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Kiel **Policy Brief**

IMF Reform in the Aftermath of the Global Financial Crisis: Let the IMF Speak Truth to Power

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Many proposals for a reform of the global financial architecture place the International Monetary Fund (IMF) at their center – as lender of last resort, supplier of authoritative economic analysis, or supervisor of global financial markets. Already, in recent months, the IMF has extended historically large loans to help prevent the imminent collapse of several troubled economies, from Iceland to Latvia, Hungary, and Ukraine.

This renewed interest in the IMF and the sharp increase in IMF lending since 2007 mark an astonishing reversal in the IMF's fortunes. Less than two years ago, IMF lending had declined to a historic low (Figure 1) and professional staff were offered golden handshakes to leave the IMF. Many observers expected the IMF to become a niche provider of modest, medium-term loans and technical assistance for macroeconomic policies in developing countries, especially under its Poverty Reduction and Growth Facility (PRGF – see Figure 1). Balance of payments crises in emerging economies, which had accounted for most of the IMF's public visibility in the past, seemed to be gone for good.

It is now clear that reports of the death of balance of payments crises or, for that matter, of the IMF were greatly exaggerated (to paraphrase Mark Twain). Nevertheless, many current proposals to expand the IMF mandate, for example, by having the IMF supervise global financial markets, appear unrealistic. This policy brief argues instead for a more modest approach. The IMF appears to be the only international institution that has the analytical capacity and political standing (potentially at least) to hold all national governments accountable to the same benchmarks and standards for macroeconomic policies and financial market regulation. Thus the IMF has a crucial role to play in the international coordination of macroeconomic and financial market policies that will be key to preventing global financial crises in the future. Therefore, the current momentum should be used to strengthen the stature of the IMF, make it more independent from member state governments, and achieve substantial but realistic reforms:

- recalibrate voting power to give all members, including borrowers, an effective say in decisions by the IMF Executive Board;
- lower the highest threshold for qualified majority voting such that no single country enjoys veto power over important decisions;
- ensure that new sources of loanable resources do not create political liabilities for IMF governance;
- provide dependable funding specifically for the IMF's monitoring and surveillance activities whose importance will grow;
- promote a culture of comprehensive public debate on IMF policy documents and country reports, involving governments as well as civil society, to ensure that findings are taken seriously (if not literally) by all member states;
- continue to apply policy conditionality to IMF loans to ensure that necessary economic reforms supported by loans are undertaken even when they are politically difficult.

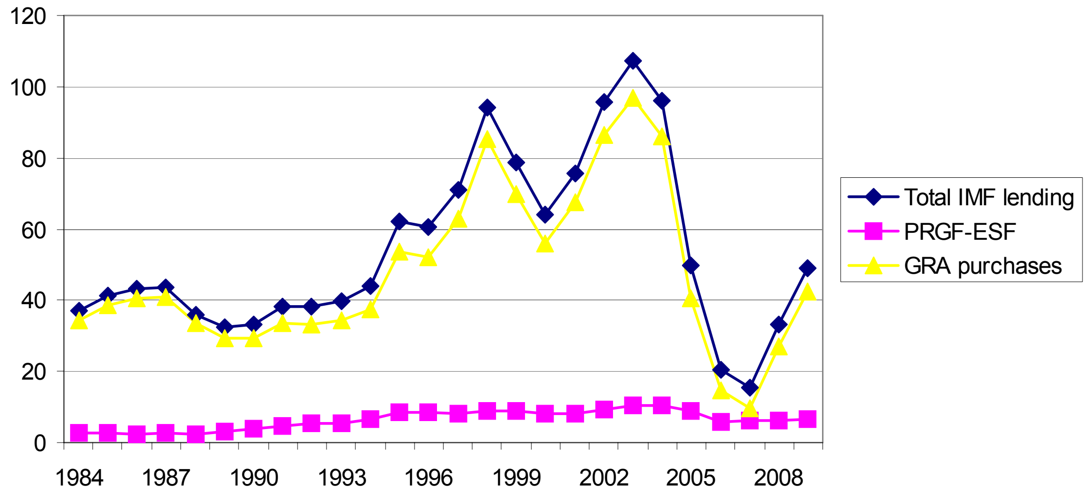

Figure 1: IMF credit outstanding, 1984-2009 (billion US$; year-end; 2009 figure is for May 31).
Source: IMF – http://www.imf.org/external/np/fin/tad/extcred1.aspx (download: August 20, 2009).

