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Is the IMF Worth Funding?

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Since the middle of this decade the International Monetary Fund (IMF) has faced triple crises of legitimacy, relevance, and financing. IMF members have endeavored to address these crises against the background of sharply diminished demand for IMF financing because of a sustained period of global expansion, of rising global imbalances, and more recently of global financial turbulence. During the turbulence, many perceived the Fund to be on the sidelines. In this paper, I take stock of these efforts, including the Fund's role in the crisis, and provide my positive, qualified answers to the question that will face the new U.S. administration: Is the IMF worth funding?

This question is particularly acute in the case of the United States because the Bush administration will have left behind it a package of measures that require the approval of the 111th Congress that takes office in early January 2009 in advance of the inauguration of the 44th president of the United States on January 20. The package includes (1) acceptance of an increase of about $7.6 billion (SDR 4.97 billion at $1.52 per SDR) in the U.S. quota in the Fund; (2) approval of an amendment to the IMF Articles of Agreement and the U.S. Bretton Woods Agreements Act that will increase the basic votes of each member of the Fund, fix permanently the share of basic votes in total votes, and provide for an extra alternate executive director for any constituency group of countries in the Fund with at least 19 members; (3) approval of a second amendment to the IMF Articles that will expand the powers of the IMF to invest certain of its financial resources; and (4) authorize the US Secretary of the Treasury to vote to approve the sale of a portion (12.97 million ounces, or 12.5 percent) of the IMF's 103.4 million ounces of gold, which is worth about $80 billion (at a market price of $800 an ounce).[1] Action by the U.S. Congress is needed for any of these measures to go into effect because they require approval by 85 percent of the weighted votes of the IMF, and the current U.S. voting share is 16.77 percent. At the same time, the governments of the other members of the Fund, including, importantly, European members of the Fund with more than 30 percent of the voting power, must act on the first three elements of the package before they can become effective.

Thus, the question is whether the IMF is worth funding. In particular, does the package of reforms contained in this legislation and other policy actions by the Fund over the past several years justify increased financial support for the institution? This is fundamentally an existential question. Without such support, the institution will not disappear, but its role as an institution of global governance promoting economic growth and financial stability would be further reduced.

[1] The first two elements of the package are linked in that the first cannot go into effect without the second. As a practical matter, the last two elements are also linked in that the expanded investment powers for the IMF will not be of much use if the IMF does not have the authority to invest the proceeds from the gold sales. Furthermore, although the U.S. Congress could act separately on the four elements, they will almost certainly be presented to the Congress as a package and most likely voted upon as a package.

This paper, first, reviews progress on IMF reform over the past several years. Second, I discuss the role of the IMF in the unfolding global financial crisis before turning, by way of a conclusion, to the title question.

My review of IMF reform is based loosely on the set of proposals in my summary of a conference that was held at the Peterson Institute in September 2005 summarized in Edwin M. Truman (2006b and 2006c). There were other IMF reform proposals at the time (by a previous IMF managing director Michel Camdessus (2005) and the then current managing director Rodrigo de Rato (IMF 2005a)) and have been others since, for example, by the current IMF managing director Dominique Strauss-Kahn (2008) and others calling for broader reforms of the international architecture such as World Bank president Robert Zoellick (2008) and U.K. Prime Minister Gordon Brown in the *Washington Post* of October 17. However, my agenda provides a framework to discuss progress on reform issues during the past three years.

Before proceeding to the review of recent IMF reform accomplishments, it is useful to remind the reader what the Fund is. The Fund, first and foremost, is its member countries as represented on the 24-member executive board or in the "advisory" International Monetary and Financial Committee (IMFC). In particular, if the members cannot reach consensus on IMF reform or the role the Fund should play in the international economy and financial system, the Fund as a functioning institution is stuck in large part with the status quo. However, the Fund is not completely stuck because the management of the Fund, in the person of the managing director, can propose, prod, embarrass, and otherwise try to lead the members of the organization to endorse proposals that promote the IMF's objectives and increase its role in the world economy and financial system. In doing so, the managing director can be substantially helped or hindered by the imagination and technical quality of the work of the IMF staff.

A Look Back at the IMF Reform Agenda

In 2005, I identified six components of an IMF reform agenda: (1) substantial progress on IMF governance, (2) greater attention to the policies of systemically important countries, in particular their exchange rate policies, (3) reestablishing the central role of the Fund in external financial crises, (4) refocused engagement with low-income members, (5) attention to the capital account and the financial sector, and (6) the need for additional IMF financial resources.[2] This list was drawn largely from papers presented at a conference at the Peterson Institute in September 2005. It did not include the issue of the financing of the IMF as an institution, in contrast with its lending operations. However, I was aware of the issue, it was addressed at the conference by Mohamed El-Erian (2006), and I will cover the topic under the sixth heading below.

