Reform of the International Financial Institutions

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*The views in this paper are those of the author and not necessarily those of the Australian Treasury.*
REFORM OF INTERNATIONAL FINANCIAL INSTITUTIONS

‘In order for our financial institutions to help manage the crisis and prevent future crisis we must strengthen their longer term relevance, effectiveness and legitimacy. So alongside the significant increase in resources agreed today we are determined to reform and modernise the international financial institutions to ensure they can assist members and shareholders effectively in the new challenges they face. We will reform their mandates, scope and governance to reflect changes in the world economy and the new challenges of globalisation, and that emerging and developing economies, including the poorest, must have greater voice and representation. This must be accompanied by action to increase the credibility and accountability of the institutions through better strategic oversight and decision making’. ¹

Introduction

At the G 20 London Summit, Leaders clearly signified that they saw the International Financial Institutions( IFIs) playing a key role in not only responding to the crisis, including in particular meeting the financing needs of countries facing difficulties, but also in minimising the prospects of future crisis. As outlined in the above paragraph from the Leader’s statement, they saw the need for much reform within the IFIs if they are to help prevent future crisis.

This paper cover aspects of the reform task facing the IFIs, and with the theme of the workshop dealing with macroeconomic policy lessons from the crisis, the focus is on reform of the IMF.

Much attention has been directed at the decision by the G-20 Leaders at the London Summit to treble the resources of the IMF to $US750 billion along with the decision to support a new SDR allocation of $US 250 billion. These were key decisions which reassured the global community that the IMF had the resources to ensure that capital would continue to flow to emerging markets and developing countries to protect their economies and support world growth.

Less attention has been given to the decision to improve the governance of the IMF through speeding up quota reform, and even less attention to the need to improve the effectiveness of the Fund’s policy advising role through surveillance, which may well be the crucial factor in terms of the future success of the IMF in promoting external stability.

Following are some comments on the role of the IMF in global risk sharing and the role of the IMF in monitoring the global economy through a strengthening of IMF surveillance. The key point is that progress in both these areas is crucially linked to the success of reforming the Fund’s governance arrangements.

The IMF is back

The IMF Managing Director commenced his press conference on 2 April 2009 at the G-20 Summit by say that ‘the IMF is back’. He went on to state that:

• the ‘IMF is back as a forecaster, pointing out that the IMF forecasts were a reference for the G 20;

¹ G 20 London Summit- -Leader’ Statement, 2 April 2009
• the ‘IMF is also back as a policymaker’, observing that while governments will not do all the time what the Fund thinks, ‘...at least we are the partner to discuss with and to realise what kind of policy should be implemented’; and,

• the ‘IMF is also back in terms of the surveillance process’, noting that IMF surveillance was central to the G 20 communiqué.

The Managing Director concluded by stating that ‘all this shows that the IMF is back’, and went on to note that the G 20 had agreed to triple the resources of the Fund, highlighting that the Fund is back in the lending business.

But if the IMF “is back”, where has it been?

Less then a year ago there was questioning of the relevance of the IMF in the prevailing international monetary system. Against the background of what appeared to be a benign world economy, with high and widespread growth, low inflation but high commodity prices and increasingly free capital mobility, the IMF was no longer in the lending business. Prior to the global crisis, the IMF had made no significant loans since 2003 and many countries repaid early their outstanding debts to the IMF.

With the prospect of continuing low interest income, the IMF significantly downsized and introduced a new income model based on investing the proceeds of gold sales to ensure that it could meet its normal operating expenses. In addition, many emerging markets, particularly in Asia but also in Latin America, adopted a policy of self insurance through the acquisition of substantial international reserves, so as to avoid the prospect of ever having to enter into a financing program with the IMF.

In addition, the Fund’s legitimacy was said to be at stake with many countries openly questioning the structure of its governance along with largely ignoring its advice. In 2006 the Governor of the Bank of England stated:

‘And if not in a deep slumber, then the Fund has appeared drowsy. It is an institution, it is said, which has lost its way. What is the truth of these allegations? Clearly, the Fund’s remit is unclear. Its lending activities have waned, and its role in the international monetary system is obscure’.2

It is somewhat ironic that the most severe crisis that the world economy has experienced for over 75 years has brought the IMF back from what many saw as a position of irrelevancy to place it once more at the centre of global financial developments. For if the promotion of external stability is a prime objective of the IMF, as stated by the Executive Board in its 2007 Decision on Bilateral Surveillance, then the magnitude of the current financial and economic crisis would suggest that the Fund had not been particularly successful in pursuing this objective.

