Bringing Balance

to the IMF Reform Debate

Issues and Recommendations

New Rules for Global Finance

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Partners in this initiative are the New Rules for Global Finance Coalition, Centre for International Governance Innovation (CIGI) and the Global Economic Governance Programme at Oxford University. Regional partners included Debt Relief International, Initiative for Policy Dialogue at Columbia University, CASE-Kyrgyzstan, and Peking University.

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Summary

There is almost universal agreement that the International Monetary Fund (IMF) is in need of reform. The IMF is in dire financial straits, which undermines its effectiveness in monitoring international financial stability, addressing key economic issues, and in providing technical expertise to finance ministries and central banks. Many countries are reluctant to work with the IMF, because they regard it as doctrinaire, responsive mainly to its largest shareholders, and a political liability. Yet, in a world of globalized financial markets, the IMF's role and functions are more crucial than ever.

To restore the effectiveness and legitimacy of the Fund the IMF needs to reform its governance structure and operational approach. The debate over the specific content and methodology of any reform package, however, has been centered in Europe and North America – the IMF's largest shareholders. By contrast the developing countries, holding over half the world's GDP, people, and reserves, have had little voice and input to the process. Consequently, New Rules for Global Finance Coalition, together with the Centre for International Governance Innovation (CIGI), and Oxford University's Global Economic Governance Programme, launched an initiative to provide countries throughout the developing world with opportunities to present their priorities for reforms of the IMF.

The initiative, entitled *Bringing Balance to the IMF Reform Debate*, began with a series of regional meetings held March-May 2008 in Africa, Central Asia, East Asia, Latin America, and the Middle East, that brought together finance ministers, central bankers, and senior advisors from their regions. The policy-makers elaborated their priorities for a reformed IMF in terms of its roles, core functions, representation and accountability. In July 2008, regional representatives then met with senior economists who specialize in global financial systems at a culminating event in Waterloo, Canada to discuss their views and recommendations.

This extensive consultative process yielded a set of recommendations that call for the IMF to reform its policy requirements, surveillance reports, representation and accountability.

This report presents these recommendations voiced by the participants at the regional meetings, which emanated from their discussions regarding four major issues areas (functional, regional, representation, and accountability) of the IMF reform debate.

I. Functional Issues

A. Policy Requirements

The consultations highlighted a number of difficulties with the content of “conditions”, or policy requirements, and the way in which they were designed.[1] At present, IMF staff relies too heavily on a common orthodoxy, which prevents them from taking into account important differences between countries, such as the strength of their institutions, the nature of their domestic markets, or their national development priorities.

Tensions over policy requirements are sometimes amplified by the IMF practice of working closely with the Ministry of Finance, which is often isolated from the rest of the policymaking process, resulting in frequent miscommunications. Many of the agreed-upon IMF programs are then implemented by lower-level officials who are often unaware of the discussions among more senior-level government officials.

Participants in the meetings, especially those from Africa and Central Asia, point to the need for the Fund to have a deeper knowledge of the political economy in which a given reform debate originates and to increase the flexibility in program design as well as the advice it provides. Central Asian participants, for instance, point out that too often the advice offered by the IMF staff tends to reflect what has been developed on the basis of African experience, with no basis on the challenges facing former centralized economies. Mission teams frequently lack country-specific knowledge, a shortcoming that is amplified by the staff’s rotation among regions, their limited regional diversity, their relatively similar academic training from major Western universities, their limited experience prior to employment at the Fund, and their mostly being Washington-based. As a result of the high rotation rate, staff advice changes, creating problems of consistency over time. By way of example, some Central Asian participants note that mission teams focused on market comparators or outcomes in countries that were just beginning a transition toward a market-economy. Those participants also report that too often IMF advice is biased in favor of the private sector, leading concerned countries to the fast privatization of strategic sectors of their economies, while providing no relevant advice or technical assistance for the post-privatization phase.

Consequently, participants at the regional meetings underscored the need to encourage greater heterogeneity of views among IMF staff through a greater diversity of experience and academic background. Moreover, by further diversifying the recruitment of staff across the various regions, the IMF could gain considerable knowledge about country conditions that are likely to affect the outcome of its programs and better shape its relationship with member countries.

