IMF REFORM: A Marathon, Not a Sprint
Remarks at a Brookings Institution Seminar

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The subtitle of my talk today is borrowed from the address of the outgoing Managing Director of the International Monetary Fund, Rodrigo de Rato, at the annual meeting of the. Fund's Governors, although he used it to characterize just one dimension of the reform effort—reform of the Fund's governance—not the process as a whole.

The current reform effort began in earnest about 18 months ago, when the Managing Director issued a paper on the implementation of the Fund's Medium-Term Strategy, in which he proposed numerous changes in the activities and governance of the Fund. Here is a partial list of those changes:

- Adopting a new way to choose the Fund's Managing Director;

- Dealing with an impending financial problem confronting the Fund itself, because the recent fall-off of Fund lending has sharply reduced its interest income;

- Streamlining the Fund's surveillance of its member countries and sharpening the focus of surveillance;

- Undertaking a new form of multilateral surveillance to assist in confronting systemic threats to the stability of the of the monetary and financial system;

- Establishing a new Facility to provide precautionary financing for countries that follow prudent policies but may nevertheless experience difficulties because of balance-sheet weaknesses and vulnerabilities;

- Reforming the distribution of IMF quotas, which govern its members' financial contributions to the Fund, their ability to draw on its resources, and, most importantly, their voting power, with the
stated aim of recognizing the increased importance of the emerging-market countries, and the low-income developing countries as well.

What has been achieved thus far with regard to these six matters, and what remains to be done?

As you know, all of the Fund's Managing Directors have come from the major European countries, and all of the World Bank's Presidents have come from the United States — reflecting a tacit bargain made when the two institutions were created. But both parts of that bargain are surely outdated. It is not difficult to name a half-dozen distinguished officials from large emerging-market countries who could discharge with distinction the duties of the Fund's Managing Director or, for that matter, those of the President of the World Bank.

This year, both institutions had an opportunity to break with tradition, with the resignation of Rodrigo de Rato from the Fund and of Paul Wolfowitz from the Bank, but the Fund had not yet adopted formally a new procedure for choosing a new Managing Director, and it did what it has always done by choosing another European, Dominique Strauss-Kahn of France. I have no quarrel with that outcome. I have known Strauss-Kahn for many years and had an opportunity recently to **meet** with him, along with others, for a full-day discussion of the problems facing the IIVIF.

It should be noted, moreover, that any member of the Fund's Executive Board has the right to nominate a candidate to serve as Managing Director, and that has happened on at least two fairly recent occasions: on the first occasion, one Executive Director nominated Stanley Fischer who was then serving as First Deputy Managing Director; on the second occasion, this year, the Russian Executive Director nominated Josef Tosovsky former Prime Minister and central bank governor of the Czech Republic, a European to be sure, but not the chosen candidate of the EU countries, who had agreed to nominate Strauss-Kahn.

When the Fund has next to choose a new Managing Director, I would hope that it will have adopted a new procedure. The Executive Board should produce a short list of highly qualified candidates, to be submitted to the Fund's Board of Governors, and the successful candidate should be the one who commands the support of a double-majority of the Fund's membership: a 70 percent majority of the members' quota-based votes plus a 60 percent majority of the Fund's membership with each member having a single vote. A more open, transparent process would help to banish the belief that the Fund is run by and for the major industrial countries.

The next item on my list has not yet led to visible reforms but has led to a set of proposals by a committee appointed by the Managing Director and chaired by Andrew Crockett, formerly the General Manager of the Bank for International Settlements. The committee's report has proposed, *inter alia,* that the Fund sell up to 400 tons of its large gold holdings and use the proceeds to create an endowment fund, the income from which would be used to finance some of the Fund's activities, including its technical assistance to developing countries. The staff of the Fund is examining this and other ways to deal with the budgetary problem but has not yet come forward with its own proposals. (I should perhaps note that the sale of some of the Fund's gold would require the approval of the U.S. Congress — which might not be forthcoming.)