IMF Governance

The principal focus of the recent IMF governance debate, and in fact the debate for at least 15 years, has been on the formulas that traditionally have been used as the basis for IMF quotas as well as on the adjustments in quotas, which affect the relative voting power in the Fund. The distribution of voting power in favor of the traditional industrial countries derives from the history of the Fund and the application of the basic formulas as it evolved until the late 1970s (Truman 2006a and Richard N. Cooper and Truman

[2] I argued that the first three items in my six-part agenda were relatively more pressing.

2007).[3] On these twin issues, there have been some changes, but it is debatable whether these changes represent significant progress. I advocated (Truman 2006a) a reduction in the combined voting share of the 26 traditional industrial countries by 10 percentage points from more than 60 percent to about 50 percent. The proposed change produces a quarter of this amount.

With respect to the formula, the IMF executive board approved a new quota formula that replaces a combination of formulas. (IMF 2008b) The single new formula is simpler to understand and at least some of the variables included are appropriate. The formula is a weighted linear combination of four variables: gross domestic product (GDP) with a weight of 50 percent, openness with a weight of 30 percent, variability of current receipts and net capital flows with a weight of 15 percent, and international reserves with a weight of 5 percent plus a "compression factor" that reduces the relative shares of a handful of the countries with the largest shares.

GDP appears as the weighted sum of two measures: GDP at market exchange rates (60 percent) and GDP at purchasing power parity (PPP) rates (40 percent). Thus, the new formula has five variables. Moreover, the GDP variables are the only ones that are free from criticism although even here the weights that have been assigned to the two measures can be criticized. As detailed by Ralph Bryant (2008a and 2008b) and by Richard Cooper and Edwin Truman (2007), the openness variable is not the conventional measure of trade as a percent of GDP, but rather it is each country's share of total trade in goods and services, reinforcing each country's economic size.[4] The variability measure also is not scaled by some measure of a country's economic size, so it also tends to

[3] See also Ralph C. Bryant (2008a and 2008b).
[4] The measure has the added weakness that it fails to exclude intra-Euro area trade.

"reward" large countries over small countries. Finally, in today's world where reserve holdings appear to be a factor impeding the international adjustment process, it is questionable whether that variable should be included in the formula at all.

After two and a half years of extensive, but not particularly imaginative, work by the executive board and the IMF staff, the result with respect to the new quota formula was decidedly disappointing. The formula points in the wrong direction. It suggests that at the time of the adoption of the new formula the share of the 26 traditional, advanced countries should increase by 2.2 percentage points vis-à-vis those of the other 159 members of the Fund.[5]

With respect to adjusting IMF quota and voting shares, the good news and the bad news is that the executive board ignored the formula in recommending quota adjustments. The result was that the advanced countries' combined quota share in the Fund is proposed to be reduced by 1.4 percentage points compared with where it was in 2005.[6] The combined voting share of the advanced countries was reduced 2.6 percentage points, but almost half of that was due to the one-time tripling of basic votes.[7] This is about a quarter of my proposed minimum adjustment of 10 percentage points. Although a political and fairness case could be made for increasing basic votes (which had not been adjusted from the founding of the IMF in 1944), in fact doing so was a feel-good gesture with little influence on the distribution of power within the IMF.

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[5] The new formula implies a set of pro forma quota shares for these countries that is 1.8 percentage points less than the old formulas, but the old formulas had been ignored. The actual combined quota share of this group was 4 percentage points below what was implied by the old formulas.

[6] The quotas of four members (China, Korea, Mexico, and Turkey) were adjusted in 2006 in the first round of the quota-reform effort.

[7] A member's voting power in the IMF consists of a certain number of basic votes (to be raised from 250 to 750) plus one vote for each SDR 100,000 of its quota.

Some argue that the reforms should have done something about the U.S. veto in the Fund, which in fact is only the capacity of the United States to block actions that require an 85 percent majority vote. Lowering the U.S. voting share below 15 percentage points could have done this.[8] Alternatively the 85-percent majorities could have been reduced to 80 percent. My view is that until the Europeans agree to a substantial reduction of their combined share in the IMF from more than the 30 percent currently for the European Union to close to the U.S. share, this is a nonstarter. As a result of the proposed changes the EU voting share would decline from 32.5 percent to 30.9 percent. The Fund would remain a European dominated institution.

Some also argue that these proposed changes in the formula, in basic votes, and in actual quotas are just the first step, and the process will continue. Since it took 30 years to bring about these changes, one can be skeptical whether the members of the Fund will return to these issues to make substantial further adjustments in the near future, absent a cataclysmic event that transforms the debate.