Rather then focusing on the fact that the ‘IMF is back’, attention could well have turned to claims that the IMF was ‘missing in action’ in failing to either sufficiently identify the risks that were developing or influence the behaviour of the players who were putting the global financial system at risk.

A pressing task facing the international community is to undertake the reforms necessary to minimise the prospects of future crises of the magnitude that has engulfed the world in 2008-09. A major focus of the G 20, working with the Financial Stability Board and other international standard setting bodies, has been on strengthening the financial system regulatory framework. As noted at the outset, attention has also focused on the reform of the IFIs, and in particular the role of the IMF, not only in

2 Speech by Mervyn King on ‘Reform of the International Monetary Fund’, New Delhi, India, 20 February 2006
responding to the crisis, but also the contribution it can make to long-term systemic reform of the international financial system and enhanced international cooperation.

The IMF may be back, particularly in its ‘crisis responder’ role in providing financial support to countries in difficulty, but what confidence should the world community have that the Fund will do a better job in the future in terms of its role in promoting global financial stability? Hence rather than saying that the IMF ‘is back’ is it more accurate to say that the Fund is ‘coming back’?

**Countries have to trust the IMF**

Much of the focus of the reform of the IMF which is considered necessary if it is to be more effective in avoiding future financial crisis is centred on restoring countries trust in the Fund.

Trust is essential if countries are to be prepared to approach the IMF for conditional financing assistance when confronting balance of payments difficulties, or to enter into a precautionary arrangement in an effort to avoid the onset of a crisis, as well as being responsive to the Fund’s policy advice. But such trust will not be forthcoming if countries believe that the IMF is not truly representative in its governance structure, or if it is perceived to be excessively influenced by one, or a small group of countries. However, as noted in the Final Report of the Committee on IMF Governance Reform, chaired by Trevor Manuel:

> Emerging markets and developing countries have perceived their voice and quota shares at the Fund to be far short of their role in the global economy, and believe they receive unfair treatment (more intensive surveillance and heavy conditionality) and insufficient attention to their needs (loan size and instruments, policy advice).

As noted previously, many emerging markets have adopted a policy of self insurance through the rapid growth of reserves. Between 2002 and 2006, the reserves of emerging markets tripled in US dollar terms. Countries were looking for balance of payments financing, if needed, from sources other than the IMF. For example, there was increasing regional pooling and financing arrangements (such as the Chiang Mai Initiative and the Latin American Reserve Fund).

Some countries were using or exploring contingent financing offered by the multilateral development banks and several central banks entered into swap facility arrangements for liquidity management. Many emerging markets expressly wanted to avoid ever being in a position of having to enter into a financial arrangement with the IMF. This palpable lack of trust was reinforced by the perceived stigma of being involved with the IMF.

The decline in IMF lending prior to the crisis was in part due to higher private capital flows, a relatively benign international environment and strengthened policy frameworks in many countries. Similarly, the recent sharp rise in IMF lending is a consequence of the reversal of private capital flows and the impact of the crisis on both the banking and real sectors of many countries. Nevertheless, many countries are highly reluctant to approach the Fund for financial support or even contingent arrangements. Many of the requests for fund financial assistance have come from the countries in central and eastern Europe, economies who do not have a history of involvement in IMF programs. The ‘baggage’ of previous involvement with IMF programs for the countries in Asia and Latin America continues to strongly influence their current attitude towards the IMF. More fundamentally, emerging markets scepticism about the Fund has been reinforced by the perception that the current financial and economic crisis itself reflects the double standards of the IMF – in particular its failure to influence the behaviour of developed economies at the centre of the crisis. This is seen by many as a consequence of deficiencies in the governance structure of the organisation. Whether or not this is the case, the perception is a reality.
A fundamental issue facing the global community is therefore whether the IMF will regain the trust of all emerging markets and developing economies. Will these countries have the confidence that they can rely on the IMF for insurance – financial support as needed – and risk management – through effective surveillance of systemically important countries?

