What role for the IMF?

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Introduction: The IMF post G-20 Summit

Writing about the current and future role(s) for the International Monetary Fund (IMF or Fund) is like trying to capture a moving target or a desert river bed fast transformed into a raging torrent following a storm.

In September 2008, the IMF looked moribund. The only loans outstanding were to low-income countries (LICs), which cost the Fund to service, rather than bringing in interest fees. It had just cut staff for the first time ever, providing silver (if not golden) parachutes for approximate 13% of its staff. Even with this cost-cutting, with no new customers and very many dissatisfied former customers, all of whom were eager to self-insure as the high price for avoiding future dealings with the Fund, the IMF was still facing an operational deficit.

By November 15, 2008, the Fund was a phoenix. The G20 Summit, led by the European Union members, has assigned it new roles, and called for substantial new funding. In the Action Plan following the Summit Declaration, the IMF is referred to in two sections. Under "Enhancing Sound Regulation; Regulatory Regimes, Immediate Actions by March 31, 2009," the single action point calls for "The IMF, expanded FSF [Financial Stability Forum], and other regulators and bodies should develop recommendations to mitigate procyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends."

Later, under "Refoming International Financial Institutions, Immediate Actions by March 31, 2009", the G20 Summit members agreed that:

- The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthentheir collaboration, enhancing efforts to better integrate regulator and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.
- The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.
- We should review the adequacy of the resources of the IMF, and the World Bank Group and other multilateral development banks and stand ready to increase them where necessary. The IFIs shold also continue to review and adapt their lending instruments to adequately meet their members' needs and revise their lending role in the light of the ongoing financial crisis.

In that same section dealing with medium-term actions, the G20 Summit members agreed:

- The IMF should conduct vigorous and even-handed surveillance reviews of all countries, as well as giving greater attention to their financial sectors and better integrating the reviews with the joing IMF/World Bank financial sector assessment programs [FSAP]. On this basis the role of the IMF in providing macro-financial policy advice would be strengthened.

- Advanced economies, the IMF, and other international organizations should provide capacity-building programs for emerging market economies and developing countries on the formulation and the implementation of new major regulations, consistent with international standards.[1]

Already large loans had gone out to Georgia, Iceland, Ukraine, Hungary, Pakistan and Belarus, with more likely. All of these loans will provide interest income for the Fund, easing its institutional deficit problems, and providing a fresh raison d'etre.

The G20's enhanced role for the IMF pales in comparison with the new role that the Fund's Managing Director, Mr. Dominique Strauss-Kahn proposed in an October 30, 2008 interview with Le Monde, where the Fund would have the roles of firefighter, builder, and architect in the new global financial system. Specifically, Strauss-Kahn set out five key ideas for the G20 heads of state and ministers to consider:

1. Develop a new loan to relieve the short-term liquidity problems some economies face; we have already defined the features.
2. Increase the IMF's resources, which could prove insufficient in the medium-term in light of the scale of the needs; this is what Gordon Brown has proposed.

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[1] Action Plan to Implement Principles for Reform, Declaration Summit on Financial Markets and the World Economy, White House Press Release, November 15, 2009.

> 3. Draw lessons from the economic policies that have repeatedly caused these "bubbles," which destroy the real economy when they burst; this is the mission we were given a few days ago by the 185 member countries of the Fund.
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> 4. Oversee the implementation of the new financial regulations drafted, in conjunction with the IMF, by the Financial Stability Forum, which brings together mainly the major central banks.
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> 5. Contribute to redesigning a simpler, more effective world system that would be more coherent and better coordinated as a result. In addition to its roles as fireman and builder, the IMF could also play the role of architect for a period of time.

What Strauss-Kahn proposes can be both too much and too little. Without further substantial changes to the its governance, staffing and capacity, the Fund will lack the legitimacy and the skills to accomplish any of these new tasks, much less the less ambitious agenda it claimed for itself in the preceding months.

The actions of the G20 Summit have put to rest any notion that the Fund might quietly fad away for lack of funds and relevance. Instead it has been assigned new tasks for the global economy. This makes it all the more imperative to ensure the Fund undergoes profound reform.

In the midst of Washington's prolonged traffic jams, known locally as "limolocks", on November 15 it was hard to recall that the majority of the countries of the world were not represented,172 of 192 had not been invited. Among the absent were all the world's poorest countries, and hence those countries still dependent on IMF "seal of approval" before donors would release any foreign aid, or the occasional investor would invest.

