

**Revised Draft
April 8, 2007
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The IMF: Victim of Its Own Success or Institutional Failure?

By Paul R. Masson*
Rotman School of Management
University of Toronto

Abstract

Many are currently questioning the IMF's relevance, due to the shrinkage of its loan portfolio and concerns about its legitimacy, especially in Asia. Countries do not want to borrow from the Fund so as not to face the intrusive policy conditionality associated with its lending, and at the same time the absence of crises makes such borrowing unnecessary. While this may be an indication of the IMF's success in limiting crises, the IMF's unpopularity stems from mistakes in its policy advice to Asian crisis countries and to Argentina. Two main approaches are being pursued to make the IMF more relevant and legitimate: involve the institution more directly in resolving global imbalances, and reforming IMF quotas to give larger shares to emerging market countries, especially those in Asia. Both approaches have their limitations, and neither promises to allow the Fund to recapture its former prominence, given the continuing expansion of private capital. Defining a more modest role for the IMF that is congruent with such an international monetary system, rather than attempting to expand its activities, seems a more promising way to reestablish its legitimacy and effectiveness.

* I am grateful to Wendy Dobson, Jeroen Kremers, and Bessma Momani for helpful comments.

The IMF: Victim of Its Own Success or Institutional Failure?

The International Monetary Fund, created at the end of the Second World War at Bretton Woods, New Hampshire, to manage an international monetary system characterized by fixed exchange rates and heavily restricted international capital flows, now faces widespread questioning of its relevance. Calls for its abolition are not new: with the abandonment of fixed parities by the major industrial countries and the demise of the “Bretton Woods system” in 1973, the IMF seemed to have become obsolete, or at least to have had its mandate drastically reduced. During the 1980s, however, the IMF once again became the key player in international finance by helping to contain the debt crisis affecting developing countries. Private capital flows to developing countries dried up after Mexico’s default in August, 1982, leaving those countries with large debts they could not service; the IMF provided new financing as well as assistance with restructuring their debts.

The IMF’s role in the world economy was further enhanced when the formerly centrally planned economies began their transition to the market and started to integrate into the world economy at the end of the 1980s. The Fund lent money to virtually all of those countries, and also became involved giving detailed policy advice on structural transformations and the creation of market-based institutions. While private capital flows to many developing countries resumed strongly in the early 1990s, the access to international capital markets did not eliminate their need for occasional recourse to borrowing from the Fund, as private capital was volatile and subject to “sudden stops.” Thus, the Fund was centrally involved in providing loans and policy advice to countries

facing crises during the 1990s: Mexico, the former “Asian tiger” countries, Russia, Brazil, and Argentina.

The current environment is quite different, and there have been no major financial crises since Argentina’s default in 2001. While the IMF, under pressure from the G-7, somewhat increased its lending to Argentina after the default, it was only peripherally involved in advising the government, and played no role in the subsequent debt restructuring. Indeed, President Nestor Kirchner’s government, elected in 2003, has made clear its rejection of IMF policy advice and even blamed the institution for the crisis. Argentina has now repaid early its IMF borrowing (with the help of a loan from Venezuela), as have Russia and Brazil. With the announcement late in 2006 that Indonesia would not seek another Fund program, the IMF’s intensive involvement with the Asian crisis countries has ceased. As a result, aside from its program with Turkey, the IMF has no large outstanding loans. This means that its lending goes almost exclusively to the lower-income developing countries¹, most of it at concessional rates and with the objective of poverty reduction—in close collaboration with the World Bank, which has a clearer mandate in this area. Given that the IMF covers its operating expenses with income received from the spread between its lending rate and the rate of remuneration paid to its depositors—the creditor countries, which now constitute the bulk of its membership—the shrinkage in IMF loans outstanding has serious implications for its budget and the continued employment of a staff of well-trained and highly paid economists.

¹ Its debt to the poorest countries, mainly in Africa, has however recently been written off in the context of a decision taken by the G7 countries at the 2005 Gleneagles Summit.

More seriously for the IMF's continuing relevance with the middle- and upper-income developing countries—the “emerging market economies”—is the fall-out from the policy advice and conditions that accompanied IMF lending during the Asian crises of 1997-98. Those countries almost unanimously viewed the IMF's prescriptions as intrusive and wrong-headed². Some have even gone so far as to blame the Fund for their economic woes: in Korea, that period is known as the “IMF crisis.” As a result, countries in East Asia—those affected by the crisis as well as others, in particular China and Japan—have accumulated vast amounts of foreign exchange reserves that may permit them to ride out future crises without access to the relatively modest amount of IMF financing that might be offered. For instance, Indonesia, Korea, Malaysia, and Thailand—countries hardest hit by the 1997-98 crisis—have foreign exchange reserves that total in excess of \$300 billion, far greater than the roughly \$50 billion provided by the Fund in the earlier period. As for China and Japan, each has forex reserves that amount to about \$1 trillion—larger than the total size of the IMF's balance sheet. In addition, the ability of countries in the region to deploy these reserves in a crisis is enhanced by pooling: the Chiang Mai Initiative allows countries in the region (ASEAN plus China, Korea, and Japan) to draw on a portion of other countries' reserves, subject to certain conditions. Part of this drawing would be aligned with IMF conditionality, but part would not. The Chiang Mai countries have committed themselves to further monetary cooperation, perhaps eventually leading to the creation of an “Asian Monetary Fund” to rival (or replace) the IMF.

² Indeed, the IMF has acknowledged mistakes, in particular that fiscal restraint was over-emphasized, too many conditions were attached to IMF loans, and financial institutions should have been rescued rather than forced to close in some cases. See IEO (2003).

In this context, it is not surprising that numerous commentators have argued that changes are needed to the IMF to make it relevant to the international monetary system, as that system currently functions. For instance, a wide range of recommendations³ emerged from a conference of academics and officials held in Washington at the Institute for International Economics (IIE) in September, 2005, including:

- Reallocate voting rights (and financial contributions, or quotas) towards the emerging market economies that are underrepresented;
- Refocus the IMF's work to include greater attention to systemic issues, such as global payments imbalances and interactions among countries;
- Increase the IMF's financial resources (through increases in member contributions, SDR allocations, or through borrowing on international capital markets) in order to make IMF programs more effective and perhaps to make the IMF into a true lender of last resort;
- Sharpen the Fund's analysis of the policy choices of member countries, particularly as regards their exchange rate regimes, and make public its criticisms;
- Create new forms of IMF lending, for instance to insure countries against shocks to their balance of payments, to pre-qualify countries for quick disbursements, or to deepen markets for developing country debt.

