The IMF’s Unmet Challenges


Introduction

There is an important role for the IMF to play in solving information, commitment and coordination problems connected with the stability of the national economies and the international financial system. The Fund can act as a trusted advisor to governments drawing on its experiences in different countries. It can raise awareness of cross border spill-overs of policies. As a lender of last resort, it can help cash strapped governments and stop them from pursuing policies that would lead to economic instability. By providing advice as well as funds, the IMF can strengthen the hands of national authorities trying to implement stability enhancing reforms.

Four challenges

The Fund, however, needs to address four challenges to strengthen its legitimacy and its capacity to execute core functions.

- The first challenge is how to organize the surveillance of the economic and financial policies of the 188 member-countries.
- The second challenge is to resolve the confusion about the kind of conditionality that must be attached to IMF loans.
- The third challenge is to define the Fund’s role in the management of sovereign debt crises.
- The fourth challenge is to address concerns about the Fund’s impartiality, i.e. whether some members have disproportionate influence on how IMF goes about discharging its responsibilities.

The first three challenges raise doubts about the IMF’s output legitimacy, i.e. the quality of the institution’s performance. The fourth challenge raises concerns about the Fund’s input legitimacy, i.e. the process through which decisions are reached and power is exercised.

Surveillance

Before the collapse of Bretton Woods, the role of the IMF was quite different. Member countries were expected to maintain a peg against the dollar. The Fund’s concurrence was needed before changing the par value.

With the collapse of Bretton Woods, the focus shifted from a system of stable exchange rates to a stable system of exchange rates. The surveillance process
was broadened to assess whether monetary, fiscal and financial policies were consistent with the objective of maintaining stability.

Risks to economic and financial stability are complex. They are difficult for national authorities to assess. The Fund has an important information sharing and advisory role to play here, drawing on its experiences in other countries. IMF’s bilateral and multilateral surveillance are analogous to the micro prudential and macro prudential policies pursued by domestic regulatory authorities responsible for financial stability.

In this context, the IMF’s failure to sound louder warnings in the run up to the subprime crisis in the US, the banking crises in Iceland, Ireland and other countries and the sovereign debt crisis in Greece is troubling. The IMF did not conduct an assessment of the US Financial sector before the crisis. After an assessment of Ireland in 2006, the IMF came to the surprising conclusion that the country could easily cope with a period of slow growth or downturn in housing prices.

The Fund needs analytic capabilities to integrate macroeconomic and financial analysis. Besides its qualified macro economists, the Fund also needs people who understand banking regulation and financial markets well. There are also special challenges in conducting surveillance of members of a monetary union like the Eurozone, where there are no national instruments of economic policy. Another concern is that the powerful member countries can bias surveillance reviews in their favour.

It would be unfair to expect the Fund to predict all crises. But the Fund can do a lot more to focus its resources in areas where the case for surveillance is strongest. These are typically areas, where the risks to stability are serious, information and commitment problems are acute and spill-overs are pronounced.

The IMF was set up to deal with problems created by disorderly and unstable exchange rates and to discourage exchange rate policies that would undermine stability. Today, the IMF is somewhat confused about whether exchange rates should be the main focus in the surveillance process.

The IMF should focus on exchange rates in two situations:

- Small open economies where the exchange rate has a great impact on inflation, growth and financial market conditions.
- Large economies whose exchange rate policies are a source of significant cross-border spill-overs.
For countries that fall in between, a very rigorous exchange rate surveillance may not be warranted.

In the case of the Euro, the IMF did not sound loud enough warnings. The Fund did not draw attention to the problems of monetary union without banking and fiscal union. It would seem that the Fund was happy to go with the EU members who accounted for significant voting power and financial contribution.

Though the IMF has talked about the need for exchange rate policies that may create external instability, it has not been very clear on how to go about operationalizing this. The Fund seems to have embraced a bipolar view of exchange rate regimes. Countries that are relatively open and exposed to large international capital flows should have either flexible market determined rates or rigid pegs. But what is open and what is flexible, has not been defined properly.

In the 1990s, the IMF warned against the use of capital controls except in the most unusual circumstances. IMF officials even mentioned that capital account convertibility might be made a statutory obligation of members. The Asian Financial crisis of 1997-98 raised doubts about such an approach. Volatile capital flows played a big role in the crisis. Capital moved in during the run up to the crisis and then moved out as the crisis started.

During the global financial crisis, countries with capital controls in place before the crisis, fared better. Iceland experienced large capital inflows and outflows and resorted to capital controls to manage the crisis. The incident brought out that problems created by international capital flows are not restricted to the developing economies.