The rest of this paper will specify fhree major reforms the Fund must undergo to accomplish any or all of these tasks. It will then suggest additional functions the global financial systems still requires, some of which may warrant separate institutional arrangements to accomplish.

Three Major Reforms for the IMF

1. Governance: The first profound reform that the IMF must undergo is in the area of governance. In the spring of 2008, the IMF Executive Board and Board of Governance approved a new formula for allocating quota shares and thus votes on the Board. The rationale was to increase the representation of "under-represented" governments, although the expectations surrounding the action were that developing countries would also increase their share of the vote. Ultimately, the outcome of nearly two years of negotiations was negligible. The under-represented countries, including South Korea, Mexico, Turkey, India, and China, as well as Ireland and Italy, shared a combined additional share of vote of 2.4%; the low income countries added 1.7% to their combined total share of the vote. Ralph Bryant, Senior Fellow at Brookings Institution, documents how this outcome was the result of a new formula for calculating shares of the Fund's quotas which was worse than the preceding formulas, and the outcomes were positive only because "gimmicks" (his word) were used to ensure even these marginal outcomes for the under-represented and for the low income countries.[2]

The G20 Summit understood the need for reform far beyond those proposed in April 2008. The Summit Declaration itself, Section 9, Reforming the International Financial Institutions, states: "We are committed to advancing the

[2] Ralph Bryant, "Reform of IMF Quota Shares and Voting Shares: A Missed Opportunity," Brookings Institution, April 8, 2008.

reform of the Bretton Woods Institutions so that they can more adequately reflect changing economic weights in the world economy in order to increase their legitimacy and effectiveness. In this respect, emerging and developing economies, including the poorest countries, should have greater voice and representation." The same intention appears in the "Action Plan to Implement Principles for Reform" which concludes the Declaration, the Summit participants commit, in their medium-term actions on Reforming International Financial Institutions.

What is apparent is that the status quo powers of the United States and Europe, under the pressure of the international financial collapse of 2007-2008, and the proximate pressure of the non-G7 economies in the room, acquiesced to changes in IMF governance that years of discussions "on principle" could not produce. Jack Boorman, former advisor to the Managing Director and Director of Policy and Development Review Department of the Fund, has argued that the Fund should abandon the agreed outcomes of April 2008, and go back to the negotiating table to get results consonant with the economic power configurations of the 2008, letting go of the allocations reflecting the powers of 1944.[3] The formula suggested by Bryant, which recognizes population and purchasing power parity as factors to include, would be a good starting point.

But in addition to voice and vote, the second core element of governance that the Fund must address is accountability. The IMF Executive Board must

[3] John T. Boorman……………….

become accountable.[4] Accountability requires transparency of Board decisions and debates; evaluation of the Managing Director, the Deputy Managing Directors, the Board itself, and the overall institution—clearly a role for the inert Board of Governors; participation by all relevant stakeholders (Parliaments, private sector, academia, civil society) and shareholders (governments); and a complaint mechanisms, to receive and redress legitimate complaints of people harmed by IMF policy prescriptions, and to allow governments to modify their arrangements when appeals to IMF country teams and EDs fail.[5]

Further, the Managing Director must be selected by all the members based on merit, not nationality, as outlined in the IMF Executive Board Resolution of July 12, 2007. And the dual roles of the MD should be separated, that of chairing the Board, from that of serving as Chief Executive Officer.[6]

Any common understanding of accountability includes the assurance that those who make mistakes will not benefit from their actions but be punished (e.g.: not promoted, reprimanded, fired when necessary). The Fund recently shut down its very small Poverty and Social Impact Assessment (PSIA) office. The Fund maintains it is not possible to determine, especially not beforehand, the likely on poor people of their policy requirements. Clearly the Fund is obligated, at the very least, to make inform guesses about the likely impact of alternative policies to resolve the specific problem.

[4] Report of the High-level Panel on IMF Board Accountability, New Rules for Global Finance Coalition, Washington, DC, April 2007.

[5] Bringing Central Asian Perspectives to the IMF Reform Debate, May 2008, p.XXXXXXXXXX; NR website

[6] Bringing Balance to the IMF Reform Debate, New Rules et al., September, 2008, p. XXXXXXXXX

Any reform of this institution must be predicated on introducing accountability into the Board and senior management, otherwise the power of inertia will win.

