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The IMF and the World Bank: A Case for Separating the Conjoined Twins

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Abstract

The IMF and the World Bank were created in 1944 to be at the center of a sound and dynamic international financial system. They have not adapted well to far-reaching changes in the global economy over the past twenty years, and are now poorly equipped to tackle the challenges that lie ahead. Their antiquated governance structures have undermined their legitimacy. Overlapping responsibilities have fostered confusion about their roles.

The United States is the principal obstacle to re-positioning these institutions to strengthen the global economy and extend its benefits to all nations. An initiative by the next President to develop fresh mandates for the IMF and World Bank could be a low-cost, high-impact element of a new foreign policy designed to move the United States from being a stumbling superpower to being a trusted global partner. Steps to visibly differentiate the two institutions, including moving the headquarters of the World Bank to Europe, could help each one become more effective.

The IMF and the World Bank

The United States is in bad place. For the past five years it has been mired in thinly supported wars in Iraq and Afghanistan. Now its financial system is in disarray and it appears to be dragging the whole world toward a period of low-growth, high inflation, and rising unemployment.

The next President will be hard-pressed to stay on top of these two great foreign policy and domestic policy challenges, not to mention other heavy issues abroad and at home such as nuclear proliferation and and excessive dependence on oil imports. Moreover, the fiscal room for maneuver for at least three years will be small because of heavy defense sector and financial sector requirements.

In this context, an initiative to give the International Monetary Fund (IMF) and World Bank fresh mandates and more appropriate governance structures has considerable appeal. It could pay large foreign policy dividends by showing the rest of the world that the United States is ready to graduate from being a paternalistic and myopic superpower to an open-minded and reliable partner. Another attraction is that such an initiative would have no budget cost and might even involve some budget savings.

The IMF was created to help the world deal with crises of the kind we are witnessing now. It can help countries make the adjustments required to minimize the adverse impact of global turmoil that is beyond their control. But the IMF is hobbled by a governance structure that disfavors rising economic powers such as China and India, and by a method for funding its operational costs that no longer works.

The World Bank is the right institution to lead efforts to raise incomes in poor countries, overcome civil disorder in weak states, and turn the corner on global warming. But the World Bank is stuck in low gear: it is too closely bound to the IMF and too Americanized. Like the IMF, it has a governance structure that fails to give rising powers the kind of stake in the institution required to be an effective global leader.

The United States more than any other country is blocking the improvements necessary to restore the vitality of the IMF and World Bank. The Europeans are part of the problem because of clinging to a decision-making system heavily over weighted in their favor. At the same time, leading emerging market countries have not been clear and consistent about the roles they want the IMF and World Bank to play. Ultimately, however, the United States holds the key to meaningful improvements because it is the only country with veto power, it is the largest shareholder, and it is both the father of these institutions and the host of their headquarters.

Relaxing its control over the IMF and World Bank will be an awkward act for the United States at a politically inconvenient time. But Americans cannot have it both ways. They cannot continue to control these two institutions and at the same time persuade other countries to develop a greater sense of ownership toward them and accept more responsibility for using them to address global challenges. If the United States fails to seize the initiative now to recast the image and the operational reach of the Fund and Bank, they will become weaker as the world's rising economic powers rely increasingly on regional institutions. The net result will be a loss of U.S. influence over policies in areas of great importance for the future well-being of the United States.

Putting the IMF and World Bank on course for the future will require two basic changes: lowering the profile of the United States in each institution, and making them more separate from each other. Forming a bipartisan commission to recommend new statutory foundations for U.S. participation in the IMF and World Bank would be a sensible first step in this direction. A parallel dialogue with our major international partners, including the rising economic powers, will also be necessary to build an international consensus on specific changes.

Shut Them Down, Merge Them, or Separate Them?

The radical left has argued for shutting down the IMF and World Bank because they do more harm than good. The radical right has argued for shutting them down because they are unnecessary and interfere with markets. A number of moderate and thoughtful leaders like Tony Blair have suggested merging them into a single institution to make them more efficient. Making them more separate looks like a smarter alternative.

Shutting down the IMF and World Bank simply eliminates two instruments that can help the community of nations deal with issues that know no borders, such as global warming. Merging the two institutions would create a monster with an unmanageable scope of work, or too much supra-sovereign power.

If it was not obvious before, it should be obvious now that all countries can benefit from having a multilateral institution dedicated to preventing financial crises in a world of many currencies and open capital markets, and to helping countries weather crises that cannot be avoided. The IMF was created precisely for this purpose and on balance has performed reasonably well until recently. It has not been able to prevent crises, and has admitted to shortcomings in dealing with some the crises that have occurred, but it can hardly be blamed for creating these crises.