The Future Mission of the IMF: Speak Truth to Power

Historically, the mission of the IMF has evolved from regulating the Bretton Woods System of fixed exchange rates to providing external financing to emerging and developing economies with balance of payments needs. Along the way, the IMF has developed considerable expertise in the surveillance of national macroeconomic policies (for example, through the Article IV consultation process), global macroeconomic forecasting (World and Regional Economic Outlooks), and monitoring of international financial markets (Global Financial Stability Report). Besides, the IMF has developed standards for data provision and transparency in monetary, financial and fiscal policies and provides technical assistance to developing countries on macroeconomic policies and financial market regulation.

Given this history, how can the IMF contribute to preventing global financial crises in the future? And would another adjustment of the IMF mandate represent mere “mission creep” by an organization whose original (1947) mandate, arguably, has long expired? To answer these questions, it is useful to take a broad look at how the regulation of global financial markets is likely to evolve now that the immediate pressures of the financial crisis are subsiding.

There is wide agreement among observers that national financial markets have become intensely interdependent through cross-border holdings of assets and liabilities. Therefore, a crisis that originates within one country (such as sub-prime mortgages going awry in the United States) may be transmitted internationally. Similarly, most observers agree that the current system for regulating financial markets, with its national focus and, at best, ad-hoc coordination among national actors, is insufficient and should be replaced with a more comprehensive international framework.

However, it is becoming increasingly unlikely that national legislators will be willing to transfer significant national sovereignty in the area of financial market supervision to a regional or international body. One plausible reason for this reluctance is the fact that national governments are still the only feasible lenders of last resort for globally large financial institutions. Even within the European Union with internally free movement of capital and right of establishment for financial institutions, the prospects for firmer EU-wide rules are uncertain. It is even less likely that the US Congress would transfer responsibility for overseeing US financial institutions to an international body.

Therefore, a more comprehensive international regulatory framework for financial markets will have to emerge through closer and more binding cooperation among national regulators. National practices in financial market regulation as well as macroeconomic policies will need to be evaluated according to common standards and developments will need to be analyzed in a disinterested but authoritative manner. Emergency lending will have to be coordinated – both for globally large financial institutions and for countries facing balance of payments problems. Among other things, such coordination requires an international institution with the credibility and political standing to "speak truth to power" – to address emerging policy concerns in any country solely on the basis of their perceived relevance for the global economy, not on the basis of political expediency or the size of that economy.[1]

The IMF appears to be the only international institution that potentially has the political standing and analytical capacity to perform these tasks. As an organization, the IMF is geared towards analyzing macroeconomic policies and financial market regulation both at the national and global levels. It also has extensive experience engaging national authorities and the international public in a results-oriented debate on its analytical findings. At the same time, communication with national authorities currently works much better when the IMF has something to offer (for example, emergency loans) in return for a government facing up to an unpopular challenge, compared to a situation when the IMF provides politically inconvenient advice to policy-makers who are driven by short-term agendas and have little to gain from engaging with the IMF.

This raises the question of what it will take to make the IMF more universally credible. At present, the undue influence of large member states on what the IMF can say publicly appears to be the single biggest obstacle. For example, the United States was able to delay the start of a much-needed critical assessment of its financial services industry (FSAP) for several years without good cause. Similarly, the IMF has found it politically difficult to analyze the exchange rate policy of China and publicize the results. As a result, the IMF's role in analyzing and developing a policy response to today's most serious global macroeconomic imbalance (the US trade deficit and Chinese trade surplus) is impaired. If large countries can avoid engaging in a serious debate with the IMF and other member countries, smaller countries will hardly be inclined to take the IMF seriously (that is, other than as a precondition for borrowing from the IMF).

[1] German sociologist Renate Mayntz calls "speaking truth to power" the main task of research-based policy advice. The term itself goes back (at least) to a "charge" given to 18th century members of the Religious Society of Friends (Quakers).