The IMF itself has reacted to its diminished role by a fever of self-examination. The current Managing Director, Rodrigo de Rato, in office since 2004, has propounded a medium-term strategy of evolutionary change that would increase emerging market quotas, focus the work of the Fund on global imbalances, sharpen its analysis and prevention of financial crises, while retaining the IMF's commitment to poverty reduction in the poorest countries but simplifying procedures and making them more responsive to local needs. Some modest steps have been taken in repositioning the Fund. First, there has been some rebalancing of quotas; in September 2006, quota increases for China, Korea, Mexico, and Turkey were approved, since—according to the application of formulas based on GDP, current payments and receipts, and forex reserves—these

³ See Truman, ed. (2006), especially chapter 2, for an agenda for reform.

countries were the most egregious cases of under-representation. While agreement in principle has been reached to bring about a more thoroughgoing reform of quotas, how this will be done is very contentious and compromise will be difficult, as will be the necessary ratification by national legislatures. Second, the G7—in particular the United States—has endorsed the responsibility of the Fund to analyse global imbalances and come up with policies to resolve them. However, despite the publicity given to this initiative, it does not constitute a new mandate for the Fund, which has always had competence in this area⁴. Without new powers of persuasion over the countries concerned—the United States, China, or the oil exporting countries, none of which has any need or intention to borrow from the IMF—it is hard to see how the Fund can in the future be more effective than it has been in the past. Finally, the issue of the continued lending by the IMF for poverty reduction, on concessional terms, does not seem consistent with refocusing the institution on its core competencies or with its straitened budgetary circumstances⁵. In short, the IMF’s response has so far been viewed as inadequate, prompting some⁶ to accuse the Fund of “being asleep at the switch” for not being more critical of China’s exchange rate policies and another⁷ to characterize the institution as “floating rudderless on a sea of liquidity.”

The critics of the Fund cannot all be right; some would abolish it, while others would increase its resources several-fold in order to make it the international equivalent of a central bank, able to flood the financial system with large amounts of liquidity at

⁴ For instance, Article 1(vi) gives one of the purposes of the Fund “... to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members” and Article IV(3b) instructs the Fund to “... exercise firm surveillance over the exchange rate policies of members, and [it] shall adopt specific principles for the guidance of all members with respect to those policies.”

⁵ See Mussa (2006).

⁶ Morris Goldstein, of the IIE, and US Treasury Undersecretary for International Affairs Tim Adams. See their chapters in Truman, ed. (2006).

times of crisis. Nor is it clear whether the current diminished role for the Fund is a bad thing, caused by its past mistakes, or rather the benign result of its increased effectiveness in eliminating crises—or at least limiting their occurrence. Even if the latter view is correct, the IMF could continue to play a valuable role as a backstop since the risk of new crises remains.

In what follows, I will briefly review the postwar evolution of the international monetary system to provide some background for the IMF's current role, then speculate on whether current trends will continue. The Fund's performance over the last decade and a half conditions the likelihood that countries will be willing to give it an expanded role. The possibility of a major redesign of the international monetary system that would put the Fund at its centre, as was done at Bretton Woods in 1944, will be considered in that light. In discussing these issues, it is also essential to appreciate how different the international monetary system is now compared to even 20 years ago, much less 60 years ago. The extent of capital mobility is incomparably greater, driven by both technological and financial innovations, as well as by explicit dismantling of capital controls. This will limit severely the extent any of the proposed reforms will significantly enhance the IMF's role.

I. How Did the IMF Get to Where It Is?

The International Monetary Fund, like the International Bank for Reconstruction and Development (or World Bank), was established at the Bretton Woods conference in New Hampshire in 1944. While the World Bank's mandate was to provide longer-term, development assistance, the IMF was given the responsibility to provide short term balance of payments loans to countries whose current account positions were in deficit as

Eichengreen (2006).

a result of insufficient exports or excessive imports. Each country was expected to fix a par value for its currency in terms of gold (later the US dollar), and to maintain its exchange rate within a narrow band. Since changing the parity was to be limited to cases of “fundamental disequilibrium,” and because private capital flows were rudimentary, an official lender was needed to provide temporary financing until the balance of payments could return to equilibrium. If shocks and their effects were temporary, then temporary balance of payments support might be sufficient, but often, a reduction of domestic expenditure and a tightening of fiscal policy would also be required. The architects of the Bretton Woods system were conscious of the trade-off between financing and adjustment; too generous finance might delay necessary adjustment, but absence of finance might require drastic policy measures that would be bad for the country concerned and its neighbours. Hence, Article I(v) of the Fund’s Articles of Agreement states that one of its purposes is

“... to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.”

It is well known that a disagreement between John Maynard Keynes’ conception of the IMF as a world central bank, issuing its own currency, and the more limited American view expounded by Harry Dexter White was resolved in favour of the latter. Thus, the IMF as created and as it operates now resembles a credit union, where countries deposit funds with the IMF (according to the size of their quotas) and the amount that

they can draw on the Fund (their access limit, though this is somewhat flexible⁸) also depends on their quota. The amount the IMF can lend is thus constrained by the funds deposited, but it is further limited by the fact that countries fulfill their quota in part by depositing their own currencies, and some of those currencies are not usable in international transactions. Unless the IMF resorts to borrowing, something it has rarely done in the past, the IMF must increase the size of quotas to increase the size of its lending; they are in any case reviewed every five years⁹.

But decisions on quota increases are contentious for several reasons. On the one hand, the relative size of countries matters for their influence in Fund decision-making, leading countries to want a larger quota. In particular, important decisions require an 85 percent majority (votes weighted by quota), and the United States, the country with the largest quota share (17 percent), is the only member with a blocking vote. It is likely to resist any set of quota increases that reduced that share below 15 percent. Quota shares matter to other countries also since they influence whether they can name their own Executive Director¹⁰, and whether they can block a decision collectively with others of like mind. On the other hand, quota increases payable in hard currencies have a real resource cost for the country concerned. Even in the United States, which can create the hard currency to pay for the quota increase, there is often concern that increases in the IMF's resources may lead to excessive global liquidity and be inflationary. Thus, quota

⁸ Normal cumulative access limits are currently 300 percent of quota, but they can be exceeded in exceptional circumstances. Turkey, for instance, has borrowed as much as 2100 percent of its quota in the context of Fund programs in effect since 2001.