A second high profile governance issue for the IMF has been the process by which it chooses its senior management. By convention, the managing director is a European and the president of the World Bank is a citizen of the United States. There have been various efforts to break this convention; see Kahler (2001 and 2006) for descriptions of those efforts. In the middle of the IMF reform effort initiated by managing director Rodrigo de Rato in 2005, he resigned in 2007 and was replaced by Dominique Strauss-Kahn. His appointment came shortly after Robert Zoellick replaced Paul Wolfowitz as president of the World Bank. In both of these transitions, the

[8] The US voting share is to be lowered by 0.3 percentage points to 16.732 percent, compared to where it was in 2005.

convention held though in the case of Fund, as has been the case in previous elections, the election was contested. That has never happened in the World Bank. On October 12, the Development Committee of the World Bank and Fund declared "There is considerable agreement on the importance of a selection process for the President of the Bank that is merit-based and transparent, with nominations open to all Board members and transparent consideration of all candidates." This approach, which is non-binding, would only align the Bank with that of the Fund during the choice of its last three managing directors. Nevertheless, there is a fair chance that the US-European consensus will be renounced or destroyed before the next elections in 2012 at the latest.

The third governance issue is representation on the 24-member executive board, which again is dominated by 7-10 Europeans depending on how you count Europeans and the day of the meeting.[9] I proposed a multi-step consolidation of European representation (2006a). The U.S. government in early 2008 proposed, as a facilitating step, an amendment to the IMF Articles to switch entirely to elected executive directors.[10] This proposal was not accepted. The Europeans have blocked any serious discussion of this issue even though a number of Europeans favor consolidation of European seats in order to enhance Europe's effectiveness in the Fund. The only change that has been proposed is that the Articles be amended to provide for an additional alternate executive director in constituencies with more than 19 member countries.

[9] Does Europe include Switzerland or just the European Union? Should we acknowledge that in some constituencies the alternate executive director comes from Europe while the executive director does not, for example, he may come from Mexico or Venezuela in the case where the alternate is from Spain.

[10] The Articles require that the five members with the largest quotas select rather than elect their executive directors. In fact, there are now a total of eight single country constituencies (China, Russia and Saudi Arabia in addition to the G-5 of France, Germany, Japan, the United Kingdom, and the United States).

This list does not exhaust the agenda for IMF governance reform. The Independent Evaluation Office (IEO) of the International Monetary Fund (2008) issued a critical evaluation of the effectiveness and efficiency of the governance structures of the IMF including the executive board, management, and IMFC. In partial response, in September 2008, managing director Strauss-Kahn appointed a committee of eminent persons under the chairmanship of South African Minister of Finance Trevor Manuel "to assess the adequacy of the Fund's current framework for decision making and advise any modifications that might enable the institution to fulfill its global mandate." One proposal favored by former managing director Michel Camdessus (2005) and endorsed by the IEO is the creation of a Council with formal decision-making power to replace what was once called the Interim Committee and is now called the International Monetary and Finance Committee. The Development Committee, under this type of approach, might well be changed to a body relating solely to the World Bank rather than its current status as a joint committee of the governors of the two institutions.

A final issue under the heading of IMF governance is how much of that governance should be exercised by outside bodies such as the G-7, the newer G-20, some intermediate group like the F-16 (C. Fred Bergsten 2006), a new G-14 (Zoellick 2008), or Gs with an IMF secretariat (Strauss-Kahn 2008). That there will be some type of steering committee for the IMF and global economic and financial topics more broadly is demanded by efficiency, as even Strauss-Kahn admitted. That it should be broader than the G-7 is increasingly obvious. Exactly what form it should take is a more difficult question. As Bergsten (2006) argues the size and effectiveness of any new steering committee is linked to the future of the European Union and its representation in international forums.[11]

Policies of Systemically Important Countries

In my agenda for IMF reform (2006), I argued that the list of systemically important countries should be lengthened. This conclusion follows from the observation that the G-7 is no longer an appropriate steering committee for the international economy and financial system. For some time, many observers (except in countries that recently ended programs with the Fund) have argued that the IMF should be more assertive in its role as a global umpire. Until recently the focus of such efforts to encourage the Fund (meaning its management and membership) has been on member countries' exchange rate policies.

Since the summer of 2008, attention has turned to the stability of the global financial system and the global financial crisis that is covered in the next section. The executive board has also approved a statement of surveillance priorities under the prodding of certain of its members, the United Kingdom in particular (IMF 2008c and 2008e). It remains to be seen whether this initiative will produce in substance; the laundry list of priorities is rather long – four detailed economic priorities and four detailed operational priorities.

With respect to my call for a higher degree of naming and shaming in IMF reports on countries, a nonscientific impression is that there has been somewhat of an increase in the critical content about countries' policies in Article IV documents with somewhat mixed results in particular in the case of exchange rate policies. To its credit the IMF management also expanded the country coverage of its staff-level Consultative Group on

[11] See Colin Bradford (2008) for a review of some of these representational issues at the leader level.