On the other hand, it seems notable that some large member countries seek to undercut public debate of IMF analyses of their macroeconomic and financial policies, rather than simply ignoring the IMF. This observation suggests that, if the IMF could act more independently and with less regard to the size and voting power of affected member countries, the analytical work of the Fund might have a greater impact on public debate and on the ultimate policy response. The remainder of this policy brief discusses several proposals for IMF reform that would help to strengthen the institutional independence of the Fund and enable it to play a key role in the emerging framework of global governance for the coordination of national macroeconomic and financial sector policies.

IMF Quota Distribution and Voting Power

The distribution of voting power in the IMF's executive board, which takes most policy and operational decisions, has been debated intermittently for several decades. Currently, voting power is based mainly on the size of each member's "quota", i.e. its capital subscription that ultimately funds IMF loans to other member countries (and also determines how much each member country can borrow from the IMF). Members' quotas, in turn, are allocated according to a formula that now includes several economic criteria such as Gross Domestic Product and international payments (Bradford, Linn, 2007; Cooper, Truman, 2007; IMF, 2008). Quotas are indicated in terms of an accounting unit, the Special Drawing Right (SDR), which reflects a basket of major currencies in world trade (on August 7, 2009, 1 SDR was equivalent to US$ 1.57). Each IMF member currently has one vote for every SDR 100,000 in quota, plus 250 basic votes (to go up to 750 basic votes under an April 2008 decision by IMF Board of Governors that still requires ratification by national legislatures). Table 1 lists the resulting vote shares of selected IMF members and relates them to demographic and economic criteria

Criticism has focused on the slow process of adjusting quotas to the rise of emerging economies as well as the choice of variables in the quota distribution formula. Decisions on quota changes are taken by the IMF Board of Governors, based on recommendations by a Quota Review Committee, and require an 85 percent majority of total voting power in the IMF. While the process was often tedious, the April 2008 decision simplifies the underlying formula and adjusts quotas for a large number of countries. This decision should go a long way towards rendering quotas much more transparent and up-to-date.

However, the focus on economic variables implies that poor countries with large populations still have only a weak voice on the IMF Executive Board. Table 1 compares IMF members' current vote shares to their shares in world population, world GDP (calculated at purchasing power parity - PPP), and world imports of goods and services. Specifically, by subtracting members' percentage shares in world population, GDP or imports from their vote shares Table 1 gives a sense of whether a given member is over- or underrepresented in terms of a particular criterion. Furthermore, the sum of absolute percentage deviations for a criterion, added up over all member countries, gives a sense of how closely the distribution of votes overall follows the global distribution of that particular variable.

Table 1: Country shares in IMF voting power, world population, GDP, and imports (percent)

	Current share in IMF voting power (August 2009)	Current minus share in world population	Current minus share in world GDP at PPP	Current minus share in world imports	After April 2008 changes are implemented	Scenario: 20 percent of votes by population
United States	16,8	12,1	-5,6	0,1	17,6	15,0
Japan	6,0	4,0	-0,9	1,2	5,6	4,9
Germany	5,9	4,6	1,3	-2,3	5,5	4,6
France	4,9	3,9	1,5	0,1	4,5	3,8
United Kingdom	4,9	3,9	1,4	-0,7	4,5	3,8
China	3,7	-16,7	-6,7	-2,2	3,4	6,8
Italy	3,2	2,3	0,3	-0,6	3,3	2,8
Saudi Arabia	3,2	2,8	2,3	2,5	2,9	2,4
Canada	2,9	2,4	0,8	-0,3	2,7	2,3
Russia	2,7	0,5	-0,5	1,3	2,5	2,5
Netherlands	2,3	2,1	1,3	-0,9	2,2	1,8
Belgium	2,1	1,9	1,5	-0,5	2,0	1,6
India	1,9	-15,3	-2,8	0,3	1,8	4,8
Switzerland	1,6	1,5	1,1	0,3	1,5	1,2
Spain	1,4	0,7	-0,8	-1,5	1,7	1,5
Brazil	1,4	-1,6	-1,5	0,5	1,3	1,6
Korea	1,3	0,6	-0,6	-1,3	1,4	1,3
Venezuela	1,2	0,8	0,7	1,0	1,1	1,0
Indonesia	0,9	-2,5	-0,4	0,3	0,9	1,4
Pakistan	0,5	-2,0	-0,2	0,3	0,5	0,9
Singapore	0,4	0,3	0,1	-1,7	0,6	0,5
Bangladesh	0,3	-2,2	-0,1	0,1	0,3	0,7
Total absolute deviation (all IMF members)		112,4	44,3	34,0		

Notes: A country is shown if its share in the the IMF vote diverges by more than 2 percentage points from its population share or by more than 1 percentage point from its PPP GDP or import shares.