Other participants, mainly from Africa, point to overly strict conditionality in Fund arrangements that are both excessively intrusive in domestic decision-making and contribute little toward achieving policy objectives in the absence of genuine national ownership. On the other hand, when countries design the program, few conditions are needed to achieve desired reform.[2]

The consultations highlight the call for more policy space for program countries by increasing the flexibility of IMF advice, especially in pre-emerging and low-income countries. Likewise, participants, especially from the Middle East and Africa, underscore that technical assistance, while relevant and important, does not offer them much choice in terms of how to structure related activities nor in choosing technical advisors.

Similarly, while the IMF is generally acknowledged as an important contributor to the stability of participants' respective economies by reining in the hyperinflation of Latin American countries or stabilizing African economies, many participants, especially those from Africa, urge the Fund to pay far more attention to the poverty and social consequences of its own advice. Evidence points to some tensions in this regard. The Fund's Poverty and Social Impact Analysis (PSIA) has not systematically informed the distributional aspects in the program design of the Poverty Reduction and Growth Facility despite Board-approved resolutions that it should.[3] The IEO has found no apparent evidence that PSIAs are having any material influence on PRGF program design, even though the findings of PSIA analysis are duly reported in PRGF documents. In addition, the PSIA unit which was recently created has already been dismantled in the wave of current budget reductions.

Finally, Latin American participants, in particular, stress the need to establish some form of international safety net, such as a rapid-response credit line, that is able to provide emergency liquidity to a country hit by a crisis of confidence in international markets, with conditionality limited to macroeconomics and financial stability, in contrast to the Contingency Credit Line, which was abandoned because it was unusable given the many conditions required in order to use it. Those participants note that resources for such a facility could be tapped from a) renewed SDR allocations and b) an application of a "graduation" system *à la* IBRD, under which it is taken for granted that a group more numerous than the G10 will not resort to Fund's resources. Access to resources by developing country members would therefore be de-linked from its quota contributions.

B) Surveillance

The IMF offers a multilateral forum for consultation and agreement among countries, or "machinery for consultation and collaboration on international monetary problems" (Art. I), in which all 185 member countries have formally committed themselves to be part of a universal system of peer review and oversight. Through the IMF, countries ought to be better able to assess trends in the world economy, ascertaining mutually beneficial policies and cooperating to implement these. The IMF was designed in this way to enable solutions to collective action problems, internalizing the externalities that would otherwise arise if each country were to set its policies independently.[4]

The regional consultations consistently point to these potential benefits for the entire membership. As its history tells, the Fund was established as a forum for international monetary cooperation, for which its lending role was accessory to avoid countries resorting to "measures destructive of national or international prosperity" (Art. I v) and to being the overseer of the international monetary system.[5] In fact, as most member countries have, at the moment, graduated from IMF assistance, reform of lending facilities is considered a slightly less urgent issue. This sense was underpinned by the prevailing awareness among participants that not using IMF financial resources does not necessarily equate to the IMF becoming irrelevant. Participants, in fact, underscored their vision of the IMF not as a lending institution but as a think tank eager to share its expertise, foster a collaborative approach, and help governments identify the missing elements in their economic policies.

Along similar lines, several participants note the usefulness of IMF capacity building activities that, for instance, have been instrumental in Central Asia and in the Middle East in setting up the statistical systems of many countries and in bringing them in line with international standards.

It is equally felt, however, that the greatest potential strength of IMF surveillance, i.e., that of reducing collective action problems, is not effectively employed by the institution. By way of example, the United States has not yet undergone an FSAP despite its considerable importance as a financial center, while many other members have, reflecting the need to improve the evenhandedness of IMF surveillance. Likewise, Asian participants point out that in its advice on exchange rate policies, the IMF has focused excessively on China without fully appreciating the multilateral nature of the issue.

Against this background, many participants emphasize that, in the current globalized economy, the spillovers from one economy to the other are significant, and thus, multilateral surveillance ought to play a greater role than it currently does. Middle Eastern participants refer, for instance, to the currency fluctuations between the euro and the dollar and their potential for generating global market disruptions in the absence of a coordinating framework among advanced economies, which the IMF should facilitate.

The consultations confirm that multilateral surveillance can have an important role as a provider of economic analysis provided the IMF has appropriately trained technical staff as well as the ability to draw information from its universal membership.

Even if the information provided under the Fund's surveillance activities partly overlaps with competing sources of analysis, most observers (including those from the Middle East) acknowledge its value. For low-income member countries, the informational role performed by the IMF is even more important, since these countries rarely attract investor-driven sources of economic analysis.

