or Louvre agreement although, of course, the IMF was on the sidelines at those events. He said the IMF is and should be equipped to be an international lender of last resort and should expand its provision of financing to low-income members. Camdessus also advocated the introduction of population into the formula used to guide negotiations on the distribution of IMF quotas, and he called for a consolidated European chair in a smaller Executive Board. In an area not addressed by de Rato at all, Camdessus argued that the Fund should have significant periodic increases in its quota resources and should positively consider the resumption of allocations of special drawing rights (SDR).

An IMF Reform Package

The Institute's conference on IMF reform did not attempt to reach consensus on an IMF reform agenda. However, the elements of an overall strategy emerge from the conference and contemporaneous developments. A critical mass of reforms should encompass six components: governance, policies of systemically important countries, the central role of the Fund in external financial crises, refocused engagement with low-income countries, increased attention to capital account and financial-sector issues, and the case for additional financial resources.

Box 1.2 Michel Camdessus's reform agenda

Michel Camdessus (2005) gave the Per Jacobsson Lecture on September 25, 2005. He identified two key challenges for the IMF, on which he focused most of his attention, and for the other international financial institutions (IFIs) over the next 15 years: helping emerging-market countries advance more rapidly and helping the poorest countries reduce poverty. To meet these challenges, he laid out a three-part reform agenda for the IFIs: mission, human and financial resources, and governance. In the course of his remarks he put forward 20 separate proposals for IMF reform.

Under the heading of the IMF's mission, Camdessus called for strengthening surveillance and proposed reinforcing the IMF's message, in particular for the major countries, by submitting the preliminary conclusions of staff missions to a broader public debate within countries before the Executive Board reviews them. He argued for paying more attention to structural rigidities (including those in labor markets), demographic developments, and large accumulations of international reserves. He advocated a "bold initiative" by the IMF to deal with payments imbalances by structuring a cooperative effort along the lines of the Plaza (1985) and Louvre (1987) agreements, but this time with the IMF—not the G-7 or the G-20—at the center of the process.

With respect to mission, Camdessus proposed revisiting the issue of orderly capital account liberalization to learn the lessons of previous experience. Acknowledging that this process would take time, he argued that, in order to promote the process of capital account liberalization, the IMF should have the same kind of jurisdiction over the capital account transactions that it has over current account transactions. He belittled the Asian countries' experience with capital controls during the Asian financial crisis and warned against using controls to buy time as a substitute for the right policies. He argued that controls promote distortions and corruption and tend to favor the rich over the poor.

In the area of debt workouts, Camdessus proposed renewing the debate about a sovereign debt restructuring mechanism or its equivalent, with the essential feature that the IMF should be in the center of its design and operation. He argued that the globalized financial system needs a lender of last resort and said the IMF is equipped to play this role. He proposed confirming the Fund in this role. He also advocated equipping the IMF with the authority to create special drawing rights (SDR) on a contingency basis to deal with global liquidity squeezes; countries not caught up in the squeeze would advance their allocations of SDR to the Fund for its use in conditional lending programs.

Finally, under the heading of mission, he proposed fighting corruption by introducing ethical requirements into the education of future business and official

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Box 1.2 Michel Camdessus's reform agenda *(continued)*

leaders. He also argued it is essential for the IMF to support its poorest members by increasing their access to concessional financing from the IMF, improving the provision of financing to countries in postconflict situations or after economic shocks, and focusing the attention of the IMF and other IFIs on the scale of the annual transfer of real resources to the poorest countries.[1]

Under the heading of human and financial resources, Camdessus proposed expanding staff resources to equip the Fund properly to carry out new responsibilities for global financial stability and the oversight of financial markets and to reduce the "cloning syndrome" in IMF recruiting efforts by seeking staff with broader skills (outside of economics) and experience (inside of national governments). He strongly rejected the view that IMF quota resources are taxpayers' money and proposed significant periodic increases in quotas and a less doctrinaire attitude against allocations of SDR.