Exchange Rates (CGER), and the staff published a report on their methodology for doing this work (Jaewoo Lee et al. 2008). On the other hand, the staff started incorporating into Article IV documents its judgments about whether a member's exchange rate was undervalued or overvalued, but many members deleted or scaled back this material if the reports were released to the public.

The IMF did not take the advice of John Williamson (2006) to establish a set of reference exchange rates for major currencies to guide the IMF in conducting its surveillance of exchange rate and other economic policies of members. William Cline and Williamson (2008) endeavored to plug this hole by publishing a set of fundamental equilibrium exchange rates for major countries and currencies consistent with internal macroeconomic balance and external imbalances.

The IMF did take the advice of Morris Goldstein (2006) and others to revamp its 1977 decision on exchange rate surveillance. The resulting decision (IMF 2007b) updated the 1977 decision, introducing two new concepts "external stability" and "fundamental misalignment."

The decision itself has been severely criticized for not breaking any new ground and further confusing the nature of the exchange rate obligations of members under the Articles of Agreement. The decision sidesteps issues of multilateral surveillance and essentially gives a pass to a country whose exchange rate may be floating, such as Japan, but nevertheless may be frustrating the functioning of the balance of payments adjustment process. Stanley Fischer (2007) has been critical of the decision for placing too much emphasis on external stability and too little on other policies, such as fiscal policies, that may affect external adjustment.

More importantly, more than a year later the new decision has produced no tangible results. It is widely understood that the IMF staff have identified to the executive board situations that, under the new decision, merit consideration of the implications a country's exchange rate policy for external stability or may involve fundamental misalignment, but the board has declined to accept the staff's judgment. In addition, the conclusion by the executive board of several countries' Article IV consultations has been delayed, including in the important and sensitive case of China.

In response to some of these conceptual and procedural concerns, the executive board in August agreed to a clarification that involves inter alia the option of a board decision to authorize an ad hoc consultation with a member in cases where a member may not be observing the principles for guidance of its exchange rate policies that have been adopted by the Fund or where its exchange rate may be fundamentally misaligned (IMF 2008a).[12] We do not know yet whether this process will yield concrete results.

We do know that the IMF management did not accept my recommendation to hold a collective consultation with major Asian countries on exchange rate issues. My view was, and still is, that such a broad approach might produce more results in terms of relaxing exchange rates policies than focusing only on China's policies. Instead, in the spring of 2006, the management of the Fund initiated a "multilateral consultation" on global imbalances involving China, the Euro Area, Japan, Saudi Arabia, and the United

[12] This action partially implements one of Goldstein's (2006) suggestions that the IMF management should more active in the use of ad hoc and special consultations, but the twist is that the suggested procedure involves the executive board, which may be a good thing if it produces any concrete results, rather than just involving the management and staff. The Fund has not acted on the third element of the Goldstein triad: issuing a semi-annual report on members' exchange rate policies based on a reference exchange rate framework.

States. The Fund, in effect, dealt itself into the policy coordination business essentially for the first time since the collapse of the Bretton Woods system of fixed exchange rates.

However, as far as one could tell, the management of the Fund exerted no pressure on the participants to make new, specific policy commitments. The participants' resulting statements of policy intention in April 2007 were not new and not news; in some respects they were less explicit than those contained in the G-20 Accord for Sustained Growth issued in Melbourne, Australia in November 2006, which followed the release of a policy strategy by the IMFC in September 2006.

The proposed measures envisaged a process of "immaculate adjustment," in other words adjustment without significant exchange rate changes. The only mention of exchange rates was by Saudi Arabia, which said that it would not alter its peg to the US dollar, and by China, which again said that its "exchange rate flexibility will gradually increase." For the United States, Japan, and the Euro Area, there was no mention of exchange rate adjustment. This is not *Hamlet* without the Prince, it is *Hamlet* set in never-never land.

It appeared that the IMF's earlier warnings about the risks of external adjustment had been turned upside down. In place of concern that there will be too little in the way of preemptive policy actions, the first deputy managing director John Lipsky (2007) declared, "excessively precipitous policy actions undertaken with the sole aim of immediate and substantial reductions in imbalances could be unnecessarily disruptive to global growth and could even undermine financial market stability." It is rare to hear a responsible official charged with promoting policy adjustment worrying about a decline in the US budget deficit that is too large, an appreciation of the Chinese yuan that overshoots, or economic reforms in the Euro Area or Japan that are too rapid. At the time, the IMF staff (2007c) claimed the results “would in combination constitute a significant further step toward sustaining solid economic growth and resolving imbalances.” In other words, nothing new needed to be done to reduce the imbalances, which would take care of themselves.