⁹ SDR allocations are another way of increasing the amount the IMF can lend, but these are infrequent. A special SDR allocation was approved by the IMF's Board of Governors in September 1997 through the proposed fourth amendment to the Articles of Agreement, but it has still not been approved by the United States and hence has not gone into effect.

increases in the United States are subject to intense Congressional scrutiny and approval cannot be taken for granted.

Reluctance of member countries to increase IMF quotas has meant that the size of the resources made available to the Fund has not kept pace with the size of the world economy, as measured for instance by world trade¹¹ (Table 1 and Chart 1). Countries' foreign exchange reserves have grown much more rapidly, but they also lagged foreign trade growth until the latest subperiod, 1991-2006 (Chart 2). Moreover, the distribution of quotas has diverged from the relative economic importance of countries. Documents prepared for the IMF's quota reviews present formulas that relate quota shares to various economic indicators, but the formulas are contentious since they can be very sensitive to innocuous changes in the variables used or to the relative weights given to each formula (since a composite is calculated). In fact, the ultimate result has reflected squabbling and arm-twisting rather than a dispassionate application of economic criteria. Moreover, there is a natural inertia to the process, since the economic indicators that are used are typically historical averages that lag the latest data, and changes in relative position are resisted. Thus, emerging market countries, which have grown strongly in recent decades, tend to be under-represented, while more mature economies tend to be over-represented. In particular, Europe, which was at the hub of the world economy at the time of the Bretton Woods conference despite the ravages of the war, has retained large quotas that by some measures no longer represent Europe's economic importance, and the EU has 7

¹⁰ Or, as the largest country in a constituency, can legitimately claim to represent that constituency and be elected to do so. Some constituencies rotate the right to nominate the director among the largest of the member countries.

¹¹ The shortfall is even greater when compared to GDP growth.

of 24 executive directors¹². Africa is the continent with the least representation, despite its large population: there are only two sub-Saharan African directors out of 24, representing 43 of the IMF's 185 member countries. Africa would not benefit from a formula that only reflected economic size, further complicating quota reform¹³.

However, it is by no means straightforward to gauge the systemic importance of countries. Table 2 gives several of the traditional measures used by the IMF—posted on the IMF's website in the context of the latest (ongoing) quota review. On the basis of GDP shares at market exchange rates, the euro zone does not seem out of line; indeed, it is slightly under-represented. When looking at the size of current payments and receipts—a measure of its importance as a trading bloc—the euro zone has an even greater claim to a higher quota share. Reserves are also one of the traditional variables, though clearly one under the direct control of countries. As can be seen, Japan and China's enormous reserves would give them a claim to larger quotas. Finally, even the measurement of the variables is contentious, in particular cross-country comparison of GDP levels. Use of market exchange rates (as is done for the quota review) penalizes developing countries because prices of their non-traded goods are significantly lower than those of the advanced economies. Thus, the IMF's *World Economic Outlook* uses purchasing power parity exchange rates, which give much larger weights to China and India. Chart 3 compares the indicators and quota shares for selected countries and the euro zone.

Despite unresolved issues concerning methodology, a thorough-going review of quotas is widely viewed as necessary to reestablish the legitimacy of the Fund as a global

¹² Six euro-zone directors, plus the United Kingdom.

institution that deals with member countries in an even-handed way¹⁴. The need for such a reform is made particularly important by the perception in Asia that the IMF's policy advice during the 1997-98 crisis was biased (in favor of US views on market opening and capital account liberalization), intrusive, and wrong. Giving these countries a greater share would increase their "voice" within the organization and their power to prevent a repeat of what they view as excessive and inappropriate conditionality. For the management and staff of the IMF, a reform is seen as desirable since it would help stave off moves to rival the Fund through the creation of an Asian Monetary Fund.

II. Capital Mobility and the Fund's Role

By most measures, the size of the resources available to the Fund has not kept pace with the world economy, as suggested by Table 1. More striking still is the extent that capital flows have expanded since the early days of the Bretton Woods system. Data are incomplete and the concept of capital mobility is hard to measure, but Table 3 gives some idea of the orders of magnitude involved. Cross-border banking claims have increased thirty-two-fold since 1977, as measured by international asset positions of (BIS-reporting) commercial banks. This translates into a 13.1% annual rate of growth, far in excess of world trade's 8.4% growth over the same period. Other BIS data indicate that international debt securities outstanding have risen almost fourteen-fold since 1987, or 15.7% annually. In contrast, amounts outstanding of domestic debt securities (all issuers) have only increased about three-fold since 1989, about the same 8% annual growth as for international trade.

¹³ Africa's share is somewhat protected by the existence of "basic votes" that do not depend on economic size. Former Managing Director Michel Camdessus has also proposed using population in the formula.

¹⁴ Helleiner and Momani (2007), for instance, stress the need for reform of the IMF's governance structures.

If we take world exports as our measure of the importance of the potential shocks to the balance of payments that the designers of the Fund intended IMF resources to cushion, the institution has been hit by two opposite trends, both of which have tended to diminish its potential effectiveness. On the one hand, the size of the resources available to it has fallen substantially since 1948, shrinking the size of the IMF's balance sheet by more than three-quarters when compared to world trade (Chart 2). On the other hand, capital mobility has increased enormously. Chart 2 shows how international bank claims and international debt securities have greatly expanded relative to world trade (these data do not go back to 1948, but start in the 1970s or 80s, as indicated in Table 3).

Increased capital mobility has had two major impacts on the Fund's role. First, it has led to the widespread abandonment of pegged exchange rates, by the major industrial countries in 1973 and more recently by most emerging market economies. Second, it has shrunk the size of the IMF's balance of payments support relative to the size of potential capital outflows. It is not surprising that the IMF's relevance has been called into question. However, Chart 1 also shows the recent sharp decrease in the use of Fund resources relative to quotas, making the case for a quota increase difficult to argue.