Under the heading of governance, Camdessus argued that "the legitimacy of the Bretton Woods Institutions is increasingly questioned" and advocated the creation of the decision-making council provided for in the IMF Articles of Agreement to give political guidance to the Fund alongside the technical guidance provided by the Executive Board. He would replace not only the consultative International Monetary and Financial Committee but also the "G-10, G-20, and other Gs," thus implying the G-7. With respect to voting shares and the Executive Board itself, he proposed introducing population into the quota formula, a single European chair with multiple alternates in the Executive Board, and a parallel consolidation of other chairs to produce a smaller and higher-caliber board. He noted that these steps would take time and argued that the Europeans should take the lead to put them in motion. With respect to the choice of management, he supported renouncing the special US and European roles in the selection processes for the heads of the Fund and the World Bank: The processes should be open and competitive.

Finally, he proposed that the annual G-8 leaders' meetings should be coupled each year with an extended meeting with leaders of the countries on the new council and presumably in the meantime with the leaders of the countries that are members of the IMFC, which would create a global governance group with more legitimacy than today's G-8 or G-20. He added one proviso: The meetings should be prepared by the IFIs and also should be attended by the UN secretary general and the heads of other relevant multilateral organizations.

1. The transfer of real resources to a country is conventionally defined as net long-term capital inflows plus net foreign direct and portfolio equity investment inflows plus grants minus associated net interest or income payments deflated by a relevant price index such as the country's export price index.

Substantial Progress on IMF Governance

Substantial progress on IMF governance is crucial to enhancing the Fund's legitimacy and restoring trust in the institution by the vast majority of member countries. Although there is widespread agreement on the need for progress on this component of IMF reform, there has been no movement to date. Action is needed in three areas: representation on the IMF Executive Board, realignment of IMF voting shares, and with somewhat less immediacy procedures to choose IMF management. Without concrete steps at least in the first two of these areas, all other efforts to reform and refurbish the IMF will be useless because the necessary broad international support for the Fund will wither away. The institution will become irrelevant to the promotion of global economic and financial stability.

On representation on the IMF Executive Board, the European Union should declare its intention over time to consolidate its representation into a single seat or at most two (one for euro area and one for non–euro area members of the European Union). To demonstrate the EU commitment to this objective, in the election of executive directors in the fall of 2006, Ireland, Poland, and Spain should agree to join EU-majority constituencies. This action would reduce the number of EU executive directors and alternate executive directors to a maximum of seven each, and it would free up two or three such seats for representatives from non-EU countries. In the election in the fall of 2008, the number of EU-majority seats should be reduced from seven to five—three appointed and two elected executive directors—freeing up two new constituencies and two more positions as executive directors and alternate executive directors, respectively. By 2010, EU representation should be reduced to two seats, with full consolidation coming at the point when the euro area encompasses the same group of countries as the European Union.

The United States has leverage over this process because an 85 percent majority vote is required prior to each biennial election of executive directors to prevent a contraction of the size of the Executive Board to 20 seats from the current 24 seats. Thus, the United States with 17 percent of the votes can block the continuation of the status quo. In chapter 9 of the conference volume, I caution that the United States should deploy this leverage very carefully, in part to ensure the continued representation of the 43 countries that are members of the four smallest constituencies in terms of voting share.[4]

Second, IMF voting shares must be substantially realigned to recognize better the economic and financial weight of key emerging-market countries in the global economy. It is not sustainable that the policies of the

4. The four smallest constituencies by size currently are represented by executive directors from Brazil, India, Argentina, and Equatorial Guinea.

IMF are determined principally by the votes of those countries that no longer need to borrow from the Fund when other countries, which may need to borrow from the institution, are positioned to provide financial support to its lending activities and should have more say over policies affecting those activities. The 24 traditional industrial countries, which never again are likely to need to borrow from the IMF, currently hold 60.3 percent of the votes in the institution. The other members are 22 emerging-market countries, as classified in chapter 2 of this policy analysis, with 20.4 percent of the votes, which may need to borrow from the IMF but can also supply significant financial resources to the Fund, and 138 other developing countries with 19.3 percent of the votes. The issue of voting shares involves principally reducing the combined share of the industrial countries by 10 or more percentage points and increasing the share of the emerging-market countries as a group.[5]