Today, we hear three interpretations of the IMF’s stewardship over the global exchange rate system over the past several years: (a) The Fund has unfairly focused on the position of China and a few other countries. (b) The Fund has been distracted from focusing on its primary mission of the promotion of global growth and financial stability by the United States, which has been using the IMF to pursue a bilateral agenda to force the Chinese authorities to appreciate their currency. (c) The Fund has been ineffective. How do I evaluate these three interpretations?

The first interpretation contains a small grain of truth. The IMF has focused insufficiently on the exchange rates and policies, including other than exchange rates policies, of a broader group of countries, starting with Japan and including the Euro Area and the United States. In its 2008 Article IV report on the United States released in July 2008, the Fund staff declared that the US dollar was somewhere between slightly undervalued or 30 percent overvalued. A year earlier, the Fund staff also reported that the dollar was overvalued by 10-25 percent, and US authorities disputed the reliability of the models producing those estimates. The US authorities protested too much about the models and their applicability, in particular under the circumstances, undermining their broader case. However, unlike the Japanese authorities, the US authorities did not insist that the estimates be deleted from the published version of the report. The 2008 Article

IV report on Japan released in July 2008 merely reported that the yen was undervalued and that the Japanese authorities also disputed the relevance of the staff's models.

The second interpretation, distraction from focusing on financial stability, has been heard from those who from the beginning did not like the idea of the IMF criticizing their own policies in this area, in particular within the European Union, and therefore favored deflecting the Fund from focusing on the exchange rate policies of other countries. It is interesting that some of the same people who urged the United States to seek multilateral solutions to problems subsequently also complained when the US authorities did so. However, there is no substance to the basic accusation. With 2,700 employees, the Fund had ample resources to focus on both exchange rate policies and financial policies.

The third interpretation, ineffectiveness, sadly, is the most compelling. Managing director Strauss-Kahn was dealt a weak hand in the flawed revision of the 1977 decision on exchange rate surveillance and the failure of the IMF staff and management in previous years to discharge their obligations under the IMF Articles, which in turn led members of the Fund not to comply with their obligations under the Articles.[13] In effect, the management of the Fund downplayed substantially its umpire or regulatory role with respect to the exchange rate policies of members. It had failed Mervyn King's (2006) test of "ruthless truth telling."

Let's look at the Fund's record on global imbalances. In 2006, at the start of the multilateral consultation, the US current account deficit was 6.0 percent of GDP. The IMF (2008g) projects that the US deficit will reach 3.3 percent of GDP in 2009 – a decline of 2.7 percentage points – and 2.8 percent in 2013. China's current account

[13] See IEO-IMF (2007) for the particulars of the failings.

surplus in 2006 was 9.4 percent of GDP, rose to 11.3 percent in 2007, and is projected to decline to only 9.2 percent in 2009 – a net decline of 0.2 percentage points – and to rise back to 9.9 percent in 2013.

Where is the major imbalance in the global economy and financial system today? It would appear to be in China. What has happened to China's real effective exchange rate since it moved to a more flexible exchange rate regime in July 2005? Through February 2008, it had appreciated 15.6 percent on the broad index calculated by the Bank for International Settlements from June 2005. Through September 2008, it had appreciated a further 5.4 percent. However, William Cline and John Williamson (2008) have estimated that the RMB would have to appreciate almost 20 percent from February 2008 as part of a balanced global set of exchange rate adjustments in which the Chinese current account surplus would be cut in half. These facts, along with the additional consideration that the Chinese authorities have been able to persuade the IMF management and their executive board colleagues to delay the completion of China's 2007 (!) Article IV consultation for more than a year, suggesting to me that the IMF (members, management and staff) have been ineffective in discharging its responsibilities.

The Central Role of the Fund in External Financial Crises

In early 2006, I wrote, "The IMF remains bedeviled by philosophical disputes about the scale and scope of its lending and crisis-related activities. These disputes distract the institution from its role as a global lender of final resort." (Truman 2006b, 532) Until recently this stalemate did not matter because many countries were paying down their obligations to the Fund. IMF credit outstanding under the general resources account (GRA), which is financed out of IMF quota subscriptions, peaked on an end of year basis at $98.9 billion in 2003. By the end of 2005, it was down to $43.2 billion, and as of September 30, 2008, it was $11.5 billion, but only two of the 23 countries with credit outstanding from the Fund had active programs with the institution (Gabon and Georgia).[14] As is well known, the IMF has been out of the lending business for several years.

All that is changing with the global financial crisis and unfolding global recession. It is highly unfortunate that during the interim, members of the Fund were not able to agree on the initiatives I advocated in early 2006: reaffirming the IMF's central role in international financial crises, including in work-out situations and establishing a "new liquidity instrument" or insurance facility.

Given that IMF management backed off from their extreme, hands-off posture in the Argentine restructuring when they handled the Uruguay and Dominican Republic cases, there is some hope that if the coming global recession and emerging market external financial crises produce a need, the Fund will discharge its traditional role in mobilizing collective action among the creditors as well as actively advising the debtors about the economic and financial implications of the arrangements they are being offered.