EDs must be more senior, currently mid-level bureaucrats; also intermediate body between Governors and Executive Board.[7]

2. Economic Philosophy: The second major reform of the IMF must involve new philosophical underpinnings. The Fund's original mandate was to deal only with trade or balance of payments imbalances. The original approach, embodied in the Articles of Agreement, rather naively assumed that trade imbalances were short-term disorders that could be rectified in short order. The Fund's longest long provisions extended only for three years. Subsequent experience demonstrates that restructuring an economy takes many more years. The short term approach may have been logical given the expectation in 1944 that there would soon be an International Trade Organization to deal with longer term imbalances and corresponding need to restructure whole economies.

Further, Lord Maynard Keynes, a major economic architect of the Bretton Woods Institution, especially wanted to ensure that countries carrying trade surpluses would be penalized. Over time, low-income IMF member-states running a trade deficit are penalized with strict stabilization policies, while those with trade surpluses are regarded as modes of successful behavior. The G20 Summit did not address the "problem" of countries with large trade surpluses, but those countries were certainly present and demonstrating economic clout in the form of Sovereign Welfare Funds.

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[7] Independent Evaluation Office, IMF Governance, date formal title, 2008

These shifts in performance by the Fund from its original mandate to today are minor compared with the strict adherence to an economic approach commonly called “neoliberalism” or monetarist. From the early 1980s until the most recent loans to Eastern European countries, IMF loans have come with strict conditions. Initially the argument was that the IMF had to “staunch the flow of blood” by stabilizing the economy. This meant that the Fund set strict limits on national budget deficits, including salary caps on government employees; redesigned the revenue side; cut tariffs and opened trade; set the exchange rate, usually by devaluing the currency; prescribed single digit inflation targets, preferably below 5%. The Fund even limited the amount of foreign aid that could be used lest it negatively impact the inflation targeting or cause the local currency to appreciate. The Fund continues to insist that growth is not possible without stability, as prescribed by the Fund.

This set of conditions has eventually resulted in more stable economies, but with limited growth, high international indebtedness, and continued extreme poverty and inequality. (The indebtedness of low income countries has decreased because of intense global campaigning that forced the hands of the G7 and other Western governments to reduce their bilateral debt and provide special trust funds to enable IFIs such as the World Bank and IMF to reduce the low income countries’ debts—but all such relief only followed after years of strict IMF policies.) Prescribing the same policies to all low income countries contributed to a fallacy of composition: with all LICs opening their economies to foreign trade by reducing their tariffs and devaluing their currencies, gave an advantage to none, but reduced the income from tariffs to all. When accompanied by World Bank projects promoting the same set of investments (e.g., coffee), the result was a global glut of coffee, and a dramatic decline in earnings to farmers, if not to consumers.

The IMF/World Bank acceptance of neoliberalism endeared it to foreign aid donor countries. But this was an economic philosophy that the wealthy countries did not adhere to in practice, not in their own histories of economic development, nor in their current responses to the global financial crisis of 2007-08. Thus, it is overdue that the Bretton Woods Institutions set aside the rigidity of the neoliberal approach—as well as their accounting model which is like an old Polaroid picture, a bad facsimile of a single moment, void of the dynamism of life and growth and diversity that characterize development[8]. To set this approach aside will require a major commitment on the part of G7 governments who are the major shareholders, the Fund's management and its staff who have faithfully adhered to these precepts as to an old religion, regardless of the evidence.

The need to change the underlying economic philosophy of the Fund is reflected in the next two major reforms proposed below.

3. IMF Staff Competencies: The third major reform at the Fund will both follow from an openness to other economic theories and will strengthen this openness to greater diversity. In addition to diverse economic preparation, Fund staff will need in-depth knowledge in two areas: 1) financial markets, for the Fund's new mandate flowing from the G20 Summit; and 2) development, or how growth happens in diverse low-income countries. The latter area of work is the

[8] See: anything by Dani Rodrik; also Ha-Joon Chang, Kicking Away the Ladder (Anthem Press, 2002).

continuation of the Fund's standard policies. The Fund has repeatedly asserted that it is not a development organization. However, at a minimum it should understand what assists and what thwarts environmentally sustainable growth with equity in a wide range of very poor countries. The policies it applies in ignorance or in adherence to abstract theoretical solutions can and have caused great harm to developing countries, especially the poorest. Therefore, the Fund must learn what works and what does not in terms of quality development. Those staff who work on low income countries should be afforded salary and recognition at least equal to those who work on the more "prestigious" issues of global finance or global trade imbalances.