A possible interim solution to the quota and voting-share issue may lie in a combination of small ad hoc increases in a few countries' quotas in addition to small voluntary reallocations of quotas without an overall increase in the size of the Fund, thus avoiding a need to increase total quotas. A limited reduction in the US quota and voting share by less than one percentage point as a consequence of ad hoc quota increases in individual quotas plus an agreement by Canada, Japan, and the major European countries to reallocate portions of their existing quotas might free up a total of 4 percentage points of total quotas for reallocation. That amount could be distributed to the six large non-European countries with quotas that, although they are now in the top 30 in terms of size, have the largest proportional discrepancies (greater than 30 percent) between calculated and actual quota shares.[6] The six countries are Singapore, Korea, Malaysia, Thailand, China, and Mexico, in decreasing order of their percentage discrepancies.[7] As a result, the average percentage discrepancy for this group would be reduced from more than 100 percent to approximately 35 percent. Such an approach, however, would leave five discrepancies of more than 30 percent between calculated and actual quota shares within the EU group—Denmark, Ireland, Luxembourg, Spain, and potentially Turkey. Thus, the Europeans would come under internal pressure to negotiate some rebalancing within their nascent group even as they converge toward a single quota.

Such an interim solution even in the unlikely event that it could be negotiated would be viewed as inadequate by those countries that advocate

5. Reform of voting shares also involves rectifying some of the distortions that have developed in voting shares within these groups of countries.

6. Calculated quota shares are derived from formulas that have been used in the past to guide quota negotiations. The estimates presented in this paragraph are based on IMF (2004g).

7. The order of absolute discrepancies is Singapore, China, Korea, Mexico, Malaysia, and Thailand.

an overhaul of the quota formula and a fundamental redistribution of quota shares along with rearranging chairs on the IMF Executive Board.[8] Thus, a redistribution of voting shares in the IMF by a few percentage points via ad hoc adjustments or reallocation of quotas is unlikely to pass the test of credibility.

On the other hand, as I argue in chapter 9 of the conference volume, the time is not ripe for the United States to reduce its voting share significantly from its current 17 percent to less than 15 percent and give up voluntarily its capacity to block (veto) a few key decisions affecting the IMF as an institution. The United States, in particular the US Congress, lacks the confidence that other members of the Fund would step into the leadership vacuum that this would create. The risk would be a further US withdrawal from multilateralism.

It follows that a more comprehensive approach is needed. At a minimum, the Europeans would have to agree to give up a much larger share of their present collective quotas—at least six percentage points—based on the logic that membership in the European Monetary Union (EMU) reduces the theoretical need for EMU members and, in particular, countries that also are members of the euro area to borrow from the Fund. Alternatively and preferably, substantial adjustments in quota shares should occur across the board in the context of an increase in the overall size of the Fund of at least 50 percent, with the large emerging-market countries contributing the bulk of the new resources. This should be part of at least two steps of successive increases in total quotas that would be directed at achieving parity in the voting shares of the European Union and the United States.

This reallocation of quota shares in the context of successive increases in the overall size of the Fund would be aided by agreement upon a new simplified quota formula for use in guiding the process of adjustment. Agreement on a new quota formula is desirable. It is not essential. Decisions on the allocation of quota shares are essentially political. In light of this fact and because the G-20 includes most of the key countries, the G-20 should take the lead in this political process, including the negotiation of a revised, simplified quota formula. Optimists can take some comfort from the fact that the G-20 meeting in mid-October 2005 agreed on the need for "concrete progress" on quota reform by the time of the annual meetings in September 2006 and suggested that the G-20 itself would seek to identify principles that could be used in the 13th general review of quotas to be completed by January 2008.

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8. The combined calculated quota share of the EU countries as a group is estimated as five and one-half percentage points higher than their actual combined share today. Moreover, the hypothetical four percentage points in downward adjustment in the combined quota share of the United States, Europe, Canada, and Japan would be about half as large as implied by Lorenzo Bini Smaghi (chapter 10 of the conference volume) and less than one-third of the adjustment that I consider in chapter 9.