Source: www.imf.org; World Bank, World Development Indicators Database.

The top ten countries in terms of vote share are the G8 plus China and Saudi Arabia. Of these countries, the top five (US, Japan, Germany, France, UK) currently control 38.4 percent of IMF votes but account for only 9.8 percent of world population; individually, they are “over-represented” relative to their population shares by between 3.9 and 12.6 percentage points. By contrast, both China and India are under-represented not only in relation to population, but also to GDP at PPP (and China in relation to its share in global imports of goods and services). Pakistan and Bangladesh, both with a history of IMF loans and macroeconomic conditionality and a combined population of more than 300 million people, have a combined vote share of 0.8 percent – approximately the same as Norway’s.

Hence the current distribution of votes does not give all members, including borrowers, a sufficient stake in the decision making process for them to feel that they “own” the decisions taken. As long as the IMF was mainly a regulator of a system of fixed exchange rates, the focus on economic variables as the basis for the distribution of quotas and votes may have been plausible because a member’s stake in IMF decisions would be strongly related to its share of global international payments. However, the IMF now plays a much greater role in the monitoring of national macroeconomic and financial policies and has a strong influence on those policies when it extends loans; in fact, we have argued above that this role should be strengthened. Therefore, population-rich and poor countries in particular need to have a stronger voice in order to develop a sense of ownership in the IMF.

One possible way of giving greater weight to this group would be to base IMF members' voting power partly on member countries' populations. The underlying logic would be to reflect the number of people potentially affected by IMF surveillance or policy conditionality who are represented by each member country. The last column in Table 1 presents a hypothetical scenario under which 20 percent of total voting power is allocated on the basis of population, while the remainder is allocated in line with the new quotas according to the April 2008 decision. Under this assumption, China and India would be among the top five members in terms of voting power, together with the US, Japan, and Germany. The combined share of Pakistan and Bangladesh would grow to 1.6 percent, whereas that of Norway would decline to 0.6 percent. While details would have to be negotiated, this example demonstrates that when population is included in the formula for vote distribution, the gross under-representation of population-rich poor countries is alleviated without introducing excessive shifts relative to current vote shares.

A conceivable alternative would be to move closer towards "one country one vote" as in the World Trade Organization. In practical terms, this could be achieved by increasing the number of basic votes (identical for all members) as a share of total votes. Already, the planned increase of basic votes from 250 to 750 per country will increase the share of basic votes in total voting power from approximately 2.1 percent to 5.8 percent; historically, this share has been as high as 11 percent. However, it is not clear that "one country one vote" would be either workable or fair. To be acceptable to large member countries, this rule would probably have to be combined either with a consensus requirement (as in the WTO) or high thresholds for qualified majority voting. However, the uncertain fate of the WTO Doha Round demonstrates that decision-making by consensus can be exceedingly tedious when more than 150 countries are involved. At the same time, the European Union under its Lisbon Treaty is moving towards lower thresholds for qualified majority voting in order to streamline its decision-making process. Therefore, a cautious refinement of the current formula for determining members' voting power by including population, rather than a move towards "one country one vote", appears to be the most promising approach to giving more voice to hitherto neglected member countries.

Other Governance Issues: Qualified Majority Voting and Selection of the Managing Director

The proposed changes in members' voting power will need to be calibrated to the qualified majority voting rules used by the IMF. Although decisions are normally taken by a simple majority of the votes cast (Article XII, Section 5c), many decisions require a qualified majority of either 85 percent or 70 percent of total voting power. These rules currently give veto power to the US alone when the 85 percent threshold applies, or to the US plus at least 3 other members with large vote shares when the 70 percent threshold applies.