Furthermore, most participants stress the need for the IMF to strengthen its bilateral surveillance output and the process through which its surveillance function is discharged. The reports that the IMF prepares on smaller countries sometimes lack thorough analysis and recommendations, while those on larger and more advanced economies tend to be backed up by more substantial analysis. The excessive lags in the production and publication of surveillance reports, as well as their standardized formats, diminish their impact. Further, the advice underpinning surveillance activities ought to be more empirically grounded and tailored to the specifics of the country concerned. This observation is borne out by the IEO's recent evaluation of exchange rate policy advice.[6] In various interviews and surveys conducted with country authorities, the IEO notes the frequent lack of formal, country-specific analysis backing IMF advice, coupled with the Fund's insufficient appreciation for the challenges of implementation. Indeed, some senior government officials reported that the usefulness of IMF advice decreases as its implementation becomes more complex and country-specific.

Participants in the meetings also discussed the "signaling role"[7] in connection with IMF activities. For low-income countries, reliance on the IMF's signals appears to be well-established—if not always welcome—policy used to catalyze official assistance, including the Enhanced HIPC and MDRI. In assessing external financing requirements, the IMF consults donors before stating a country's aid figure, a number that reflects what is likely to be available, rather than what is needed. Once this forecast becomes the IMF's own assessment, it becomes a self-fulfilling prophecy of donor commitments. Participants, especially from Africa, note the crucial importance of the Fund's role with respect to ODA. They object to the fact that the Fund has infrequently been proactive in signaling incremental aid needs consistent with a country's absorptive capacity and growth objectives. With donor harmonization and budget support, this signaling function has only become more important for low-income members.[8]

Some participants refer to instances in which the signaling role of the IMF provides needed credibility to the policy framework of a concerned country. For example, the IMF has been playing an effective role in the difficult and politicized setting in which the Palestinian Monetary Authority operates by conferring its seal of approval to strengthen the credibility of the Palestinian policies. In a different context, the IMF facilitated the loan package to Lebanon from its political allies in 2007, by conferring its seal of approval to the reform policies put forward by the Lebanese government. In Jordan, likewise, the IMF supported a successful adjustment program in the wake of the Gulf War that lowered the risk premium.

Looking forward, participants in the meetings, and particularly those from Latin America, note that IMF advice should focus on issues such as excessive debt accumulation and overvalued exchange rates, and managing capital inflows and reserve assets. They express the concern that, on the one hand, their regions were exposed to the Fund's lack of instruments to coordinate exchange rate management between the major currencies and to manage financial market volatility. On the other hand, they are skeptical of any attempt aimed at giving the Fund more powerful instruments that could interfere with their own economies, as the Fund is perceived to be an institution overly influenced by northern economies, and insufficiently skilled in analyzing, predicting, and preventing financial crises.

II. Regional Issues

Since the Fund was established, member countries have carved out a number of regional or plurilateral financial initiatives, reflecting similar initiatives in the area of international trade. While in the latter the hierarchy between bilateral, regional, and multilateral arrangements is codified, at least in theory under Art. 24 of the GATT and Art. 5 of the GATS, in the former no similar codification has been established.[9]

African participants note that the IMF should work more with regional organizations, as they are increasingly becoming an important way for countries to pool their efforts and resources. They also express strong frustration with the limited number of staff and senior management from their region, and are considering the positive consequences of relocating the African units of both the World Bank and the IMF to an Africa-based institution so that policy advice and signaling could finally originate from within the continent. Participants cite the several cooperative initiatives toward monetary unions, such as in West Africa, and that designed for the SADC region. They also point to the regional collaboration among heads of central banks.

Latin Americans commented frequently about their positive experience with the Latin America Reserve Fund, a low-conditionality, fast-disbursing plurilateral facility that enables seven countries of the Andean region to pool their reserves effectively, even if they are hit by similar shocks. The Caribbean and Central American sub-regions are eager to replicate this experience. In the Middle East, countries from the Gulf Cooperation Council are working towards the ambitious goal of a monetary union that may be in place by January 2010 with the aim of creating an area of monetary and financial stability in a much-afflicted region.

The principal of subsidiarity suggests an approach whereby the first defense in dealing with financial crisis is the institution closest to the problem. Subsequently for broader issues or crises, the regional or global institution such as the IMF, is the appropriate institution. Regional participants see a complementary, not conflictual, relationship between the IMF and regional institutions, and encourage the Fund to regard these institutions in the same favorable light.