Third, on the somewhat less pressing issue of procedures for choosing the IMF's management, the United States and the Europeans at last should recognize that their claims that only their citizens may be in the pool of potential leaders for the IMF and World Bank lack credibility and undermine the legitimacy of the Bretton Woods institutions. They should propose agreement in the IMFC and Development Committee, or by resolutions adopted by the boards of governors of the IMF and World Bank, on open and transparent procedures to pick the next managing director of the IMF and the next president of the World Bank (Kahler 2001; chapter 11 of the conference volume). The procedures should encompass (1) dropping the convention that the president of the World Bank should be a US citizen, that the IMF managing director should be a European, and that the first deputy managing director of the IMF should be a US citizen; (2) developing a list of requirements for the positions; (3) assembling a short list of candidates, possibly including internal candidates; and (4) putting in place an open vetting process.[9] The new procedures also should include principles for use in reviewing the performance of the incumbents as heads of the IMF and World Bank should they wish to be reelected for second terms in 2009 and 2010.

Finally, as in the past, the IMF in the future will need to be steered by a dedicated group of its most important members. This is a practical reality. However, the G-7 is no longer the appropriate steering committee for the world economy. It should be replaced by the G-20, preferably transformed into a Finance 16 (F-16)—the G-20 with a single EU seat—as advocated by C. Fred Bergsten (chapter 13). It is essential, in this regard, that IMF management and senior staff stop resisting the emergence of the G-20/F-16 as the steering committee for the world economy, which includes the IMF as one of its major institutions.

Policies of Systemically Important Members

Today the IMF is behind the curve on the central issue of the first decade of the 21st century: promoting macroeconomic and exchange rate adjustments. Moreover, the benign economic and financial conditions that have sustained those imbalances during the past few years are unlikely to persist. Unless the IMF as an institution can more effectively discharge its responsibilities for the identification and resolution of global imbalances and other systemic threats to global prosperity, it will become increasingly ignored. The performance of the global economy and financial system will suffer.

9. In this area of institutional governance, the IMF and World Bank lag substantially behind the World Trade Organization, the Organization for Economic Cooperation and Development, and UN agencies such as the United Nations Development Program in implementing more transparent leadership selection procedures.

The IMF must assert its role as a global umpire as well as develop stronger means to increase its leverage over the macroeconomic policies of systemically important countries. In its efforts to influence these countries' policies, the IMF management and staff should start with sound analysis and quiet persuasion. However, the Fund must employ more than those limited, though essential, tools. This component of IMF reform should include four elements.

First, the Fund should introduce into its consultations with systemically important countries an element of "naming and shaming" of specific countries. Article IV reviews of those countries' policies should be more precise about the measures that those countries should adopt to improve their economic performance and contribute to global economic and financial stability. For example, the IMF should not merely recommend that the United States reduce its budget deficit but also state by how much and over what time horizon. Similarly, the IMF should not only suggest that countries adopt more flexible exchange rate regimes when in fact their currencies should appreciate in effective terms but also state by how much they should appreciate. In addition, Article IV reviews should include sections on why the systemically important countries have not accepted the IMF's previous advice.[10] For the systemically important countries, all IMF surveillance and review documents should be made public.

Second, the IMF needs to establish an overall framework for its surveillance activities with respect to systemically important countries. To this end, the IMF should implement unilaterally a scaled-back version of the Williamson (chapter 6) proposal to use reference exchange rates to guide its surveillance activities. The reference exchange rates would be based on macroeconomic policies that are consistent with the achievement of external and internal balance in each of the countries. Absent an immediate buy-in by the relevant countries to Williamson's full proposal to use reference exchange rates to guide judgments on intervention policies and on the appropriateness of countries' macroeconomic and financial policies, the IMF management and staff should develop and publicize its own set of reference exchange rates. This initiative should not be excessively challenging because at least until recently IMF staff regularly produced similar reports and presented them to the IMF Executive Board.

Third, the Fund should embrace Morris Goldstein's triad of proposals (chapter 5): (1) issue a semiannual report on the exchange rate policies of members that should be based on the reference exchange-rate framework described above; (2) make more frequent use of its existing powers to conduct special or ad hoc consultations on members' exchange rate policies; and (3) review its existing guidelines for surveillance over members' exchange rate policies to see whether they need to be clarified or updated.