Many nation states and international organizations require qualified majorities for changes to their constitutions and organizational structures. However, given the paramount importance of strengthening credibility vis-à-vis all members, it seems no longer appropriate for the IMF to give veto power to a single member or a very small group of members. This assertion may appear to be contradicted by the example of the UN Security Council where five member countries that possess nuclear weapons enjoy veto power. However, (i) the Security Council has proven to be ineffective in handling international conflicts where any of the veto powers have taken sides (e.g. Kosovo), which limits the Council's ability to fulfill its mission; (ii) there is wide-spread dissatisfaction with the current setup of the Security Council as evidenced by the long-lasting debate about Security Council reform; and (iii) the Security Council often deals with matters of war and peace where it may be imprudent to ignore the views of any country that has nuclear weapons to back up its views, irrespective of the merits of that country's views otherwise.

Therefore, the 85 percent threshold for qualified majority voting should be eliminated and a single rule for qualified majority voting instituted, say, with a threshold of two thirds of total voting power. This should be sufficient to prevent erratic decisions that lack the support of key IMF member countries while not granting excessive influence to a single member or a small group of countries.

One change that is already on its way to being implemented concerns the selection of the IMF Managing Director. There was in the past an informal understanding, backed up by the respective countries' voting power in the IMF and the World Bank, that the President of the World Bank would be nominated by the US whereas the Managing Director of the IMF would be nominated by the West European members. Clearly, the independence of the IMF and its ability to speak truth to power would be enhanced if the Managing Director did not owe his or her appointment in part to his or her national government. There appears to be an understanding on the part of the US and West European members that whenever the next Managing Director is appointed, the current restrictive leadership selection process will no longer be used. The examples of the selection processes for the United Nation Secretary General and the WTO Director General demonstrate that an open selection process can lead to the appointment of dedicated individuals who enjoy broad support among members.

New Sources of Funding for Loans and Surveillance

Enhanced independence of the IMF will need to be backed up by funding that is both robust to the influence of individual members and adequate for the tasks of the IMF. This requirement applies to financing for IMF lending as well as to current income to pay for the surveillance of national macroeconomic and financial policies.

With respect to lendable resources, the April 2009 London Summit of the G20 has called for tripling the available amount to approximately US$ 750 billion. As actual IMF lending stood at less than US$ 50 billion at end-May 2009 (Figure 1), this total might seem excessive. It is motivated, however, by the new flexible credit lines that emerging economies with sound macroeconomic policies may call upon in the event of a crisis, such as a sudden reversal in private capital flows. Mexico has already received a credit line for US$ 47 billion that is not reflected in the figure for total IMF lending because the credit line has not been drawn upon. Therefore, the large increase in lendable resources will give the IMF ample but not excessive resources to counter future instability in financial flows to developing and emerging countries.

Traditionally, lendable resources derived mostly from the quota subscriptions of member countries. Quota subscriptions are paid in full when a country joins the IMF; subscriptions cannot be withdrawn, but constitute the basis of most types of loans to member states with balance of payments needs. By contrast, new lendable resources will come mostly from bilateral borrowing agreements with high-income countries (Japan, US, EU, and several others) as well IMF notes likely to be issued to China, Brazil, and Russia. Borrowing and note purchase agreements will be on similar terms, with a period of commitment on the part of the creditor between one year and five years. IMF notes will be tradable within the "official sector", i.e. all IMF member governments, their central banks, and 15 multilateral institutions.

The maximum maturity of five years corresponds closely to the repayment periods of stand-by arrangements and flexible credit lines. Thus, as long as borrowers repay the IMF on schedule, the IMF should be able to meet its own obligations towards its creditors. However, if borrowers face unforeseen debt service problems and require longer repayment periods, the IMF might become quite dependent on creditor countries to roll over loans or notes, unless it can find lendable resources elsewhere.

Therefore, large lenders might gain influence on IMF decisions beyond their formal voting rights as their decision to either extend or withhold lending could have far-reaching consequences for the IMF and global financial markets. IMF notes are thought to be attractive in part because they are tradable among official creditors and denominated in SDR; they may help countries with large international reserves to reduce their exposure to the US dollar (although the US dollar still accounts for 44 percent of the value of the SDR). What can be said at this point that all this is untested territory. As borrowing and note purchase agreements are implemented in the coming months, it will be important to keep an eye on possible future challenges they may pose to the IMF's independence.