With respect to new financing vehicles, members of the Fund have wrestled for the past decade with questions of the desirability and usefulness of a semi-automatic credit facility that would be available to countries with sound policies. In 1999, the contingent credit line (CCL) was created as a component of the supplemental reserve facility (SRF) that had been established two years earlier. The CCL provided for a

[14] Three other countries had active programs but had not drawn upon them: Honduras, Iraq, and Peru.

specified amount of financing to be automatically available to countries that had previously been approved to receive it if conditions changed. Despite some interim tinkering with the CCL, no member signed up for it, and the mechanism was not renewed in November 2003. Nevertheless, discussions of a new liquidity instrument are ongoing (IMF 2008c and 2008e). Once again in the area of IMF lending, the IMFC (2008) has called for decisions on an "accelerated basis in those areas where there is strong consensus – such as the establishment of a new liquidity instrument -- and on the full range of issues by the time of the 2009 annual meetings." [Given recent global financial developments, it is possible that a new liquidity facility will be in place before this paper is delivered.]

With respect to a liquidity instrument, the traditional tension is between those members who oppose any semi-automatic IMF lending (and in some cases any lending at all) without strong policy conditions associated with the lending, and those that see such an insurance arrangement as a desirable feature of the IMF's arsenal of lending instruments in the 21st century. We have reached a point at which some argue that a number of countries are being sideswiped by the global financial turbulence and no facility of this type is in place. We also are witnessing the potential involvement of bilateral or regional lenders or arrangements to substitute for such a facility in the Fund: Russia for Iceland, China for Pakistan and maybe a host of other countries, the European Union for Hungary and other member states, and Japan and others within Asia in the ASEAN plus three or plus six where visions of an Asian Monetary Fund have again begun to dance in the heads of finance ministers who want to avoid going to the IMF for help and foreign ministers who lack anything useful to do..

In my view this trend toward bilateralism and regionalism weakens the international financial system unless such arrangements are firmly anchored in the IMF. In most cases, the borrowers see the arrangements as a substitute for IMF assistance that comes with conditions on economic and financial policies. Thus, the inability of the members of the Fund to agree on a semi-automatic disbursing facility during a period of calm means that it is not there when the storm breaks.

Refocused Engagement with Low-Income Members

The IMF's involvement with its low-income members has received extensive criticism, in particular from the NGO community, which often criticizes the Fund for focusing too much on macroeconomic stability and too little on economic growth and the reduction of poverty. Over the years, there also has been extensive criticism of the collaboration (or competition) between the World Bank and the IMF with respect to these countries. In 2006, I wrote, "the Fund should be more selective and focused in its engagement with its low income members, ready to assist them in areas of its comparative advantage, reluctant to add to their debts, and respectful of the skills and opportunities offered by institutions centrally involved with development issues." (Truman 206b, 534)

For obvious political reasons, the Fund in recent years could not afford to pull out of engaging with low-income countries; the authorities in these countries want the financial assistance the IMF might provide preferably without policy strings. However, the Fund has pulled back from full force engagement with its low-income members. Along with the Bank, it established a review group under the chairmanship of former Brazilian finance minister Pedro Malan to review Bank-Fund collaboration. The resulting report (IMF 2007d) is a sensible document that points in the direction of more cooperation and less competition across 19th street in Washington, DC. To an outside observer, the Fund and the Bank appear to have been diligent in implementing the recommendations of the Malan Report.[15]

Following the implementation of, first, the Highly Indebted Poor Countries (HIPC) initiatives and, later, the Multilateral Debt Relief (MDR) initiative, the debts of many low-income countries to official agencies including the IMF have been substantially reduced. A total of 35 member countries have been assisted through the IMF, 33 countries under the HIPC initiatives and an additional 2 countries among the 25 assisted under the MDR initiative. In recent years, again facilitated by benign conditions in the global economy as well as better policies, IMF credit outstanding to members under the Poverty Reduction and Growth Facility (PRGF) and related arrangements, which are financed primarily by loans to the IMF outside of its quota resources, has been reduced by 40 percent from a end-year peak of $10.5 billion in 2003 to $6.1 billion at the end of September, 2008 for 57 members. Only 23 members have active PRGF programs, less than a third of the eligible total. A few countries have converted to, or established, “programs” under the Fund’s new Policy Support Instrument created in October 2005, which involves IMF endorsement and oversight of a member’s policies, but no funding.

The test of whether the IMF can continue its more balanced approach to its involvement in low-income countries will come with the pending slowdown in the global economy. Will the Fund, again, be drawn, or forced by the policies of high-income members, into stepping up its engagement to the point of unbalanced intrusion?

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[15] For managing director Strauss-Kahn’s view on the Fund’s activities in low-income countries see IMF 2008e.