10. Managing Director de Rato (IMF 2005k) made a similar proposal for the advanced or industrial countries; it should be applied to all systemically important countries.

Fourth, as a bold initiative to implement the second Goldstein proposal, the IMF should embark upon a collective consultation with the major Asian economies as a group—including at least China, Hong Kong, India, Japan, Korea, Malaysia, Singapore, Thailand, and on an informal basis Taiwan—about their macroeconomic and exchange rate policies. Each of these countries follows, or has followed in the recent past, a policy of heavily managing its exchange rate vis-à-vis the US dollar. The IMF (2005m) estimates a collective 2005 current account surplus of $215 billion for these countries or almost one-third of the IMF's estimate of the US current account deficit. Individually, the leaders of each economy look closely at their Asian neighbor's policies when setting their own exchange rate policy. Thus, modifications in the policies of these countries as a group are at the core of the resolution of global macroeconomic imbalances.

Central Role of the Fund in External Financial Crises

The IMF remains bedeviled by philosophical disputes about the scale and scope of its lending activities. These disputes distract the institution from its role as the global lender of final resort. This component of the IMF reform agenda should include three elements.

First, members of the Fund should reaffirm the central role of the IMF in international financial crises, including through its potentially large-scale lending activities. Unless the IMF distances itself from ideological preoccupations with excessive crisis lending and moral hazard concerns, the Fund will go into eclipse as an international crisis lender and the international community will lose its leverage over antisocial national economic policies.[11] Note that if the quota shares of the large emerging-market countries are increased as advocated in my agenda, those countries will be supplying the bulk of the additional financial resources for the IMF to lend. This shift in responsibility would be consistent with the original intent of the revolving character of IMF resources.

Second, in cases requiring debt restructurings, in particular those involving a sovereign default to private creditors, the Fund should embrace the proposal by William Cline (chapter 14 of the conference volume). To

11. Observers and critics from European countries, in particular, fail to recognize the implications of a world that differs from when their countries faced balance of payments crises in the early 1950s through the middle of the 1970s. Those countries during that period received large amounts of financial support from the IMF often supplemented by special bilateral financial arrangements even in the context of the protection offered by their capital controls. No one raised a peep about moral hazard at that time. Today, no sensible observer or critic advocates returning to a world of comprehensive capital controls. As a consequence, the potential need for the IMF as a lender of final resort has increased, not decreased.

guide the debt renegotiation process, the IMF should establish and publicize its estimates of high, central, and low "resource envelopes" for the country. Such resource envelopes would indicate the amounts of financial resources the country could reasonably be expected to devote to external debt service, under a range of assumptions about external conditions and the country's policies, in order to achieve a sustainable trajectory for servicing the country's debts.

If at the request of the member country the Fund's involvement with the debt renegotiation process stops there, the international financial community should be informed. At that point, the IMF additionally should be required to tell the borrower the parameters of a proposal for debt restructuring that is not only sustainable but also comprehensive in that it is likely to be embraced by a very high proportion of the country's external creditors. Preferably, all countries should welcome the IMF's central involvement in sovereign debt negotiations because the Fund is positioned to provide a public good in the form of coordination in the face of a market failure of coordination and uncertain amounts of asymmetric information. In complicated cases, neither the country (nor its advisers) nor its private creditors are in a position to supply unbiased information. The Fund should play this coordination role regardless of how extensive and detailed a code of conduct the parties may have accepted in advance to govern their financial relationships.

In the post-2001 Argentine case, none of the above procedures was in place. Therefore, it is appropriate that the IMF review and clarify its policy on lending to a member that is not maintaining its debt-service payments to its external private creditors—IMF lending into arrears—to provide clearer guidance to members and markets.

Third, with respect to new facilities, the IMF (management and members) should keep an open mind. Tito Cordella and Eduardo Levy Yeyati (chapter 17) propose a country insurance facility in the IMF for which a member would prequalify and receive automatic access to an adequate amount of finance to deal with an external financial crisis without requiring major changes in its fiscal stance. Using their tight parameterization, this facility will make only a marginal contribution to dealing with presumptive liquidity crises. That fact should not preclude experimentation with such mechanisms in the spirit of modernizing the IMF for the 21st century.