Turning from matters internal to the Fund to those involving relations with its members, it can be said that the Fund has taken important steps to reform bilateral surveillance. Heretofore, the Fund has sent a staff mission to most of its members every year, and they have prepared compendious reports on the countries' economic situations and policies. This practice has placed an enormous burden on the staff and the Executive Board,, which must read and discuss each report. (The Managing Director noted in his main paper on reform that members of the Board have been confronted with some 80,000 pages of reading, and the bilateral surveillance reports have bulked large in this total.)

Therefore, the Managing Director proposed and the Board adopted a streamlined approach to bilateral surveillance. The Fund will no longer undertake bilateral surveillance of many member countries, especially small stable countries, but will do so biennially. It will also focus on matters of particular concern to the Fund and pay more attention to financial and balance-sheet vulnerabilities.

More importantly, the Managing Director proposed that more emphasis be given to the original aim of surveillance—assessing the consistency with its members' macroeconomic and exchange-rate policies with national and global stability. Therefore, the Executive Board revised its guidelines for surveillance for the first time in three decades. The new guidelines are broader and, more importantly, include new language. Henceforth, a country may be deemed to violate its obligations under the Fund's Articles of Agreement if it aims at maintaining an undervalued exchange rate in order to increase its net exports. Not surprisingly, the Chinese Executive Director was alone in opposing the addition of this criterion.

The surveillance of individual economies, appropriately limited in frequency and scope, is very useful, but it cannot readily grapple with global problems, especially those involving the world's largest countries and those that play a major role in key commodity and financial markets. Therefore, the Managing Director proposed a new process of multilateral surveillance aimed at the collective adjustment of those countries' policies. Existing multilateral forums are not well structured for this purpose. The G-7, comprising the major industrial countries, does not include any of the large emerging-market countries, nor does it include the Fund itself.

The new process proposed by the Managing Director would begin with bilateral consultations between the Fund's staff and the key countries involved, followed by multilateral meetings with those same countries. (The countries involved would vary, of course, with the nature of the problem at issue.) The staff of the Fund would then draft a report to be discussed by the Executive Board. Thus, the first round of consultations focused on the problem of global imbalances, and the participants were China, the Euro Area, Japan, Saudi Arabia, and the United States. But the process did not have the intended effect — achieving agreement on policy changes aimed at reducing global imbalances. Instead, the key participants, China and the United States, reaffirmed commitments they had already made. Chine promised once again to "improve the exchange-rate formation mechanism in a gradual and controllable manner" with the aim of achieving a gradual increase in exchange-rate flexibility relative to a basket of currencies, but it said nothing about the time it would take to achieve that objective. For its part, the United States offered up the fiscal-policy changes already proposed in the President's budget for fiscal 2008 — proposals that were deal on arrival at the other end of Pennsylvania Avenue.

Multilateral surveillance can perhaps contribute to the resolution of global problems, but it is unlikely to produce a modification of national policies unless the staff of the Fund is empowered to put before the participating governments its own views on the policy changes required of those governments.

I turn now to the penultimate item on my list, the creation of a new precautionary facility. As you know, countries normally seek financing from the Fund after they run into trouble, and they have then to negotiate the policy conditions that will be attached to that financing. The Managing Director has therefore proposed the creation of a new precautionary facility, different in some significant ways from its predecessor, the Contingent Financing Facility, which was never used by any member country. The new facility would be available to countries that have strong macroeconomic policies and sustainable debt burdens but are still vulnerable to crises because of balance-sheet weaknesses and vulnerabilities. A country qualifying for access to this new facility would be free to make a very large drawing. Policy conditions might be attached.to drawings on the new facility, but they would target policies aimed at maintaining macroeconomic stability and reducing the country's vulnerabilities, rather than focusing in great detail on a country's immediate problem and the policies needed to deal with it.