It was clear by 1973—when the major industrial countries were forced to abandon their dollar pegs by massive capital flows—that high capital mobility makes it very difficult to operate pegged exchange rate systems when their credibility is called into question. This reflects the so-called impossible trinity: high capital mobility, monetary policy independence, and fixed exchange rates are incompatible. Countries willing to abandon one element of the trinity, e.g. monetary policy independence, may quite successfully operate a pegged exchange rate as long as they can convince markets of their

commitment. For instance, before they joined the euro zone, Austria and the Netherlands successfully pegged their currencies to Germany's and Luxembourg to Belgium's (in the context of the Belgium Luxembourg Economic Union). Such pegs work best where it is clear that there is no value to the smaller country in retaining monetary independence, so that a commitment to the peg is perfectly credible. Otherwise, doubts may rightly arise about the commitment, stimulating speculative flows.

Until the 1990s, developing countries mostly retained sufficient capital account restrictions that they were able to operate their pegged exchange rate systems¹⁵. This changed with expansion of lending to developing countries in the form of marketable instruments. In this environment, many developing countries saw great advantage in attracting foreign capital by reducing capital account restrictions, some even giving incentives for residents to undertake short-term foreign borrowing over domestic borrowing¹⁶. The boom in inflows set the stage for their rapid withdrawal, making it difficult to prevent a financial crisis. Even if a net withdrawal does not occur, a "sudden stop" in gross lending will provoke a crisis if a country has substantial debt coming to maturity, which needs to be at least partially rolled over to prevent a default.

The virulence of the financial crises that occurred in the 1990s led to a re-consideration of the assumption that capital accounts should be liberalized. Malaysia imposed capital account restrictions at the height of the Asian crisis, and, though it suffered serious output losses and financial distress, it was somewhat less affected than its neighbours. Ten years after the crisis, however, it is clear that Malaysia's strategy will

¹⁵ Official exchange rate regime classifications can be misleading, since some countries declared their exchange rate regimes to be flexible while operating de facto pegs, and conversely some pegged rates were altered frequently.

¹⁶ For instance, the Bangkok International Banking Facility.

not be the new paradigm. Not only has that country partially reversed those restrictions, its experience and that of others has made it evident that there are costs from insulating oneself from international capital markets in today's world. Chile, which used a tax to discourage short-term capital inflows and hence reduce vulnerability to speculative outflows ("hot money"), learned that restrictions could be evaded through clever financial engineering. Chile has now also abandoned these controls. The adoption of flexible exchange rates makes capital controls mostly redundant, while financial development makes them increasingly costly. At most, therefore, the last decade's experience of emerging market crises may slow the movement to freer capital movements, not reverse it. The international monetary system, barring the equivalent of nuclear meltdown, will not move back to a system of pegged exchange rates and controls on capital. With more flexible exchange rates and greater access to international capital markets, countries are better able to cushion shocks without recourse to the Fund's lending.

III. Success or Failure?

The IMF has assumed three major new tasks since the 1980s debt crisis: 1) helping transform centrally planned regimes; 2) large-scale crisis lending to emerging market economies; and 3) promoting transparency, data dissemination, codes of conduct for monetary and fiscal policy, and financial regulation¹⁷. These new activities supplemented the traditional roles of performing surveillance over advanced and developing economies, promoting international economic cooperation and trade liberalization, and lending to finance current account deficits. These new tasks were, to an extent that is hard to assess, the result both of challenges thrown up by the world economy that naturally devolved to

¹⁷ A survey and explanation of the Fund's activities is presented in Masson and Mussa (1995), which focuses on financing and surveillance.

the Fund, and an explicit attempt by management of the institution to expand its mandate. The period when these new tasks were taken on coincides with the tenure of Michel Camdessus as Managing Director and Stanley Fischer as his senior deputy¹⁸. Both were convinced that the IMF should be **the** preeminent international economic organization, and were skillful in convincing others to give the IMF new responsibilities. Thus, both the challenge posed by the fall of communism and the emerging market crises in the 1990s led the G7 to endorse an enlargement of the Fund's role. Camdessus and Fischer were also sincerely dedicated to reducing world poverty, which helps to explain the institution's expansion into a territory previously occupied by the World Bank.

Evaluating the IMF's success or failure in performing these new tasks is of course complicated because outcomes have to be compared to a counterfactual—what would have happened otherwise. As for the first of the three new activities, transforming centrally planned economies is largely completed, and this in itself is reason for considering it a success. Though there were clearly areas where in retrospect errors were made, and of course the IMF was not the sole agent for change, it is hard to dispute that both the IMF's lending, and the technical assistance and policy advice that accompanied it, helped facilitate the transition and cushion its negative effects. Unfortunately for the IMF's future role, this activity was a one-off event.

Crisis lending in a context of high capital mobility, task 2), has garnered much less praise for the institution. The type of lending that was done in the 1990s—to Mexico, the Asian tigers, Russia, Brazil and Argentina—was different in character from the IMF's

¹⁸ Camdessus was Managing Director from 1987-2000; Fischer was First Deputy Managing Director from 1992-2001. In the 1980s, Camdessus was also instrumental in expanding the IMF's involvement with G7 economic policy coordination and with assistance to the poorest countries. See IMF (2000).

traditional lending, because it was done in the context of liberalized capital movements and large short-term foreign debt¹⁹. Thus, the potential balance of payments gap was substantially larger than just the current account deficit. Also, this lending included much more extensive policy conditions than the lending to developing countries in the 1980s. There are several causes for this. First, the IMF had gotten involved with structural conditionality since it seemed necessary for the centrally planned economies, and staff continued along that path. Bureaucratic imperatives make appearing to be tough with the authorities a winning strategy at head office. Second, management was convinced that the traditional requirements of IMF programs, namely establishing macroeconomic stability and liberalizing trade, were not enough: what was now also needed were “second generation reforms” that strengthened a country’s institutions and improved the functioning of its financial system. Thus, Michel Camdessus listed among the objectives of IMF programs²⁰:

- “sound financial systems and flexible markets that promote an efficient allocation of resources;
- transparent regulatory systems that establish clear rules under which the private sector can flourish;
- appropriate social policies that protect the most vulnerable segments of the population; and finally,
- “good governance”--that is, transparent and accountable governments that follow the rule of law.”

Third, management had become more hands on; instead of establishing broad guidelines and leaving the negotiations to staff, Stanley Fischer in particular became much more involved in the details of Fund programs, communicating continuously with staff in the

¹⁹ This led Camdessus to term the Mexican crisis the “first crisis of the 21st century.”