If fixing the IMF were not feasible, then closing it down and creating a new institution in its place would make sense. The major overhaul of the IMF in the mid-1970s, however, suggests that the laborious and time-consuming process of creating a new institution can be avoided. The real choice today is between making marginal improvements in the functioning of the IMF or undertaking a second major overhaul.

The special value of the IMF today comes from its mandate to promote financial stability, the expertise of its staff, and the pool of financial resources at its disposal. These are unique attributes. No other institution comes close to having these features.

Beyond the small steps agreed earlier this year to improve its governance and its funding basis, relatively few steps are required to make the IMF more effective. Three would go a long way:

- *Focus more narrowly on the advanced economies*. For a variety of historical reasons, much of the energy of the Fund is directed to small, low-income countries that have no "systemic" importance in the global economy. Too little attention is paid to the United States and the other "G-10" countries that together hold a majority of the voting shares. "Ruthless truth-telling" by the IMF when it sees systemic risks in the policies of its major shareholders is essential to the task of promoting international financial stability. If the United States and Europe and Japan, for example, do not take seriously the IMF's concerns, then why should rising powers like Brazil, Korea, and Russia take them seriously? Refocusing in this manner does not require the IMF to ignore small, low-income countries. Instead it requires the IMF to play a supporting role (mostly in the form of technical assistance) behind the World Bank in "normal" circumstances and only taking a lead role in these countries when short-term balance-of-payments support on a non-concessional basis can be justified.

- *Give rising powers more voice and vote*. The single most meaningful step that can be taken to improve the governance of the IMF is to abandon the practice of having a European managing director (to balance an American World Bank president) and to adopt an open selection process based on merit. Other critical steps are to adopt a quota (shareholding) formula that gives more weight to the rising powers, reduce European representation on the Executive Board from eight to two or three, and eliminate the exclusive ability of the United States to veto important decisions. An additional step that has received remarkably little attention is to further downplay the role of central banks in the governance structure so that the IMF is more clearly seen as an instrument of finance ministers.

- *Grant formal jurisdiction over capital account convertibility*. For historical reasons, the IMF has only been granted formal jurisdiction over current account (trade and services) convertibility. In a world where capital movements are so large and crises have become more closely linked to these movements, it is anomalous to withhold this responsibility from the IMF. An effort in the mid-1990s to correct this situation was derailed by the financial crises in Asia in 1997. Critics of the Fund unfairly accuse it of aggressively pushing developing countries in the 1990s to eliminate capital controls and de-regulate their financial sectors. The Fund was being pushed in this direction by the United States and other major shareholders away from its instinctively pragmatic position. This is a litmus-test issue. Refusing to give the IMF this responsibility is in effect a vote of no-confidence in the institution.

Fixing the World Bank requires equivalent improvements in governance: an open process for selecting the President, an allocation of capital (and voting shares) that gives the new powers a meaningful stake in the institution, correcting Europe's overrepresentation on the Executive Board, and eliminating the U.S. veto. Another overdue governance improvement is to formally end the Development Committee's status as a joint committee of the Governors of the IMF and World Bank. This ministerial-level committee, which meets twice a year, will be taken more seriously if it is a Bank-only committee and if it drops its original title that signals a preoccupation with "the transfer of real resources to developing countries." Similar advantages would accrue from uncoupling the Bank's annual meetings from the IMF's annual meetings and perhaps holding them back-to-back with the annual meetings of the regional development banks in rotation.

In addition, two bolder improvements will be necessary to overcome the image of the World Bank as an instrument of U.S. policy:

- *Move the headquarters to Europe*. Despite having a staff four times as large, the World Bank is over-shadowed by the IMF, its neighbor across 19th Street in Washington, DC. Few people in Washington understand the difference between the IMF and World Bank and even fewer in the countries where the two institutions have been most active in recent years. Both institutions would benefit from being seen as having fundamentally different functions. Moving the World Bank makes more sense than moving the IMF. Spain appears to offer the best location and has the advantage of not hosting already a major multilateral agency. A move spread out over five or more years could have a minimal cost, taking into account the market value of the buildings in Washington owned by the World Bank and the amenities that Spain can be expected to offer as the host country.