With regard to financial markets, the Fund has not nor has it claimed to be an institution with expertise in financial products and markets, as opposed to national level macro-economic policy. Neither do Executive Board Members have expertise in financial matters. Therefore the IMF will be required to hire senior staff with expertise in finance, without hiring those recently fired from Wall Street who still subscribe to a view of a self-regulating market where the government and its pesky regulators have no role.

In addition to finance and development, the IMF staff overall needs greater diversity in experience and in training. At present the norm is the IMF staff join the institution immediately after receiving their Ph.D. in macro-economics in a major institution that adheres to the US/UK philosophy of the free market. The ethnic origin of the staff person and the actual location of the university have relatively little impact on the staff's perspective within the Fund. This intellectual homogeneity is reinforced by the strength of the management in requiring discipline in discussions about Fund policies, especially once any decision has been made—and of course there is even tighter discipline about external discussions before decisions are made.

Thus, the governments who are the major shareholders must insist on diversity; management must support and encourage diversity; and then staff will certainly display it. Governments who have had loans from IMF would further insist that staff have experience outside of academia, ideally in government, so they know what it is to put together a national budget, arrange tax policies, cut programs, deal with trade imbalances, and try to cajole donors.

<u>Wanted--Additional Global Functions:</u>

The G20 Summit addressed many aspect of global financial regulation, but at least three gaping holes remain: an international bankruptcy or debt workout mechanism for sovereign debtors; an international tax organization; and a global currency.

1. International Sovereign Debt Workout Mechanism: Responsible lending whether between states, states and international organizations, or individuals, must anticipate failure to pay. The capitalist system has set up bankruptcy courts to deal with such inevitabilities. This is not the arrangement on the international scene. Creditors are allowed to act in concert to demand any behavior of the debtor over any time frame. Bilateral creditors who are members of the OECD meet jointly with one debtor at a time through the Paris Club. To qualify for debt rescheduling they must have an IMF policy in place. Further

relief for heavily indebted poor countries is strictly controlled by extended performance conditions demanded by the sovereign creditors and implemented by the IMF. Even so, not all sovereign creditors ascribe to the Paris Club and its terms. And the debtor still must deal with private bank creditors and private bondholders. And when all these arrangements have finally been concluded, so-called "vulture funds" can purchase old debt on the secondary market and through developed country courts still secure full payment of the face-value of the debt. Truly for the sovereign debtor, regardless of the national situation or that of its citizens there is no exit. Many low income countries are still wrestling with debt from the 1980s.

In contrast, domestic bankruptcy arrangements allow the debtor to retain his/her dwelling, transportation, and other necessities of life. The Fund's loan conditions over the many years of the debt crisis have meant repayment at any cost (including education, health—although those conditions are better of late), and certainly no consideration of enabling the debtor to grow its way out of debt. The absence of international bankruptcy facilities is not the fault of just the IMF, but of its major shareholders. There is no indication yet that the Emerging Market Economies who are members of the G20 will use their new found power to insist on an international debt workout mechanism for sovereign debtors, whether through the IMF or independent of it.

2. International Tax Organization: The original version of the Monterrey consensus document for the International Conference on Financing for Development contained a proposal for an International Tax Organization.

However, the incoming George W. Bush administration insisted on a whole new text, which eliminated many proposals, including that for the ITO. What remains is the continued role of the OECD, a gathering of the 30 richest countries, setting tax policies for the entire world. The OECD taxes corporations based on the location of their corporate headquarters; developing countries have tried unsuccessfully to have corporations taxed according to where they earn their income.

The UNDP's Special Unit on South-South-South Cooperation has launched a new project, South-South Sharing of Successful Tax Practices. At its inaugural meeting at New York University in May 2008, several developing country tax commissioners requested help with transfer pricing, taxes of natural resources, and how to develop a tax culture where citizens willingly pay taxes. The central position of transfer pricing is understandable in light of recent research by Global Financial Integrity and Tax Justice Network on the amount of resources lost to developing countries through transfer (mis)pricing.[9] Raymond Baker estimates roughly $500 billion is lost annually to developing countries, of which roughly half or $250 billion is due to transfer mispricing, whereby corporations inappropriately allocate losses to high tax locations and allocate all profits to low or no tax locations. Since all these corporate decisions are secret or at best made without reference to market prices, they are unchallengeable.