Regarding income to pay for current operations, most IMF revenue so far has come from fees charged on loans to emerging economies. These fees were sufficient to pay not only for the operational cost of credit intermediation but also for the administration of loans to low-income countries (e.g. under the Poverty Reduction and Growth Facility) along with surveillance and technical assistance. However, the sharp decline in lending since 2003 led to a full-blown budget crisis in 2007 and 2008 which has eased only when lending and the associated fee income recovered recently.

For the IMF's surveillance of national policies to be independent and credible, it should not depend on being effectively cross-subsidized by other IMF operations but should have a solid source of income to pay for it. Since it constitutes a public good, it would be appropriate to charge IMF members according to their ability to pay, measured for example by their Gross National Income converted at market exchange rates. While details would need to be worked out, the assessment of UN members for their contributions to the regular UN budget constitutes a possible example, with reduced charges for low-income and least developed countries as well as a cap on national contribution to ensure that the richest country (the US) does not pay an excessively large share.

As discussed by the Crockett Report (IMF, 2007), national contributions could be complemented by higher investment revenue, for example by allowing the IMF to invest lendable resources in the capital market as long as they are not needed for lending to members, and by selling IMF gold reserves to create a capital endowment. However, implementing a system of national contributions, even if it initially covers only a small share of the expenditures for surveillance, would establish the important principle that surveillance of national policies is a global public good that IMF members need to pay for and may therefore be inclined to take more seriously.

Promote a Culture of Public Debate on Policy Documents and Country Reports

Over the last ten years, IMF operations have become much more transparent as most policy documents and country reports are now published in a timely manner. This trend is to be welcomed because, absent an IMF loan to the member country in question, IMF surveillance will be effective only if the results become part of the public discourse on economic policy options. If members can delay analytical work (such as the US FSAP), influence the presentation of conclusions, or prevent the publication of findings altogether, there will be little pressure on national authorities to amend policies. Therefore, surveillance should be rules-based: according to a set time schedule, against transparent and widely discussed standards, with the analysis and conclusions published in a timely manner. If members then do not cooperate or do not agree to publish country reports, this fact should be publicized so that financial markets may pass judgment on it.

At the same time, while economic analysis and surveillance by the IMF should be of high quality to be authoritative, no economic analysis will ever be infallible. Therefore, IMF analysis should be considered primarily as an input into an informed public debate, rather than as the end point of that debate. The more a culture of informed debate is established, markets will not over-react to published findings of IMF surveillance work but rather look at them in connection with national authorities' responses. Ultimately, IMF analysis will be the more effective the better it holds up under the scrutiny of an informed international and national public.

For national authorities to avoid public debate by delaying surveillance work or keeping findings secret should be seen as a sign of great weakness. For them to disagree publicly with IMF analysis should be seen as natural, up to a point, and their arguments should be judged on their merits. Already, many country reports on the annual Article IV consultations between IMF staff and national authorities reflect a dialogue along these lines. If would be helpful to bring this experience to bear on the surveillance of national financial systems (e.g. the findings of the Financial Sector Assessment Program).

The situation differs somewhat in the case of policy conditionality for loans to member countries with balance of payments needs. While the underlying economic analysis here is not infallible either, the IMF staff will ultimately have to recommend some conditionality to the Executive Board, and the Board will have to make a decision – leaving the potential borrowing country with the choice of either taking the loan along with the conditionality or leaving it. Typically, borrowers have pursued macroeconomic policies that have landed them with the balance of payments problems that lead them to request IMF assistance in the first place. Therefore, a long-term solution to the balance of payments problems will require policy changes.

Hence the IMF should continue to tie its lending to policy conditionality that ensures that borrowers implement those policy changes that are required to overcome the crisis and pay back the IMF loan. A full dialogue with national authorities should deal with both, what is needed and how much can feasibly be done within a given time frame and level of external support. It is also true that in the past there may have been, at times, a counterproductive overreach on conditionality by the IMF. However, to do away with policy conditionality altogether on the grounds that it limits "policy space" or national sovereignty would be tantamount to throwing out the baby with the bathwater. The credibility of policy conditionality will be enhanced by open debate and public scrutiny, but conditionality remains an essential element of loans to member countries.

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