- *Decentralize, scale down, and re-staff*. The World Bank has been decentralizing its operations but it can go considerably further toward the kind of structure seen in globally active commercial banks. Its staffing requirement could also be reduced substantially by integrating the separate staffs of the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA), and combining their separate balance sheets. The Bank could achieve additional economies by drawing new talent more from the pools of domestic and expatriate experts in the countries where it operates and less from PhD programs at leading universities in the West. The Bank could also have a bigger impact by being more innovative (taking more risks), and by being less wedded to the lifestyle in Washington, DC, that contributes to its image of arrogance and insensitivity.

The U.S. Chokehold

Think about the simplest step to improve the governance of the IMF and World: adopting an open process for selecting their CEOs. The United States alone has the ability to get it done. It can simply announce that it will not seek a second term for the current President of the World Bank, Robert Zoellick, and support the open process developed several years ago for selecting the next president. The budget cost of this step would be zero and the public opinion dividend would be huge. It is not necessary to negotiate the quid pro quo of getting the Europeans to give up their claim on the IMF Managing Director position. If the United States moves first, the European position will become untenable. With a unilateral announcement, the United States will garner all of the credit for the improvement instead of sharing it with the Europeans.

Next, the United State can announce unilaterally a willingness to give up its sole veto power in the IMF and World Bank. Again, the budget cost of this step is zero and the public relations dividend is large. Far from diminishing U.S. influence in these institutions, giving up the veto will enhance its influence for two reasons. First, other members will have to give greater weight to U.S. views in order to keep the United States strongly committed to the Bank. Second, proposals from the United States that are accepted on their merits will be implemented more effectively than proposals adopted because the United States has bullied others into submission. At a minimum, giving up the veto will not represent a significant loss because the United States has not found it expedient to exercise this power.

Other areas where the United States has been blocking progress are: the adoption of the Fourth Amendment of the IMF's charter, equilibrating the allocation of Special Drawing Rights to all current members; selling gold to fund an "endowment" to generate revenue to cover administrative costs instead of relying exclusively on the spread between borrowed resources and loaned resources; and increasing substantially IMF quotas (its capital, in effect).

Finally, the United States Congress is notorious for seeking to micromanage the IMF and World Bank by mandating the votes of U.S. Executive Directors on a wide range of matters, such as expropriation. These mandates have little impact on the actual operations of the two institutions but contribute significantly to their image as instruments of U.S. policy rather than instruments of the global community. Here again, the United States could have more influence by making a strong case for its views rather than playing political football with the two institutions.

A Winning Strategy

George W. Bush is the first U.S. president in at least 40 years who has not addressed the assembled Governors of the IMF and World Bank at one of their joint annual meetings, which are held in Washington, DC, in two out of every three years. The next annual meeting, in October 2009, will provide a superb opportunity for the next U.S. president to show how far his foreign policy will move beyond the policies of the past five years. Well before then, presumably, a new vision of a less unilateral foreign policy will have been articulated that involves less preaching, more listening, and a credible commitment to be global partner. And initiatives on more urgent matters will have been announced.

Eight months into the new president's first year in office, however, an initiative focusing on the IMF and World Bank could be extremely attractive because of its negligible budget cost and its potential foreign relations benefits. It will not be an easy sell domestically, but the financial crisis that began in 2007 and a discouraging outlook for global economic growth could magnify the benefits and strengthen the case for action in this area.

Presented to the 184 other members of the IMF and World Bank on the occasion of their 2009 annual meetings, an initiative with the following five elements would have a magnificent impact:

- Committing to an open process for selecting a new president of the World Bank at the end of Robert Zoellick's term in mid-2012, and for selecting the next Managing Director of the International Monetary Fund at the end of Dominique Strauss-Kahn's term later the same year.

- Creating a bipartisan commission (in consultation with the leadership of the new Congress) to recommend new and separate statutory foundations for U.S. participation in the IMF and World Bank. The new laws would replace the Bretton Woods Agreements Act of 1945 and remove or consolidate most of the related mandates in the Foreign Assistance Act.

- Initiating a parallel dialogue with a representative group of other economically strong countries, including rising powers such as China and India, to identify a package of improvements in the IMF and World Bank that will help these institutions remain at the center of efforts to promote global economic progress while maintaining financial stability.

- Expressing a positive attitude toward substantial improvements in the governance of both institutions such as giving up the U.S. veto, reducing Europe's representation in their governing bodies, and adjusting capital subscriptions/voting shares to fully reflect the large and growing role of emerging market countries in the global economy.
- Signaling support for moving the World Bank's headquarters out of Washington to underscore its distinct role, enhance its legitimacy, and boost its effectiveness.