²⁰ Remarks by Michel Camdessus to the Mid-America Committee, Chicago, Illinois, April 11, 1996.

field. Management's involvement in practice led Fund programs to include a greater number of conditions, to an extent that many believed to be excessive²¹.

There were numerous criticisms at the time and subsequently of IMF programs with Asian crisis countries. As noted, the countries concerned have very unpleasant memories of their involvement with the Fund, leading them to try to avoid any future occurrence. The IMF itself, both in the form of staff papers and reports of the Independent Evaluation Office²², has admitted to some deficiencies in the conditions accompanying IMF lending. As a result, the institution has committed to strengthening its pre-crisis surveillance and reducing the scope and detail of its program conditionality.

More difficult to judge because of the counterfactual problem is the effectiveness of IMF lending in actually limiting financial crises. What is certain is that even in the best of cases, large IMF lending did not prevent sharp currency depreciations, large output losses, and severe hardship. The most successful of these programs was probably the one for Mexico; early in 1995 the IMF and the US government lent over \$40 billion to that country, which faced large redemptions of US dollar-linked securities (Tesobonos) as well as a large current account deficit. The lending package allowed all the Tesobono holders to be repaid, but the Mexican peso nonetheless depreciated from a little more than 3 to 10 to the dollar, and output contracted by 6 percent in 1995, rebounding the following year. In Asia the crisis was more protracted, and the program with Thailand did not prevent contagion to other countries in the region. Thus, it seems clear that even very sizable IMF lending packages were incapable of preventing domestic disruption and its spread elsewhere. Of course, there were structural weaknesses in each of the countries

²¹ Stanley Fischer's response to noncompliance with previous conditions was to slap on more conditions.

²² See IEO (2003) for Asian crisis lending, and IEO (2004) for IMF programs with Argentina.

concerned, justifying greater caution on the part of international investors (“wake up call”), and adjustment measures are unlikely to be painless. But it seems to be the case in the present environment of high capital mobility that minimizing the impact of crises and eliminating their spread would require substantially greater lending than the IMF has been able to provide. IEO (2003) concluded that the Fund’s initial program with Korea (in 1997) was ineffective because it did not involve enough financing²³. As for Argentina, the IMF’s continued lending in the face of policy problems has been blamed for making the ultimate crisis worse, when it finally came; by that time, the IMF no longer was willing to lend the additional amounts that might have prevented a default²⁴.

Turning to the third new task, the IMF has contributed in a modest way to improving the transparency and accountability of countries willing to adopt its standards on data dissemination, financial regulation, and codes of conduct of monetary and fiscal policy. Among other factors, this has had the effect of putting emerging market debt on a par with high yield corporate debt as an asset class²⁵, contributed to the narrowing of spreads on emerging market borrowing, and further enhanced capital mobility to developing countries. As a result of greater information, investors now discriminate more easily between different countries. Thus contagion, which was rampant during the 1997-98 Asian crises, was absent at the time of Argentina’s default late in 2001. Time will tell whether this progress is durable. Success in this area tends, in any case, to reduce the need for crisis lending, a much more visible and exciting task for the Fund.

²³ The initial program needed to be supplemented by pressure from G7 governments on their banks to maintain exposure to Korea.

²⁴ See discussion in Mussa (2002).

²⁵ See World Bank (2006).

IV. Prospects for Meaningful Reform

If one accepts the hypothesis that the Fund's current role is diminished and will remain so unless there is significant reform²⁶, then one can ask whether there are plausible reforms that can significantly expand its role. The main reforms being considered are changes that would expand its mandate and those that would improve its governance. Taken together, they might make the substance of the IMF's work both more relevant to today's international monetary system and more acceptable to a broader set of its membership.

1. An updated role at the centre of the international monetary system?

As argued above, the current environment of high capital mobility makes a return to a system of pegged exchange rates both undesirable and unlikely. Thus, the IMF will not reclaim the mandate it had under Bretton Woods to manage such a system. Furthermore, capital mobility will continue to increase as a result of financial innovations, such as the increasing use of derivatives, that expand the possibilities of taking long or short positions in different countries or currencies. The decline in the size of IMF resources relative to private capital flows will tend to worsen, diluting its impact further.

There are two possible avenues that could stem or reverse that decline in influence²⁷. The first is the conversion of the Fund to a true lender of last resort, as advocated notably by Stanley Fischer (1999). A domestic central bank can stave off financial meltdowns by massive injections of liquidity into financial markets. The IMF

²⁶ This was the premise underlying the conference held at the Institute for International Economics, whose proceedings are reported in Truman, ed. (2006).

²⁷ A third one, for the IMF to become a world bankruptcy tribunal for sovereign lenders, was rejected when proposed by former First Deputy Managing Director Anne Krueger.

could be given the resources to do so, or, like a central bank which can create unlimited amounts of its own currency, the right to create liquidity, for instance in SDRs or as Keynes suggested, in a world currency (“bancor”).

If the current system in which the size of the Fund’s resources are constrained by quotas remains in force, the quota increases necessary to allow the Fund to play the role of lender of last resort in a substantial way would be enormous. Thus, even in the aftermath of the financial crises of the 1990s, the response to Fischer’s call was resoundingly negative. In the current environment, a consensus among IMF members in favour of a very large quota increase seems very unlikely—even if there is a resumption of volatility in capital flows to emerging markets.

A more fundamental way of increasing the Fund’s ability to play the lender of last resort would be to give it the ability to create its own liquidity, without the need to increase quotas or go through the formal ratification process of SDR allocations. Such a scheme could allow the creation of balances in an international currency that would be under the control of the IMF and that could be increased as needed in an international crisis. In this way, true liquidity crises—the attempt by lenders to liquidate risky assets and turn them into cash, thus provoking a crisis—could be staved off, since investors would recognize that liquidity would always be available for countries that were solvent to meet their external obligations.

Though this vision of the international monetary system has much to admire, it raises fundamental issues of delegation of national sovereignty. Clearly, a true lender of last resort role would require the IMF to issue its own (world) currency, not the currency of any member country. Thus, issuing the SDR would not be possible without a change

in the nature of the SDR, which in its current form is a basket of national currencies (dollar, euro, yen, and pound sterling). Otherwise, the IMF would usurp the roles of the respective central banks. While having a multilateral institution at the top of the international monetary pyramid makes sense, it requires a much more elaborate and effective international governance structure than we have today or that is likely to emerge for many decades to come.