One of the lessons of the crisis is that relying on the US consumer as the ultimate driver of global growth carries enormous risks. The global growth strategy of the last 10-15 years has been built around widening global imbalances, where the flip side to unsustainable housing investment and consumption in major advanced economies is exports of excessive volumes of both capital and goods from emerging market economies. This growth model can not continue. We are already seeing signs that the demand side of this equation may be starting to unwind, with households in major advanced economies responding to the enormous contraction in their balance sheet due to sharply reduced asset prices and by consolidating their expenditures (particularly on durables such as cars and electronics) and raising their savings rates. If sustained, this has structural implications for many emerging markets, who can not continue to adopt a growth strategy based on increasing net exports. They must stimulate domestic demand. But to do so, they need to move away from a policy of self insurance through accumulating reserves and they must have trust that if they face financing difficulties, they can turn to the IMF and will receive appropriately tailored assistance. As Maria Jose Romero has observed with respect to Latin American countries:

“Now they (Latin American)countries must decide between participating in the recapitalisation of the IFIs and demanding reform that gives them more power in their decision-making, and advancing towards the construction of South-South cooperation mechanisms, giving shape to regional currency and setting the bank of the South into operation”.

A key element of regaining that trust is rebalancing quota shares. As noted in the IMF Staff’s paper on ‘Lessons of the Crisis for the Global Architecture and the IMF’ (SM/09/37. Supplement 1), quota reform will give emerging and developing countries a ‘greater sense of ownership of the Fund and will alleviate their doubts about its ability to serve their interests’.

The nature of the IMF’s lending instruments and the application of conditionality are also important aspects of determining how emerging markets perceive the IMF. In this regard, the recent decision by the IMF to introduce the Flexible Credit Line (FCL) and the reform of its lending and conditionality framework are important developments which have been positively received by emerging markets. The decision of Mexico and Columbia to obtain an FCL arrangement is particularly significant in terms of demonstrating that emerging market perceptions towards the IMF may be changing, while Poland’s use of the FCL will be an important demonstration of the effectiveness of Fund insurance in the region most severely affected by the crisis.

The IMF’s First Deputy Managing Director, John Lipsky, remarked that the advent of the FCL and improvements in the flexibility of program conditionality were unfinished business following the financial crises in Latin America and Asia in the 1990s. These crises exposed that the Fund’s lending instruments and approach to program conditionality, which were designed before the advent of today’s global capital markets when balance of payments pressures typically originated in the current account, were inadequate for responding to capital account crises. The fact that it took more than a decade to correct, requiring a crisis of global proportions, severely affecting emerging market economies on the doorstep of the Fund’s major European shareholders as well as the large shareholders themselves, has been seen by some commentators in Latin America and Asia as further

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3 Bretton Woods Update, Spring meetings addition 2009, the Bretton Woods Project
evidence that the IMF’s voting structure is an impediment to the institution responding in a timely and effective manner to their needs.

**Problems with IMF surveillance**

International surveillance aims to identify domestic and cross border vulnerabilities – whether they stem from shocks, policies, exchange rates – that could spark systemic disruptions. Surveillance over the global economy and countries policies is primarily the mandate of the IMF. As regards the success of IMF surveillance, Jean Pisani-Ferry has noted:

‘...against the background of a credit boom of rare magnitude, massive capital flows from poor to rich countries, the build-up of colossal reserves, and enduring controversies over exchange rates, the Fund has not been able effectively to exercise its mission to ‘oversee the international monetary system in order to ensure its effective operation’.’

The crisis has exposed fundamental shortcomings in the regulatory structure in the financial system in major financial centres. This was notwithstanding that after the Asian financial crisis, a greater focus was placed on financial analysis and the joint IMF-World Bank Financial Sector Assessment Program was established to examine macro-financial linkages and to identify vulnerabilities. The crisis has also raised questions about the operation of monetary and fiscal policy that was not picked up or sufficiently pressed through IMF surveillance. With the focus largely on stabilising inflation, central banks did not sufficiently take into account the impact of asset price movements, credit booms and the build up of systemic risk. On fiscal policy, many governments did not take advantage of a period of high growth to reduce public debt.

What went wrong and what can be done to improve the effectiveness of IMF surveillance in contributing to the objective of maintaining external stability.