The tax issue relates to the IMF in two ways. First, the IMF is the IFI responsible for advising countries on their tax policies, and in the cases of low

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[9] Raymond W. Baker, Capitalism's Achilles Heel (Wiley, 2002); Christian Aid, Death and Taxes, Londong, 2008; and Tax Justice Network, Tax Us if You Can, London, 2005.

income countries, of requiring tax policy “reforms.” These requirements usually include heavy reliance on VAT or consumer taxes, which are regressive unless all major items consumed by the poor are exempted. Income taxes are discouraged as being too complex for developing countries to implement. Tariffs, a simple tax to collect, are discouraged in the name of promoting freer trade, but rarely do countries ever recover more than 30% of their tariff losses via other options.

The second reason an ITO is relevant to this essay is that enhanced tax revenue would enable a developing country to have greater flexibility in its development strategies. And, a well-executed tax policy would mean that developing countries would have less need of foreign assistance and therefore of IMF financial support and policy prescriptions.

That there is no current conversation about an ITO does not reduce the importance of such an institution.

3. Global Currency: The idea of a global reserve currency is at least as old as the Bretton Woods Institutions. Keynes had hoped to include a global currency, the bancor, as a core feature of these institutions. That did not happen. Instead the dollar assumed that role. Initially the dollar was tied to the gold standard, meaning every dollar was convertible, on demand to gold. This arrangement worked well from the found of the BWI in 1944 until 1973 when US President Nixon effectively devalued the dollar by removing it from the gold standard. The US was suffering from inflation linked to the government funding

guns in the Vietnamese war and butter in the domestic war on poverty. The dollar was replaced by a basket of hard currencies.

Even today with the United States as the world's largest debtor in terms of the government's deficit and the country's trade imbalance and the epicenter of the 2007-08 financial collapse. US Treasury bills remain the most secure reserve. The dollar has been going down in value, but the euro has fallen farther, and the British pound further still. The Japanese yen lacks the liquidity of the dollar and the Chinese renminbi is not an international currency. This arrangement has advantages and disadvantages for the United States; it mainly has disadvantages for the rest of the world, except there is no alternative.

The US enjoys what some call an "inflation tax" because even when the value of the dollar declines, there is still a demand for it. In addition, the US can print its way out of budget shortfalls. A fiscal stimulus is possible regardless of the state of the economy. On the other hand, the US cannot control its own currency since there are so many stateless dollars. In order for other countries to have reserve currency (dollars), the US must run a trade deficit while other countries run trade surpluses. This means that US exporters operate at a disadvantage in terms of the costs of products, resulting in continuous pressure to reduce the cost of US wages to bring down the costs of exports.

While the US may experience some disadvantages, other countries, especially those with weak trading positions are severely disadvantaged. Developing countries must earn hard currency through loans, remittances, investments or trade in order to repay any debts, pay interest or profits on international investments or purchase international products. When the US changes the interest rate on the dollar, it has ramifications in all corners of the world. The international debt crisis of the early 1980s is often linked to the policy of the US Federal Reserve “wringing inflation out of the economy” by raising the real interest rate. This meant all foreign debts with adjustable interest rates were more expensive, along with anything valued in dollars such as all petroleum products.

If the world had an international currency then it could be issued to stimulate growth where and when needed; in times of high growth it could be withdrawn to serve as a brake on the system. The world has a reserve currency but has not chosen to use it, namely the SDR or Special Drawing Right. Created in the 1960s, it is the accounting mechanism of the IMF. It can be created by *fiat* by the IMF, subject to approval by 85% of its governors, that is, requiring the approval of the US, and more specifically the approval of the US Congress. The SDR could be used to help countries meet their Millennium Development Goals, as well as to provide liquidity for interbank loans.

Whether as the bancor or the SDR, governments are reluctant to let go of the power to create and print money. With a global market, especially a global financial market, the need for a global reserve currency becomes more useful, even necessary. Without global financial institutions that enjoy the trust of major economic powers, a global currency will not be used.