The experience with creating a common currency in Europe is instructive. It is clear that the European Central Bank needs to lean on other community institutions for public support and to resist pressures from governments to modify its monetary policy. Europe has institutions developed over the last 50 years—a parliament, court of justice, a supra-national executive body (the EU commission) with responsibilities for trade and competition issues, among others—and there has been widespread harmonization and cooperation in a number of fields. Despite this, there are concerns about a “democratic deficit,” and the ECB has had to assert its independence and establish its legitimacy. Without global supporting institutions, a world central bank would have difficulty operating effectively. More tellingly, governments would not accept to give it the powers that such a role would require.

The second avenue for reestablishing the IMF’s influence would boost its role in managing a system of mostly flexible exchange rates—that is, by increasing its exchange rate surveillance, rather than increasing its lending operations. Critics of the 1976 Jamaica Agreement that legitimized the current international monetary system (what some have called a “non-system”²⁸) have been vocal from the start. They have objected to the complete discretion it gives to countries to choose any exchange rate regime going

from a hard fix to a clean float. Even if one accepts the need for that discretion, more conditions could be put on how countries operate the regimes they have chosen. To date, the IMF's policy advice has focused more on macroeconomic policy than on foreign exchange market intervention. In the view of some, the Fund should take a much more pro-active stance with countries, like China, that intervene heavily in foreign exchange markets and consistently in the same direction (see, e.g. Goldstein, 2006). This, after all, is a sign of "currency manipulation" that is proscribed by Article IV and by the Guidelines to Floating established by the IMF's Executive Board in 1977.

Can this provide a major boost to the Fund's role? That institution has been reluctant to label a country a currency manipulator, essentially for two reasons. First, it is hard to formulate the criteria to apply in a world where there is no reason to outlaw any particular exchange rate regime. Since countries have the right to intervene in order to reduce volatility, some amount of one-way intervention is normal if shocks, even temporary ones, are persistent. Countries like China with undeveloped financial markets and facing imperfect capital mobility are more likely to need to intervene than more advanced countries with deep financial markets. The alternative would be for China to accept potentially large exchange rate movements that could weaken its financial system and cause widespread bankruptcies. Thus, caution is in order when formulating any rule that would limit the scope to intervene²⁹. The second, practical, reason that the IMF has not been pro-active in this area is that member countries, through their representatives on the Executive Board, have been reluctant to point the finger at others because they themselves might be on the receiving end. For instance, the prolonged speculative

²⁸ Corden (1983)

attacks against the European Monetary System parities led EU countries to undertake prolonged one-way intervention, so they are not well placed to criticize others in this regard. Similarly, any country might become embroiled in a political or economic crisis that might be made worse by turmoil in foreign exchange markets.

It is also needs to be recognized that China's case is a special one which is likely to be resolved sooner or later since the authorities agree in principle with the need for greater flexibility. As noted, most other emerging countries have already adopted more flexible exchange rate regimes. Hence, even if the IMF became more engaged with China, this would not provide a model for an enduring new role in managing the world economy. As for the IMF becoming more active in resolving global imbalances, this is an even greyer area than exchange rate manipulation. Current account deficits and surpluses are not necessarily bad: some countries have investment needs in excess of their own saving, and conversely. Judgment needs to be applied to identify the cases when the imbalance is the result of an inappropriate policy mix. When, as now, the United States' external deficit position is in large deficit (with as counterparts the current account surpluses of Asian economies and the oil exporting countries) and the IMF is critical of US policies, the likelihood that the IMF can have a major influence in resolving imbalances is small. It is clear that the current US administration has no sympathy for the view that that US policy is at fault for causing its current account deficit, preferring to blame excessive saving in the rest of the world³⁰.

2. More equitable representation?

²⁹ Nevertheless, the extent of China's intervention and the size of her foreign exchange reserves make the case for currency manipulation fairly clear.

Changing the financial shares and voting power within the Fund is now widely agreed to be essential. Doing so should help to increase the legitimacy of the Fund in Asia and Latin America, which bore the brunt of the Fund's policy advice during the financial crises of the 1990s. However, as suggested above, finding other countries willing to see their shares reduced is extremely difficult³¹. As noted, the United States insists on retaining a blocking minority share. European countries, though obviously over-endowed with seats at the Executive Board, are resisting the loss of seats influence that would result from a major reduction in their quotas.

The existence of the euro zone since 1999 would seem to present a golden opportunity for a rationalization of European seats (and reduction of euro-zone quota shares). Instead of having six euro-zone directors, as at present (those from Belgium, Finland, France, Germany, Italy, and the Netherlands³²), there could be a single director representing the euro zone. Such a reform, advocated by the United States government and others and on the face of it rational, runs into several snags which European directors are using to successfully resist it. First, it is countries, not regional institutions, that are members of the IMF. Second, the activities of the IMF are not only monetary, especially given the demise of the pegged exchange rate system; the IMF essentially provides budgetary support to governments. In fact, it is often a country's finance minister (not the

³⁰ When the IMF tried to single out the fiscal policies of the Reagan administration as the culprit for the large global imbalances in the first half of the 1980s, the US Treasury was successful in preventing the staff's study from reaching the Executive Board.

³¹ It is of course true that the ad hoc quota increase for four countries agreed in September 2006 reduced the shares of all the others, but not by enough to be very contentious. And the quota increase did not have to be approved by the other countries' legislatures, since their own contributions were not affected.

³² Only those for France and Germany are appointed; the others are elected by constituencies of several countries. Some euro-zone countries are members of other constituencies not represented by the above six directors; for instance Ireland, which is a member of the Canadian constituency, nominates the Alternate Executive Director of that constituency, and Spain belongs to a grouping of Spanish speaking countries currently represented by a Venezuelan director.

governor of the central bank) that is the country's IMF Governor--that is, its lead representative³³. Finally, the contributions to the IMF's resources are a budgetary matter, necessarily involving treasuries, and thus government approval is required for quota increases. Hence, sole representation of the European Central Bank at the Fund's executive board would not be appropriate, unless the ECB were given the right to speak for those governments—surely contrary both to the hard-won independence of the bank and the interests of the EU governments.