As part of its examination of the lessons from the crisis (SM/09/37), IMF staff have identified a range of problems with surveillance, including:

- **Warnings given by official bodies before the crisis being generally too scattered and unspecific to attract domestic – let alone collective – policy action.** For example, in describing risks associated with the securitisation model ‘the text was coded and embedded in lengthy discussions or lists of concerns’. Although even more important, the Fund staff acknowledged that they missed that securitised instruments, and associated risks, remained with the core banking systems, in part due to insufficient data.

- **There were missed interlinkages, in particular an under-appreciation of systemic risks coming from links between financial markets, of spillovers across countries, and of the strength of the resulting financial sector feedbacks onto the real economy.**

- **The outlook for the advanced economies at the centre of the financial crisis was too optimistic, with Fund surveillance echoing the general view that advanced economies with low and stable inflation and highly profitable and well capitalised banking sectors could withstand the unwinding of any ‘froth’ in housing and capital markets.** The Fund notes that it did warn about the risks from external sources through global imbalances, but the message tended to become more muted rather then louder as imbalances continued to rise with little apparent instability.

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4 Jean Pisani-Ferry, 'will the crisis trigger a Revival of the IMF? Proceedings of the conference organised by the Reinventing Bretton woods Committee, New York, 24-25 November 2008
The Fund missed the vulnerabilities associated with the shadow banking system and shortfalls in financial system regulation in key advanced economies, although some institutional weaknesses in the US financial sector might have been uncovered if assessments usually undertaken in the FSAP context had been made.

As to other identified shortcomings identified with IMF surveillance, Jean Pisani-Ferry observed that surveillance was handicapped by "the rise of giants and by doubts about the adequacy and legitimacy of Fund advice".

Bilateral surveillance may have served a role for small and medium-sized countries, but it appeared largely ineffective for larger economies. As noted above, the Fund appeared to be largely silent about the build-up of credit risks in the US. The emerging markets criticise the Fund for not being even-handed and exercising appropriate surveillance over the large advanced economies. The Chinese Deputy Governor commented at the 2008 Annual Meetings: ‘the Fund must draw lessons from the crisis and take corrective measures to enhance its surveillance over the developed economies….especially the reserve currency issuing countries”.

However the IMF’s reluctance to criticise large economies appears to extend to large developing economies as well as developed. An example often cited is the failure of the IMF to exercise greater ‘candour and clarity’ with respect to exchange rate issues in large emerging markets. It failed to follow through on its 2007 Surveillance Decision which raised the prospect of the IMF identifying countries whose exchange policies were considered to be contributing to external instability.

As regards multilateral surveillance, a 2006 report by the IMF’s Independent Evaluation Office (IEO) found that ‘multilateral surveillance has not sufficiently explored options to deal with policy spillovers in a global context: the language of multilateral advice is no more based on explicit considerations of economic linkages and policy spillovers than that of bilateral advice”.

Participants at an October 2008 IMF panel discussion on the future of the IMF reiterated similar concerns, adding that many developed countries have impeded the IMF’s efforts at multilateral surveillance by largely ignoring IMF’s bilateral surveillance of their own economies and not fully embracing the IMF’s first attempt at multilateral consultations on global imbalances in 2006. While the commitments made during the multilateral consultations were broadly seen as moving policy in the right direction, many outside observers have criticized the commitments as being too general and without clear timelines, thereby weakening the effectiveness of surveillance on follow-through. Overall, the outcome from the multilateral consultations was generally considered to be disappointing.5

Steps to strengthen the capability of surveillance

Some of the specific measures to strengthen surveillance that have been identified by the Fund, and many of which are being implemented, include:

- Developing a joint IMF-FSB early warning exercise, which combines the IMF’s macro financial expertise with the FSB’s regulatory perspective to produce a more holistic view of evolving concerns. A pilot of the IMF-FSB early warning exercise was presented to Governors at the IMFC Spring 2009 meetings.

Recognising that systemic risks can come from all quarters, including developed economies. The implicit presumption prior to the crisis was that tail risks lay mainly in developed economies and emerging markets. The Fund’s vulnerability exercise is being expanded to developed economies and integrated with the early warning exercise. As Fund staff note:

‘the renewed emphasis on advanced country risks also implies new perspectives on existing concerns, such as those coming from large current account deficits and corresponding capital inflows. This underscores the need for resolution of the vulnerabilities coming from continuing imbalances, currency misalignments, and capital flows between the fund’s largest members’.  