In addition, the facility proposed by Michael Mussa (chapter 21) to reschedule IMF claims in exceptional and well-defined cases should be established. This proposal should be implemented before the global economic and financial environment becomes less benign than it has been for the past three years and before the next Argentine type of case develops, for example in connection with Indonesia, Turkey, or Uruguay—three representative countries with sizable outstanding liabilities to the IMF and substantial sovereign and external debt ratios.

Refocused Engagement with Low-Income Members

Poverty reduction in all its dimensions, from raising standards of living to defeating the scourge of disease, is one of the major challenges of the 21st century. However, it does not follow from this fact that the IMF should be transformed into a relatively ill-equipped development finance institution as some of its caring but less thoughtful members appear to advocate. The IMF's mission is to promote maximum sustainable global growth and financial stability. If it is successful, the Fund's low-income members will benefit more than any other group. Low-income members, when they face short-term balance of payments problems, also should receive temporary financial assistance from the Fund, possibly on subsidized terms.

However, the Fund should be selective and focused in its engagement with its low-income members, ready to assist them in areas of its comparative advantage, reluctant to add to their debts, and respectful of the skills and opportunities offered by institutions centrally involved with development issues. The Fund cannot successfully be all things to all countries; that violates the law of comparative advantage. It is important that the Fund's members and management recognize its limitations.

Moving forward on this component of IMF reform will not be easy although hints at a convergence of views are encouraging. Political leaders in low-income countries want all the financial assistance they can get. However, some of those leaders now recognize that too much help can create distractions and policy overload. This critique is implicit in Steven Radelet's review (chapter 20) of the IMF's engagement with poststabilization, low-income countries. Political leaders in traditional donor countries, in particular finance ministers, trust the Fund and value the soundness of IMF policy advice more than the advice of the traditional development institutions; they also have greater confidence that the Fund is more circumspect in its disbursements. Moreover, political leaders in many member countries other than the low-income countries point to their own development and poverty problems that tend to be neglected, as discussed by Kemal Derviş and Nancy Birdsall (chapter 16).

The answer to the question of the appropriate depth of IMF involvement with its low-income members lies in partnership and a thoughtful division of labor, in particular, between the Fund and the World Bank. IMF Managing Director de Rato and World Bank President Paul Wolfowitz have committed themselves to yet another attempt to establish a framework for cooperation across Northwest Washington's 19th Street.

The first step is to recognize that all past efforts have been halfhearted and failed. The Fund is perceived by the Bank as an organization populated by know-it-all elitists, and the Bank is perceived by the Fund as an organization populated by uncoordinated do-gooders, each with a personal solution to the multiple challenges of development but with no appreciation of budget constraints—financial, political, or administrative.

Both perceptions contain kernels of truth. Thus, the Fund should develop a culture that says the Bank is better than we are in many important areas and vice versa.

A concrete action for the IMF reform agenda is the Radelet proposal (chapter 20) that the World Bank invite the Fund to provide the assessments of members' macroeconomic policies in the Bank's Country Policy and Institutional Assessment (CPIA) system.[12] This proposal could be built on by requiring that all World Bank loan documents include IMF assessments of the member's macroeconomic policies and debt-service capacity. On the other side, no longer should negative staff assessments along with their implicit endorsement by the IMF executive directors be sufficient to block substantial access to World Bank and regional development bank resources. Finally, the members of the IMF should reject Managing Director de Rato's suggestion that the IMF should become more actively involved in institution building; this is an area where the IMF generally does not have a comparative advantage.

If the IMF were to refocus its engagement with low-income countries on its core areas of comparative advantage—policy advice on macroeconomic and financial policies, surveillance, and temporary balance of payments assistance—the result would be a substantial reduction in lending through the IMF to these countries.[13] Lending to countries eligible for Poverty Reduction and Growth Facility (PRGF) programs will be reduced in any case. At least 18 countries will have 100 percent of their debts to the IMF written off, and those countries should not be eligible for new IMF loans in the immediate future. Another group of the low-income countries can be expected to take advantage of the new Policy Support Instrument, which involves IMF support for a country's policies but no commitment to lend to it. Finally, if the members of the IMF also were to embrace Managing Director de Rato's call for a substantial cutback in IMF involvement in the development of Poverty Reduction Strategy Papers, the net result would be a substantial scaling back of PRGF-type activities and the de facto transfer of many of those activities to the World Bank.