III. Representation Issues

A fundamental strength of the IMF is its universal membership. This basis for legitimacy contrasts with the various ad hoc intergovernmental fora such the G7, or even the G20, which have only limited representation. Some go so far as to posit that the Fund's constituency system of governance is a model for reconciling efficiency with universal representation.[10] However, the constituency system as well as the allocation of votes among countries as currently organized works to de-legitimize the institution.

Participants support strengthening mechanisms of accountability for the Executive Directors to their respective constituency members. The current composition of the Board, with 8 single chairs and the remaining 16 multi-country constituency chairs, raises severe problems of effectiveness of representation making it difficult for constituency members to hold their Board representative to account. This asymmetry in the accountability and effectiveness of representation affects low income countries most of all. Indeed some participants, recognizing the *de facto* relative weakness of their respective Executive Directors, recount going directly to G-7 Board members to solicit support for their programs.

The asymmetry in representation corresponds to the asymmetry of voting power within the institution. While the recent decision to allow for an additional Alternate Director in each of the two largest African constituencies is a welcome development, far more needs to be done to balance the representation of the Fund's global membership on its Executive Board. Even though the recent tripling of basic votes allocated to each member country is welcomed, it is strongly felt that the formula used to calculate a member's quota accomplishes little to address the gap in the representation between developing and advanced economies at the Fund, a gap which erodes the Fund's legitimacy.[11]

Many participants identify the selection process of the Managing Director as another major obstacle to an effective and legitimate institution, since the chief of the institution becomes politically accountable to those who have selected him rather than to the entire membership, thus reinforcing the skewed power distribution of the Fund's governance. Some participants suggest splitting the role of the Managing Director as Chief Operating Officer as well as Chairman of the Executive Board. In their view, the current situation limits the Board's ability to improve staff performance and the quality of interactions with member authorities. Splitting the top position would also have the advantage of strengthening the position of the Board vis-à-vis the Managing Director.

IV. Accountability Issues

There is a need to strengthen the mechanisms of accountability throughout the Fund, including its staff, by correlating progression in career with country outcomes. While a country advisor is accountable to his government for the quality of his advice, IMF staff have no accountable relationship to member countries, which they ultimately serve. Current IEO evaluation on interactions with member countries provides some operational proposals in this regard. Moreover, there is the broader issue of the accountability of a Board sitting permanently in the headquarters and not making public its deliberations toward the authorities and the political bodies at large in member countries. [12]

Participants underscored that many times the opinions of national authorities have not been taken on board by Fund staff. This renders the dealings between Fund staff and national authorities less candid and effective than it should be. Furthermore, the interaction between the concerned Executive Director and staff is at times equally difficult, as Executive Directors, even those of developed nations, have difficulty in getting their views accepted by staff. An appeals committee should be established to give countries the chance to raise issues regarding specific recommendations made by the Fund's staff. Disagreements in program details can be reviewed by such a standing committee. This also provides a mechanism to help ensure that Executive Directors' decisions are fully implemented.

All participants in the regional meetings acknowledge the continued relevance of the IMF, especially for global financial issues, while expressing deep concern about the inability of the Fund to influence the policies and actions of the largest economies. Similarly the participants are united in their insistence on the Fund's seeking improved governance, and increased diverse backgrounds and experience of its staff and management.

Recommendations

The IMF should take the following steps with regard to:

I. Policy Requirements

- **Ensure maximum policy space, encouraging countries to design their own programs, and providing capacity training as requested;**
- **Provide countries with alternative approaches to achieve the agreed outcomes and to demonstrate the social and poverty impacts associated with each alternative;**
- **Design policy recommendations with an eye to long-term growth, without an overemphasis on short-term stabilization;**
- **Insist that all policy recommendations are derived from data and, are not theory driven;**
- **Provide public market rating information on a country only when requested by the country;**
- **Ensure that staff have in-depth knowledge of specific countries and regions and that missions extend their visits to deepen their knowledge as well as engage in broad consultations with the Members of Parliament, the private sector, and civil society, which go well beyond meeting with just the Finance Minister and the head of the Central Bank;**
- **Make fast-disbursing funds available in the event of exogenous shocks, with a minimum of additional conditions or delays;**
- **Take steps immediately to re-introduce SDR as a genuine global currency to remove much of the risks of currency imbalances and corresponding financial instability;**
- **Recruit senior staff experts in financial products, dynamics and possible regulations.**