Giving greater emphasis on integrating the Fund’s financial sector work into the World Economic Outlook (WEO) and Article IVs. The IEO had observed that there was little use of the results of FSAPs in Article IV consultations. To enhance the understanding of macro-financial links, a new macro-financial unit has been established in the Research Department with the aim of developing new analytical tools. In addition, the FSAPs will be sharpened, with greater emphasis on external links and spillovers. To date, FSAPs have focused on compliance with standards and have not sufficiently covered stability issues.

**But will IMF surveillance influence countries’ actions?**

As noted, the Fund has identified a number of shortcomings in the coverage of its surveillance, its analytical ability and the way it has expressed its findings. Addressing these shortcomings will improve the analysis and quality of IMF surveillance, but will it influence the actions of governments?

The IMF provides analysis and advice. It does not have the power to compel nation-states to act in accordance with IMF Board conclusions. Although there have been suggestions that the IMF, or some other international organisation, should have quasi-judicial powers, at least in some areas of financial regulation, similar to the WTO.

For example, Barry Eichengreen has proposed a World Financial Organisation (WFO), whose membership would be compulsory for all countries seeking freedom of access to foreign markets for domestically-chartered financial institutions. The WFO would define obligations for its members and would appoint independent panels of experts to determine whether countries were in compliance with those obligations, with sanctions being imposed against those countries who failed to comply with those obligations.

Eichengreen recognises that countries would likely object to an international organisation dictating domestic policy, and suggests a less ambitious approach based on reputational costs for countries whose ‘domestic regulatory practices are not up to snuff’, based on firmer surveillance by the IMF and the FSF (now FSB). But even here, he questions whether the IMF would ‘have the backbone to take on its large shareholders when their national practices are not up to snuff’.

The IMF can, and does, serve the role of being an external commentator of countries policies. Whether the ‘reputational cost’ of not following IMF advice will be effective in influencing a country’s policy choices will depend not only on the quality of that advice but most importantly on

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6 IMF Staff paper ‘Initial Lessons of the Crisis’, SM/09/37

the credibility and legitimacy with which the IMF is perceived. An important contribution that the IMF can make in influencing a government’s policy choices is through contributing to the public policy debate within the country.

The influence of Fund advice in influencing the public policy debate will be negated if the governance structures of the IMF are considered unrepresentative and it is perceived to be under the influence of a small group of developed countries. But also for large developed countries, if the IMF is considered to be largely irrelevant to the countries circumstances, then the published views of the IMF will have little impact on the public debate in that country, and in turn policy decisions. If both developed and developing countries are detaching themselves from the Fund for whatever reason, its capacity to influence the policy choices of countries will be significantly limited.

Rather then simply seeing the IMF as an external commentator of a country’s policies, perhaps more emphasis should be placed on the mutual obligations that countries have as members of the Fund and the fact that they have a joint responsibility to achieve the Fund’s mandate of promoting external stability. More specifically, the IMF should not be perceived as an organisation of around 2,500 staff based in Washington, sitting in judgement on the performance of countries and it is totally within the discretion of countries to ignore the Fund’s. Rather, it should be seen by member countries as ‘their’ institution which serves their interests and assists them in fulfilling their obligations. A step towards recognising mutual accountability would be for countries to publicly respond to Article IV reports.

For countries to accept a degree of mutual responsibility for the performance of the IMF, would require all IMF members feeling that they had an appropriate level of ownership in the Fund. This comes back to the importance of reforming the governance of the Fund and ensuring that countries representation in the IMF is in keeping with their relative economic weight in the world economy.

In addition, for countries to feel that they have ‘ownership’ in the institution and a collective responsibility for its performance, Finance Ministers need to be involved in the activities of the organisation. At the London Summit, G20 Leaders agreed that consideration should be given to greater involvement of the Fund’s Governors in providing strategic direction to the IMF.