Attention to the Capital Account and the Financial Sector

Capital account and financial-sector issues are central to the IMF's role in the 21st century. Technology, demography, and policy have converged to

12. The CPIA system is the World Bank's internal mechanism used to provide guidance on the scale of its lending to individual members. In the past, countries' performances have been grouped by quintile and published. Starting in 2006, the individual country assessments will be made public.

13. Today, most IMF lending to low-income countries eligible for Poverty Reduction and Growth Facility programs involves resources that have been lent voluntarily to the IMF, not its own quota-based resources.

stimulate and release unprecedented global flows of capital. These international forces mirror and build upon comparable developments within countries.

As a component of the IMF reform agenda, members should exploit an emerging consensus and upgrade the IMF's capacity to provide policy advice and analysis on members' external and internal financial sectors. IMF advice should not be limited to destination countries, in part because many of those countries increasingly are also source countries and in particular because the principal source countries need advice as well (Williamson 2005).

An amendment of the IMF Articles of Agreement to establish and clarify the IMF's role with respect to the capital account is not essential at this time; the Fund can do its job without one. On the other hand, IMF members should accept, at least implicitly, that full capital account liberalization is an appropriate long-run objective for all member countries. The consensus on this proposition is greater today than was the consensus in 1944 favoring current account liberalization. An amendment to clean up the IMF Articles can wait until this consensus is more widely recognized and embraced. Meanwhile, the IMF should shape its policies and expertise accordingly.

Finally, consistent with the principle of comparative advantage, the IMF should scale back its role in providing advice and technical assistance to its members on financial-sector issues and transfer much of this activity to the World Bank following the formula sketched out above for macroeconomic policy assessments for World Bank borrowers. Under this model, the Fund would concentrate on financial-sector assessments and analyses of the vulnerability of its members to financial-sector weaknesses and shocks such as those faced by East Asian countries in the late 1990s: excessive reliance on short-term capital inflows, inadequate attention to currency mismatches, and weak financial-sector supervision. The IMF should leave most technical assistance in this area to the World Bank with two exceptions: first a country receiving IMF financial support and where the technical assistance directly contributes to the achievement of the program's objectives, and second, a specific request as a result of a surveillance recommendation.

The report of the McDonough Group (IMF 2005l), formally known as the Review Group on the Organization of Financial Sector and Capital Markets Work at the Fund, reportedly does not consider this option for reforming the Fund's work on the financial sector. The McDonough Group did not talk with the Bank. On the other hand, Managing Director de Rato is right (IMF 2005k; chapter 3 of the conference volume) to point to the need to refocus the Fund on financial-sector analysis as its key contribution to international financial stability in the 21st century. In this respect, the McDonough Group's report apparently makes clear that the Fund has a long way to go if it is to be effective. Reform must start at the leadership level.

Additional Financial Resources

The IMF will not need additional financial resources in 2006. However, IMF credit outstanding to all members increased by more than 50 percent from the end of 2000 through the end of 2003—a period of global recession. Credit to its emerging-market members in May 2005 was still more than 20 percent above the level at the end of 2000 despite overwhelmingly benign economic and financial conditions during the past two years that have facilitated large net repayments to the Fund. Wise observers caution that those benign conditions are coming to an end, and the demand for external financial support from the IMF is likely to rise.

Statements by US officials and officials of many other industrial countries that the IMF does not now need additional financing convey the implicit message that the IMF will never need (or deserve) additional financing. That message is wrong. It was right to increase the IMF's financial resources in 1998; IMF credit outstanding increased by one-third during the subsequent five fiscal years. Moreover, nothing in the scale of the improvements of the global economic and financial system during the past decade supports an abrupt decline in the scale of IMF financing relative to the nominal expansion of the world economy and financial system; see table 6.1 and the associated discussion in chapter 6 of this policy analysis.