The Capital Account and Financial Sector

The global financial turbulence that erupted in August 2007 and escalated with virulence a year later confirms my judgment in 2006, "Capital account and financial-sector issues are central to the IMF's role in the 21st century. Technology, demography, and policy have converged to stimulate and release unprecedented global flows of capital." (2006b, 536) It was obvious at the time that the IMF needed to make another attempt to reorganize its work on the financial sector.

Following the report of the McDonough Group (IMF, 2005b), the Monetary and Capital Markets Department was established and its semi-annual Global Financial Stability Report has been gradually transformed into more of a forward looking document along with quarterly updates. For example, this group produced early estimates of the size of potential losses by financial institutions from the global financial meltdown, estimates that were regarded as exaggerated at the time but that since have been confirmed as on the low side.

Nevertheless, criticism of the IMF's work in this area continues with some justification. See, for example, IEO-IMF 2006 for a set of judgments roughly coincident with those of the McDonough Group, and the more recent conclusion of the International Monetary and Financial Committee (IMFC-IMF 2008), "Work should also be undertaken toward a revamped Financial Sector Assessment Program that is better integrated with the Funds surveillance mandate." I will return to this topic in the next section.

A related issue that I discussed in 2006 is whether the IMF Articles of Agreement should be amended to clarify the IMF's role with respect to the capital accounts of members. I concluded (Truman, 2006b, 563) that it is not essential to do so. However, in light of recent developments including calls for a more active role for the Fund in this area, it would be appropriate to revisit this contentious issue.

Finally, to complete this short review of the Fund's recent record on financial issues, I note with approval and satisfaction the institution's impressive contribution in facilitating the work of the International Working Group of Sovereign Wealth Funds (SWFs) in expeditiously reaching agreement on a set of Generally Accepted Principles and Practices for SWFs (IWG 2008) that will help to defuse the issue of the role of these government investment vehicles and make the world safer for them.

Additional IMF Financial Resources

In 2006, as IMF members were actively repaying credit received from the IMF partly as result of benign global economic and financial conditions as well as improved policies, I noted, "Wise observers caution that those benign conditions are coming to an end, and the demand for external financial support from the IMF is likely to rise." (2006b, 537) I was somewhat off in my implicit prediction of an immediate need to augment IMF financial resources, but I endorsed the proposal of Desmond Lachman (2006) that the IMF should put in place a mechanism so it can borrow from the private market as a temporary supplement to its quota resources.

At the time, I also advocated that in January 2008, at the conclusion of the 13th review of IMF quotas, members should approve a general increase in IMF quotas as part of an overall package to rebalance IMF quotas; see also Cooper and Truman 2007. Unfortunately, not only was the effort to rebalance IMF quotas woefully deficient, the

IMF executive board (meaning the members of the Fund) declined to recommend a general increase in IMF quotas. The result is that as the Fund faces renewed demands to lend to members, such lending scaled on the basis of the size of each member's quota that was approved a decade ago when the world economy was substantially less than half the size that it is today. Consequently, in the context of the current emergency the Fund will revisit the contentious issue of access limits (IMF 2008c and 2008e) rather than proceed to use limits based on quotas that were agreed in January this year.

It is true that the IMF's current financial resources for lending are substantial, an estimated one-year forward commitment capacity of $201 billion as of the end of August 2008. It is also true that total IMF quotas will have been increased by 11.5 percent since 2005 if the second round of ad hoc quota adjustments (of about 9 percent) is approved by members, starting with the United States whose approval is necessary if the major portion of the increase is to go into effect.[16] However, very few of the 54 countries that would receive increases in their quotas are likely to need to borrow from the Fund over the next several years.[17]

How serious is the impending financial crisis for emerging market countries? The Institute of International Finance (IIF 2008) estimates that its sample of 30 emerging market (and formerly transition) economies will continue to run a collective current account surplus in 2008 and 2009 as they have over the past several years, but the surplus is more than accounted for by China and Russia.[18] The collective current account surplus

[16] In 2006, a first round of ad hoc adjustments in the quotas of China, Korea, Mexico, and Turkey boosted total IMF quotas by about 2 percent.

[17] An interesting fact reported in IMF 2008c (table 1) is that only 35 of 185 members of the Fund have never used IMF credit, and a few other countries, such as Germany, used the Fund for other types of financial transactions.

[18] The IMF (2008g) projects a current account surplus of $785 billion for all emerging and developing economies, but China, Russia, and the Middle East group account for $1,023 billion. In 2009, the

for this group of countries was $435 billion in 2007 and is estimated at $378 billion this year, and $338 billion next year. However, non-direct investment inflows were $596 billion in 2007 up more than 50 percent from 2006, and they are projected to fall at about 15 percent this year and another 15 percent next year, for a total decline of $280 billion with an estimated drop of $266 billion in net flow from foreign commercial banks. These data illustrate why many emerging market economies are likely reluctantly to be turning back to the IMF for financial assistance.