Now the IMF acknowledges that capital flows have substantial benefits as well as risks. There may be circumstances that warrant capital controls. It remains to be seen how the Fund will respond if its position comes into conflict with that of a major shareholder.

**Conditionality**

In the Bretton Woods era, conditionality focused on monetary and fiscal actions needed to maintain exchange rate stability. But with the collapse of Bretton Woods, there was a change in focus from stable exchange rates to stable economic and financial conditions. Accordingly, the goal of IMF lending programs also changed. Now it was to maintain economic and financial stability and avoid taking drastic steps such as suspending the operations of banks and financial markets. IMF conditions also expanded to cover structural,
in institutional and procedural measures ranging from public enterprise privatization and pension reform to labour market liberalization and tax administration.

The conditions imposed on Indonesia during the Asian Financial crisis became controversial and the government fell following social unrest. The lesson is that broad based conditionality where the areas subject to reform are not tightly linked to the IMF’s mandate is quite likely to face political resistance. Conditionality should focus on policy reforms central to the borrower’s ability to restore financial stability and growth and exit the program as quickly as possible. The IMF should specify clearly what the conditions are designed to achieve and how they will be achieved. This will ensure a more disciplined design and a focused conditionality that will be politically more acceptable. Governance reforms are also needed to address concerns on whether influential members are behind the conditions imposed.

**Sovereign debt crises**

The IMF has been involved in sovereign debt problems in recent years. The Fund faces the challenge of determining when a country’s debt is sustainable and when it is not. A government’s decision to make or suspend payments can be as much a political as an economic decision. The Fund’s decision not to insist on debt restructuring in Greece in 2010 was heavily criticized. It was widely believed that France and Germany influenced IMF’s decision as they were concerned about the impact of any debt restructuring on their own banks. In fact, there is a general criticism that the IMF is often very late when it comes to insisting on sovereign debt restructuring. But it is unfair to blame the IMF for being cautious as debt restructuring does not always proceed smoothly and can affect the market access and the financial system of the country involved.

Unfortunately, if emergency finance is provided while delaying debt restructuring, things will get tougher, the economy will become weaker and more haircuts will have to be applied as and when debt restructuring starts.

One possibility is to stop lending to countries where there are serious doubts about debt sustainability. The 2002 **framework on exceptional access** decided to provide large scale financing without debt restructuring only if the country’s debt was sustainable with a high probability. But in 2010, the Fund took a step back during the Greek debt crisis. Under a **systemic exemption clause**, the IMF Board authorized exceptional access in cases where there is high systemic risk even if there are doubts about the sustainability of the debt.

**Governance reforms**
Reforms that give appropriate voice and weight in decision making to all members are critical for enhancing the legitimacy and effectiveness of the Fund. The resources contributed by members are called quotas and the voting rights are based on quotas. Major decisions require 85% voting majority. The US and Europe are in a position of power as they can veto a decision.

Quota shares have not been altered over time to reflect the fast growth of emerging markets, leaving these members underrepresented in decision making. Day to day management is through the 24-member Executive Board. The US, Japan, France, Germany, UK, China, Russia and Saudi Arabia have individual representatives on the Board. Other countries have to share a representative and enjoy less clout in decision making.

In 2010, the Board of Governors decided to double quotas and realign the quotas so that the largest members would be US, Japan, France, Germany, Italy, UK, Brazil, China, India and Russia. It was also proposed to abolish the right of the five largest quota holders to appoint their own members on the Executive Board. Instead all Executive Board members would be elected by groups of countries. Countries with a total of 80% of voting shares agreed but since 85% was needed, the consent of the US congress was required. Unfortunately, the US Congress has been reluctant to ratify the agreement.

In recent years, emerging economies have accumulated vast amounts of forex reserves. This will reduce their dependence on IMF. But self-insurance is expensive. Various central banks have also negotiated bilateral currency swap lines to provide one another with additional insurance. But the institutions involved do not have a track record and are limited to their regions. That is why the IMF still has a role to play as lender of last resort.

The US should support governance reforms. The country benefits from an institution with the legitimacy to act as a trusted advisor and emergency lender to governments. The IMF can globally coordinate discussion of risks to economic and financial stability and encourage policy adjustments that take into account cross border spill overs. Governance reforms are urgently needed for the IMF to have legitimacy. Governance reforms will not make the IMF fit for the future. But without reforms, the IMF does not have a future.