II. Surveillance

- **Ensure that surveillance of small countries has the same data-based and nuanced excellence as larger economies. (Surveillance, lending, and technical assistance should respect and collaborate with national and regional institutions, consistent with the principal of subsidiary: those closest to the problem should respond first and have the greatest authority);**
- **Supplement nation-specific surveillance of global imbalances to advise on the negative consequences for small and medium economies when large or global currencies are not in balance or suffer severe volatility shifts;**
- **Ensure equal treatment for all members of the Fund in adhering to recommendations contained in various surveillance studies. This presumes the Fund has the highest caliber and diversity of expertise to warrant such adherence.**

III. Representation

- **Expand the voice and vote of developing and emerging market economies on the Executive Board beyond the modest steps approved at the April 2008 Spring Meeting, (see R. Bryant in References);**
- **Incorporate greater diversity of nationalities, training and experiences, (notably experience in government and/or private sector) in management and staffing at all levels of the fund.**

IV. Accountability

- **Select the Managing Director from a list of candidates vetted for merit and experience without regard to nationality, thereby ensuring the Managing Director is accountable to the Board and not to a sub-set of powerful member countries;**
- **Take steps to amend the Articles of Agreement, so that the functions of chief executive officer or managing director and that of Chair of the Board are separated;**
- **Establish a complaint mechanism so that governments which disagree with staff recommendations can be heard, and adjustments made;**
- **Ensure the transparency of policy decisions made at the Executive Board level by making Board decisions public in the shortest time feasible.**

Endnotes

[1] The IEO (2007b) reports that in some cases Fund missions listen too little and tend to impose their own views despite the rhetoric of "ownership." According to a survey carried out by the IEO, only about half the IMF staff interviewed admitted using the analytical work and experience of the authorities for PRGF analysis and design. When it comes to utilizing the PRSP as a basis for PRGF program design, only 40 percent of surveyed staff agreed that it provides the basis for the PRGF. However, twice as many noted that the PRGF provides the basis for the macroeconomic implementation of the PRSP, the inverse of Board directives.

[2]Ownership is notoriously difficult to measure directly, and thus one can only point to the extent to which one can observe indirect evidence that is consistent with authorities' increased ownership. The IEO (2008) reports that PRGF arrangements enjoyed greater compliance rates than non-concessional GRA programs, although both types of programs exhibit relatively low compliance that becomes even lower in non-core sectors. Importantly, the average compliance rate is not significantly correlated with the overall success of the individual program, and it exhibits substantial variation across sectors within individual programs.

Further insight into the relationship between conditionality and ownership can be inferred by investigating whether conditionality is effective in bringing about follow-up reforms, which can be done by considering the degree to which compliance with a certain condition is followed by additional reforms in the same sector. All in all, the IEO evaluation (2008) uncovers no significant correlation between compliance and continuity of reforms, casting doubt on the extent to which, on average, conditionality has worked as a tool to support overall economic reforms.

The average compliance rate for concessional arrangements is 61 percent in core sectors and 39 percent in non-core ones. In GRA-supported arrangements, the respective rates stand at 49 and 54 percent.

[3] See IEO (2007b), Oxfam (2007), and Lombardi (2007).

[4] See Lombardi and Woods (2008).

[5] See Lombardi and Woods (2007).

[6] See IEO (2007a). For a scholarly assessment of IMF surveillance, see Momani (2006).

[7] It "refer[s] to the conveying by the Fund of information that influences the financing decisions of outsiders, whether through some form of on/off mechanism or through the rendering of a multidimensional picture" (IMF, 2004). Thus, it encompasses, but is not limited to, the catalytic effect of Fund financing—the indirect signal sent by the Fund through the use of its own resources.

[8] See Lombardi (2007).

[9] See Henning (2006).

[10] See Woods and Lombardi (2006).

[11] On April 28, 2008, the Board of Governors of the IMF adopted Resolution 63-2 to propose an amendment of the Articles of Agreement. The amendment proposes a tripling of basic votes, a mechanism that will keep constant the ratio of basic votes to total voting power and provisions enabling each of the two Executive Directors representing African constituencies to appoint an additional Alternate Director. The agreement reached among the membership also foresees the adoption of a new single quota formula, substituting the five used until now, based on four variables: GDP, openness, variability, and reserves. The quotas resulting from the application of the new formula together with the tripling of the basic votes imply a shift of voting power from developed to developing countries of 2.7 percent of the votes. This, however, comes mostly from the tripling of the basic votes. For an in-depth analysis of the revised formula, see Bryant (2008).

[12] For a fuller discussion of the need for accountability within the IMF, see the New Rules for Global Finance Coalition, Report of the High-Level Panel on IMF Board Accountability, April, 2007.

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