The Committee on IMF Governance chaired by Trevor Manuel and the IEO evaluation on Governance of the IMF, both recommended activation of a ministerial-level Council along with a change in the composition of the Council so that it reflected global economic realities. The Committee emphasised that their recommendation for the activation of a Council was linked with the recommendation to bring forward the quota review to realign existing shares with members’ global economic weights and that steps be taken to allow for greater representation of emerging and developing economies at the Board, so that the Council is established with as much legitimacy as possible right from the beginning.

While some of the advantages of the activation of a ministerial-level council include enhancing accountability within the Fund and clarifying the role of the Executive Board, a potential major advantage of a ministerial level Council is that with ministers more involved in the activities of the IMF, they will feel more responsible for its performance, including the effectiveness of surveillance. A disadvantage with the resident Executive Board, where Executive Directors are officers of the IMF, is that there is too large a distance between Board members and the policy makers in capitals. The current structure reinforces perceptions that the IMF is a distant, external commentator that can be ignored. Moreover the discussion that takes place over risks and vulnerabilities may never reach the ears of the actual policy advisers or decision makers.

The Manuel Report emphasises that for the reform package recommended by the Committee to be effective, it would take the personal involvement of ministers and Governors. The members of the Council would have to have a sufficiently high level of authority, requiring finance ministerial level
participation, to discuss core global macroeconomic and financial issues, if there is to be traction. And this is the ultimate objective, not only to improve the quality of the staff’s analysis on economic and financial issues that can feed into its surveillance reports, but to gain traction in making policy choices at the national level that will contribute to achieving the objective of external stability. Such traction is likely to be more forthcoming if those directly responsible for making the policy decisions, namely finance ministers and governors, are more directly involved in the IMF’s activities and feel more directly involved in its performance. As the Manuel Report notes, this will require from all a spirit of multilateralism, leadership and ownership.

In terms of the IMF Executive Board’s role in surveillance, the IEO identified a number of telling statistics. More then 400 hours of annual boardroom time is dedicated to country items, primarily Article IV discussions. About half of the Board believes it spends insufficient time on multilateral surveillance. Only 20 per cent of Board members (and 15 per cent of staff) think the Board contributes ‘significant value added’ to Article IV consultations, and a similar proportion thinks it contributes ‘no or negative value added’, a view shared by 40 per cent of staff. The IEO observes that this result may reflect the finding that, on average, only four Executive Directors attend Article IV consultations. The IEO concludes that reconsideration of the Article IV surveillance process might be in order, or at least that the Board should explore alternative ways to provide its input. It is a good illustration that part of the reforms of the IMF should include clarifying the role of the Executive Board, a point highlighted by the IEO and the Manuel Committee.

Conclusion

It is unrealistic to expect that the IMF should have prevented the crisis. As noted previously, even if the Fund clearly identified all the risks that led to the crisis and articulated a clear policy response to mitigate those risks, it can not compel nation states to take action. But there were shortcomings in the depth and coverage of the Fund’s analysis which needs to be rectified. And where the Fund did note vulnerabilities that ultimately contributed to the crisis, its ability to persuade governments to take appropriate policy action was muted. The crisis has highlighted that changes are required in the operation of the IMF for it to be more effective in facilitating global financial stability.

At the core of these changes is restoring the trust of countries in the IMF as a central, collective, body which is at the forefront of responding to systemic risks in the global economy. Countries must have trust that they can rely on the IMF for appropriate financial support as needed and for effective, firm and even surveillance over members’ policies. If there is not trust in the IMF, the trend will continue toward alternative and less efficient arrangements, including self insurance. The trend for growing global imbalances will continue. In addition, if members’ do not see the Fund as a credible and legitimate institution that represents their interests, they will not be open to the policy advice that comes from Fund surveillance.

Central to the restoration of trust and legitimacy is redistributing quota shares and Board representation. It would promote a greater sense of ownership in the Fund by all members and alleviate doubts about its ability to serve their interests. But all members must take ownership in the Fund, and recognise that they have a collective responsibility in achieving the Fund’s mandate to promote global financial stability. The greater involvement of ministers and governors in activities of the IMF will help facilitate that sense of ownership and add traction to policy discussions. Hence governance reform is central to enhancing the effectiveness of the IMF.

Would the IMF have been effective in avoiding the crisis if the governance reforms now being advocated were in place? It is impossible to answer this question. But it is clear that the prospects of the IMF being more effective in preventing future crisis will be enhanced if these reforms are implemented.