This appeared at first to be an attractive proposal, especially for countries that fear contamination from a neighbor's problems or from the effects of a tightening in global credit conditions. Nevertheless, it has one serious weakness illustrated in a paper by Tito Cordella and Eduardo Levy Yeyati who worked with a simplified version of the proposal. Compiling data for 34 countries from 1991 to 2002, the two authors found that the countries' ratios of debt to GDP and of budget deficits to GDP would have impaired the eligibility of 11 countries, temporarily or permanently, after they had qualified initially, and it would have precluded altogether the eligibility of 22 other countries. Chile was the only country to qualify continuously. As the data used by these authors as proxies for strong policies and debt sustainability would have been readily available to market participants, any deterioration in those data, foretelling a loss of eligibility, would be a very serious matter; it could actually expose a country to a severe crisis. This risk and other concerns have led many to conclude that few if any countries would avail themselves of the new facility, and the proposal is quite likely to be shelved.

I come now to the final item on my list, the question of quotas and voting power in the IMF. There has been progress on this issue, but the most likely outcome it not likely to produce a substantial change in the governance of the Fund. There would appear to be an emerging consensus on three steps, but they are rather modest. First, there will be an increase in the number of so-called basic votes, which are distributed uniformly to all members of the Fund. This will be the first such increase since the creation of the Fund more than 60 years ago, and it will increase appreciably the voting power of the Fund's smallest countries, but their voting power will still be very low. Second, a new formula will be used to allocate Fund quotas, in which gross national product at current exchange rates will be the most important variable, but gross national product at purchasing-power parity will also play a role, and some other variables may likewise be included in the formula. Third, there will be an increase of Fund quotas on the order often percent. But a ten percent increase of quotas will not greatly raise the voting power of the emerging-market and low-income countries, regardless of the formula used to distribute it. A back-of-the-envelope calculation will show why.

At present, 12 countries have *59.4* percent of total votes in the Fund, leaving 40.6 percent to all the others. (The 12 countries are Belgium, Canada, China, France, Germany, Italy, Japan, the Netherlands, Russia, Saudi Arabia, the United Kingdom, and the United States.) Suppose that there is a ten percent increase of quotas and that these 12 countries agree to forgo completely any increase in their quotas, giving their share of the global increase to the rest of the Fund's members. This would reduce the votes of those 12 countries from *59.4* percent to 54.0 percent and thus raise the share of all the others to 46.0 percent. (It would have the effect, however, of reducing the share of the United States to *15.5* percent, precariously close to the voting share required to approve many key decisions in the Fund and thus the ability of the United States to veto those decisions.) Suppose instead that the 12 countries agreed to 'disclaim' half of the 10 percent increase in quotas; the share of the 12 would fall by less, to 56.7 percent, and thus raise the share of the rest to 43.3 percent.

Without knowing the parameters of the new quota formula, moreover, it is impossible to know how much a 10 percent increase of quotas would narrow the large gaps between various countries' actual quotas and the new formula-based quotas. It is nevertheless clear that a single 10 percent increase in total quotas cannot alter substantially the distribution of voting power in the Fund. It might take several such increases to have that effect, and that would surely be opposed at a time when few countries are drawing on the Fund.

I have not touched on all of the issues involved in reform of the Fund. I have paid no attention to the so-called 'silo' problem — the tendency of each department within the Fund to function as a self-contained unit, with adequate communication within the department but far less communication with other departments that may have something to learn or say about a particular problem. Nor have I said anything about the division of labor between the Fund and the Bank. As you may know, a committee chaired by Pedro Malan has addressed itself to that question in a recent report and has suggested that the Fund should continue to make short-term subsidized credit available to low-income countries but should leave long-term development lending to the World Bank and its affiliates. Finally, there is the question of European representation in the IMF, an issue addressed recently by Tommaso Padoa-Schioppa, the Finance Minister of Italy and the new chairman of the Fund's International Monetary and Financial Committee. He has suggested, as have others, that the representation of the euro-area countries should be consolidated because they have a single currency and single central bank. Depending on the nature of the new formula for calculating quotas, this could help to reduce the overrepresentation of the EU countries, whose voting share is just about double that of the United States.

But let me stop here to entertain your comments and questions.

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