While the IMF has admitted a representative of the euro zone to the Executive Board as observer, consolidation of euro-zone seats continues to be resisted, and it would probably require an amendment to the Articles of Agreement. It is thus unlikely to provide an easy solution to the under-representation of emerging market countries. Moreover, as discussed above, the contention that the euro-zone is over-represented in terms of quota shares is by no means indisputable. However, Truman (2006) has concluded that only a consolidation of European quotas, allied with a large quota increase so that no country would actually reduce its quota in SDR terms, could bring about a meaningful expansion of the voting share of emerging market economies. But a large quota increase and amendment of the Articles of Agreement would generate major resistance, and its success would by no means be assured.

The effect of a reallocation of quota shares on the IMF's operations should also not be exaggerated. Most decisions are taken by consensus at the Executive Board. Some aspects of Fund programs are influenced by lobbying of major shareholders before they are presented to the Board, and the exact quota share is not likely to make much of a

³³ Thus it is the UK Chancellor of the Exchequer Gordon Brown, not Bank of England Governor Mervyn King, who is the current chairman of the Fund's guiding body, the International Monetary and Financial

difference here. In any case, the United States is likely to retain its preponderant influence. Thus, even though adequate representation is something that emerging market countries, especially those in Asia, can rightly demand, its achievement would be more symbolic than substantial.

V. What Should the IMF Do?

The IMF's strength is that it is at present the only effective global financial institution. The IMF's role in standing ready to provide finance to countries with balance of payments problems needs to continue. While the IMF is less active now, it would be reckless to assume that it will no longer be needed to assist in the case of future financial problems. However, as is recognized by member countries and endorsed by the IMF's management and executive board, IMF lending needs to be more limited and accompanied by fewer conditions. As suggested above, with increasing mobility of private capital this role has been diminishing, and will continue to do so.

The IMF also has a comparative advantage in acquiring and analysing information on macroeconomic, balance of payments, and financial matters. While it is by no means the only organization able to do so—for instance, such information is also available from the OECD, the BIS, and the World Bank—its traditional mandate in this area and the extent of its membership has meant that expertise is broader at the IMF than at these other institutions. It has the responsibility under Article IV to perform “firm surveillance” over members’ policies in this area, so that it can insist on accurate and up-to-date information.

It should continue its evolution in the direction of making data, analytical information, and candid assessments publicly available. While two decades ago the reports prepared for IMF consultations were rarely if ever made public, now it is routine to do so. This is an important public good. The IMF's *World Economic Outlook* publication now makes its data base available on the web, and the IMF posts many other staff papers. Clearly dissemination of information is an important activity that deserves to be expanded. The IMF could go further in making public its assessments of the overall policy stance of countries. Moreover, these could be more candid—less influenced by the desire to make a negotiated program succeed by painting an overly optimistic picture of the outlook.

As argued, it seems inevitable that the IMF should have a less prominent role in the international monetary system than it had in the 1980s and 1990s. In such an environment, it is important for the institution to concentrate on the tasks for which it has a clear comparative advantage. This would involve not of an expansion of IMF activities, but rather the IMF doing better what it does best. Such a strategy would be more likely to enhance the reputation of the institution than a search for new mandates. The IMF's failures during the 1990s were to a significant extent the result of getting involved in too many different areas where staff had limited expertise and power to effect change. Achieving institutional reforms, for instance, is largely dependent on political forces beyond the control of officials in Washington; respect for a country's sovereignty and democratic processes should in any case limit the Fund to an advisory role in this area.

The IMF would be well advised to learn from the experience of national central banks. After the oil price shocks, the central banks of many OECD countries were taken

to task by their populations for neither maintaining full employment nor containing inflation. Through reforms that aligned their objectives more clearly on inflation control, and by achieving their targets, central banks were able to reestablish their authority. Legitimacy and public support for an official institution are enhanced by a well-defined mandate and targets that are in its power to achieve.

VI. Conclusions

Capital mobility is here to stay, and no system that requires reestablishing extensive restrictions on capital will work. This has several implications. First, the exchange rates between most of the world's currencies—all but the currencies of the smallest countries, or those with so-far undeveloped financial markets—will exhibit a considerable degree of flexibility. The IMF will not once again be given the mandate to manage a system of pegged exchange rates, and its role in managing a more flexible system with vague rules of the game will necessarily be a modest one. Second, no international organization can serve as international lender of last resort because the amount of liquidity required would be dwarfed by private capital flows—unless that institution can, like a domestic central bank, create its own liquidity. However, the world is not yet ready for a global central bank, nor is it likely to be for the foreseeable future.

A third implication, resulting from the first two, is that the international monetary system in its current form cannot be managed to the extent it was in the immediate postwar period. It will necessarily evolve in ways that are driven mainly by private capital, rather than being dictated by the official sector. In that context, any reforms to the IMF are not going to change fundamentally its position in the world economy.

However, there are reforms that can help the IMF function better within its limited role. IMF lending should be more short-term and accompanied by fewer conditions. More equitable representation of countries can help to increase its legitimacy and improve decision-making. Greater diffusion of information and more candid country assessments can enhance the IMF's contribution to international public goods.

Paradoxically, reforms that expand the Fund's powers beyond its capabilities may be counter-productive. A more modest but focused role can help promote effectiveness and accountability by restricting the institution to areas where it has a clear mandate and unchallenged expertise.

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**Table 1. Sources of Global Liquidity and World Trade
(annual rates of growth, in US dollars)**

	1948-2006	1948-73	1973-91	1991-2006
IMF Quotas	6.62%	6.16%	7.54%	6.30%
Foreign Exchange Reserves	8.39%	5.58%	9.93%	11.34%
World Exports	9.56%	9.36%	10.68%	8.56%

sources: IMF International Financial Statistics and Sept. 2006 World Economic Outlook.