When messages about expanding IMF resources are couched in the language of domestic budgetary debates—the way to close down programs is to starve the beasts of financial support—they are further debilitating to the Fund and to perceptions of its role in the global financial system. Officials of industrial countries should modify their messages, state that they will support an increase in IMF quotas when the case is made, acknowledge that the case may well be made before January 2008 when the 13th review of IMF quotas is scheduled to be completed, and start to lay the groundwork with their parliaments for an increase in IMF quotas at some point during the next three to five years. As noted above in connection with the issue of IMF governance, a decision in early 2008 to increase IMF quotas might well be essential to achieving substantial progress on that component of IMF reform.

In the meantime, the IMF should put in place a mechanism so it can borrow from the private market as a temporary supplement to its quota resources as supported by Desmond Lachman (chapter 23). The IMF has this power without an amendment to its Articles of Agreement. A debate on this issue should proceed in parallel with a serious discussion about how to provide the Fund with a stable source of income to finance its nonlending activities. The IMF's expanding nonlending activities are financed principally from its lending operations, which appear to be on a downtrend and, in any case, are cyclical in nature. This important issue is discussed by Mohamed El-Erian (chapter 26).

Final Comments

The first three components of the six-part agenda for IMF reform offered here—governance, systemically important countries, and external financial crises—are time critical. Concrete progress on IMF governance is necessary to underpin the relevance of the IMF's role with respect to the second two components. The last three—low-income countries, the capital account and financial sector, and IMF resources—are less time critical because, unless the triad of principal components is successfully confronted, how the IMF performs on the other components will not matter. The IMF will become an ill-equipped development institution, offering advice of limited global relevance and without the need to supplement its financial resources because, in effect, it will be in the business of administering grants to low-income countries to support macroeconomic policy adjustments.

Reforming the IMF to enable it to discharge its core mission of promoting international economic growth and financial stability in the 21st century is urgent if the Fund is not going to sink into irrelevance. No one can predict accurately the tipping point at which the IMF loses the support of its 20 to 30 systemically most important members and thereby loses its capacity to provide financing to those countries if they should need financial support, or to support their other global economic and financial objectives even if they should not. However, at some point—and on the present trajectory I suspect that point is not too distant—enough IMF members will conclude that the institution as currently constituted is not sufficiently relevant to their national interests, and they will cease to support the Fund and its provision of international public goods.

Therefore, the IMF needs a proactive reform agenda, an agenda with more precision and promise than that put forward by Managing Director de Rato. The agenda must contain a critical mass of reforms covering the six components listed in this chapter. It must address the interests of all members. It must be a package that provides something for each country even if each country does not get everything it wants and has to swallow some elements it would prefer to leave out.

The agenda outlined above does not require an amendment to the IMF Articles of Agreement at this time or in the next few years. On the other hand, if over the next year or two a consensus emerges to increase IMF quotas in 2008 and, much more important, if agreement can be reached on a more ambitious reform package than the one sketched out here, a fifth amendment of the IMF Articles of Agreement might be part of that package.[14]

14. The fifth amendment might include (1) an increase in basic votes, discussed in chapter 4 of this policy analysis, (2) authorization for special, temporary SDR allocations to help the IMF deal with external financial crises, discussed by Lachman (chapter 23 of the conference volume), (3) adjustments in the provisions of the current Articles to facilitate the consolida-

The rationale for the proposed agenda for IMF reform is to create a better Fund to better serve the global community. The Fund needs reforming, and the management of the Fund recognizes that fact. However, IMF member governments must commit the necessary political capital to make IMF reform a reality.

tion of EU representation in the IMF, which I discuss in chapter 9, even though substantial if not total consolidation of EU representation could be accomplished without an amendment, and (4) establishing a framework for IMF membership and relations with regional monetary arrangements, discussed by C. Randall Henning (chapter 7). Presumably such an expanded package would include a commitment from the US government to push for passage of the Fourth Amendment of the Articles authorizing a special, one-time allocation of SDR principally to those members, including Russia and most of the former Soviet Union and Eastern Europe, that were not members of the IMF in 1970–72 or 1979–81 when SDR were allocated. The United States promoted the amendment, 131 members of the IMF with 77 percent of the weighted votes have ratified it, and the IMFC routinely calls for the completion of the ratification process, which cannot happen without US action.