Table 2. Quotas, GDP, Reserves and Current Payments and Receipts

	*****	in millions of SDRs			*****	Shares of World Total			*****	Memo:
	quota c/	GDP d/	Reserves d/	Cur. P&R e/	quota	GDP d/	Reserves d/	Cur. P&R e/	GDP at PPP f/	
United States	37,149	7,917,828	58,279	2,296,558	17.1%	28.7%	2.7%	18.1%	20.1%	
Japan	13,313	3,150,662	544,326	817,421	6.1%	11.4%	25.3%	5.0%	6.4%	
euro-zone	49,859	6,474,584	137,590	4,649,125	22.9%	23.5%	6.4%	31.5%	14.8%	
other EU	20,405	2,272,055	143,799	1,641,648	9.4%	8.2%	6.7%	11.4%		
Asian "tigers" /a	18,607	2,442,216	662,466	1,712,742	8.6%	8.9%	30.8%	11.4%		
China	8,090	1,272,694	333,596	735,207	3.7%	4.6%	15.5%	5.0%	15.4%	
India	4,158	449,889	77,462	148,218	1.9%	1.6%	3.6%	1.0%	6.0%	
Korea	2,927	458,617	115,821	338,462	1.3%	1.7%	5.4%	2.3%		
Malaysia	1,487	79,836	37,085	169,533	0.7%	0.3%	1.7%	1.1%		
Singapore	863	72,079	69,202	188,121	0.4%	0.3%	3.2%	1.2%		
Thailand	1,082	109,101	29,300	133,201	0.5%	0.4%	1.4%	0.9%		
Latin American EM b/	9,469	1,039,670	99,305	537,294	4.4%	3.8%	4.6%	3.8%		
Brazil	3,036	407,520	34,157	131,346	1.4%	1.5%	1.6%	0.9%	2.6%	
Mexico	3,153	456,473	41,619	301,342	1.4%	1.7%	1.9%	2.1%	1.8%	
other	68,733	4,273,331	508,558	2,883,306	31.6%	15.5%	23.6%	18.8%		
Total	217,535	27,570,346	2,154,323	14,538,094	100.0%	100.0%	100.0%	100.0%		

a/ China, India, Korea, Malaysia, Thailand, Singapore

b/ Argentina, Brazil, Chile, Mexico, Uruguay

c/ includes quota increases authorized in September, 2006 for China, Korea, Mexico, and Turkey

d/ in 2004. GDP is at market exchange rates

e/ Current payments plus receipts, average, 2000-04

f/ GDP for 2005, evaluated at Purchasing Power Parity exchange rates, from Sept. 2006 *World Economic Outlook*

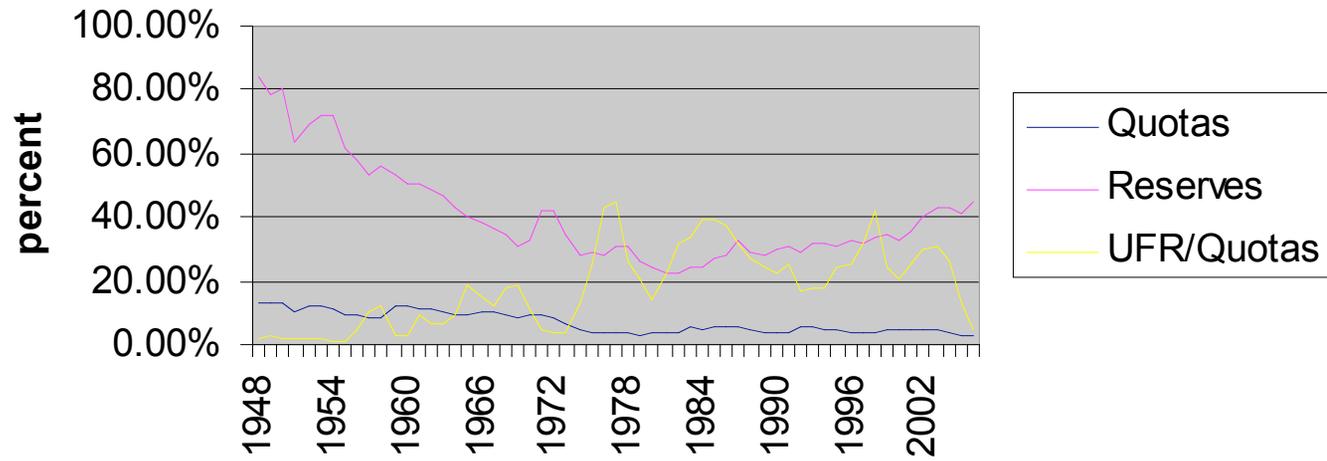
Sources: IMF, Feb. 2007 online data for Quota Review, and *World Economic Outlook*, Sep. 2006

Table 3. Growth in International and Domestic Claims and World Trade

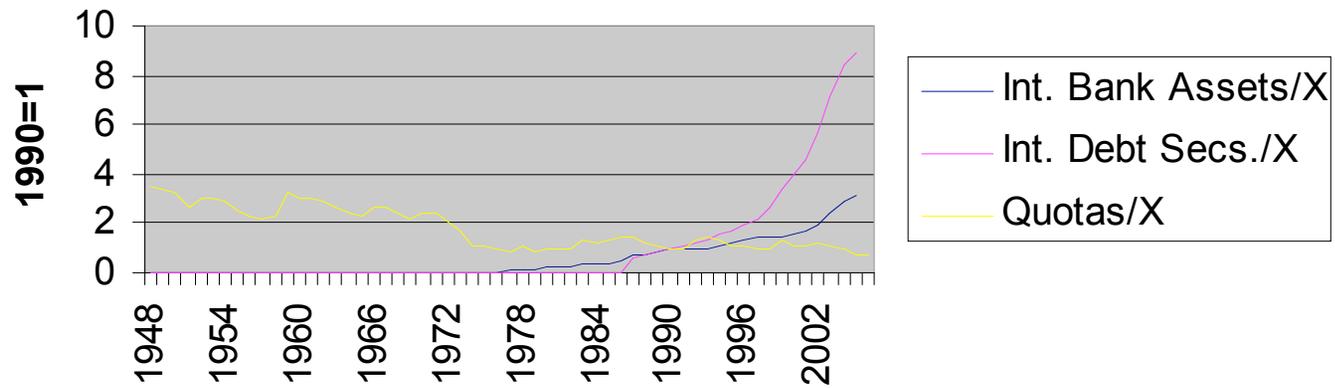
	1977-2005 (annual growth rates)	1987-2005	1989-2005	2005 level (US \$ bn)
Banks' international assets	13.13%			23,916
International debt securities		15.72%		14,614
Domestic debt securities			7.51%	45,076
memo: World exports	8.43%	8.59%	8.21%	10,354

sources: IMF, International Financial Statistics; BIS Quarterly Bulletin September 2006, end-year data

Chart 1. Quotas and Reserves as Ratios to World Trade, and Use of Fund Resources



**Chart 2. IMF Quotas and International Claims,
ratios to world exports, 1948-2006**



source: IMF and BIS

Chart 3. Quotas and Economic Variables