To the extent that the IMF gets back into the lending business again, the financing crisis that it has faced in recent years should ease. However, as was argued persuasively in the Crockett Report (IMF 2007a), since the lending activities account for less than 25 percent of the administrative budget of the IMF, it is inappropriate to finance all of the Fund's activities from earnings on those activities. This is the rationale behind the proposal to sell 12.5 percent of the IMF's gold, invest the proceeds (in effect as an endowment), and use the income on those investments to finance the non-lending activities of the IMF. As noted in the introduction, this sensible step cannot be taken unless the US Congress authorizes the Secretary of the Treasury to vote for it.

The IMF and the Global Financial Crisis

It is ironic that a year or so ago, it was fashionable to argue that the IMF is now irrelevant. Benign conditions would prevail forever in the global economy and international financial system. All relevant countries had self-insured against future external financial crises. The IMF was financially strapped, and had nothing to do.

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corresponding figures are $612 billion and $875 billion, but they are based on the assumption of an oil price of $100.50 a barrel.

Starting in mid-September this year, the criticism shifted to “Where is the Fund?” It is not discharging its duty to protect the international financial system. We must remake the international financial architecture with a central role for the IMF. A sub-theme of the recent discussions, as noted earlier, is whether the IMF has been distracted from focusing on the emerging crisis by the US insistence that the Fund focus on exchange rate policies. An alternative view is that by not focusing on global imbalances the IMF contributed to the crisis.

How the IMF handles the current global financial crisis, including the role its members assign to the Fund, no doubt will affect the future role of the Fund and support for the institution, including by the United States.

As I discussed earlier, the IMF will have a financing role in connection with the likely global recession associated with the global financial crisis, which after all started before the 2007 annual meetings. In the lead up to the 2008 annual meetings, the IMF was thrust into a central coordinating role. In his remarks in advance of the annual meetings on October 10, 2008 managing director Strauss-Kahn signaled that he is prepared to seize the moment in the name of the Fund. He was implicitly critical of the work of the Financial Stability Forum (FSF).[19] The Fund is a member of the FSF but it does not have a dominant role. Moreover, the FSF as formally constituted reports to the G-7 finance ministers and central bank governors.[20]

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[19] The G-7 finance ministers and central bank governors in 1999 established the FSF in 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. Its members include representatives of the G-7 countries, a number of other financial centers, the IMF, World Bank, OECD, and BIS, international standard setting bodies such as the Basle Committee on Banking Supervision and Regulation, and two BIS committees that are dominated by the G-10 central banks.

[20] Stanley Fischer, Governor of the Bank of Israel, and former first deputy managing director of the IMF was more pointed in his remarks on the Per Jacobsson Foundation panel on October 12, “The Financial Stability Forum was set up after the Asian Crisis in a way that ensured the IMF would not be closely

The FSF was called upon by the G-7 in September 2007 to prepare a comprehensive set of recommendations for addressing the weaknesses that have produced the crisis that was than breaking and for strengthening the financial system going forward. After several interim reports, a final report with 67 recommendations was submitted to the G-7 in April 2008 with associated timelines for action in five areas: strengthened potential oversight of capital, liquidity, and risk management; enhanced transparency and valuation; changes in the role and uses of credit ratings; strengthened official responsiveness to risks; and arrangement for dealing with stress in the financial system.[21] In its report to the G-7 and IMFC in October (FSF 2008), FSF chairman Mario Draghi added four additional topics: monitoring and addressing the international interaction and consistency of emergency arrangements and responses; work to mitigate pro-cyclicality in the financial system; reassessment of the scope of financial regulation to cover institutions, instruments and markets that are unregulated (or lightly regulated); and integration with macroeconomic oversight and prudential supervision (so-called macroprudential supervision).

In principle, the IMF could coordinate the work on the FSF agenda. One issue going forward is the extent to which the work of the IMF and FSF are indeed complementary, as both now claim in public, or competitive, as has been the case in the past for the Bank and the Fund with regard to low-income countries. A second issue for

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involved in this area [global financial stability]. . . . That was simply a mistake. The FSF is doing excellent work, but it is not a global institution as is the Fund." (IMF 2008f)

[21] Other individuals and bodies have released competing or complementary reports, including Morris Goldstein (2008). See Annex B to FSF (2008) for a list of documents and reports by official or semi-official bodies. Goldstein's ten recommendations cover some of the same ground as the FSF recommendations although some of his suggested reforms are deeper and more specific or cover different ground. For example, Goldstein calls for action on the macroeconomic dimension in the form of coordination between monetary and supervisory authorities during the build-up of asset-price bubbles; establishment of a clearing house for OTC derivatives; new standards for compensation; rationalizing the US financial regulatory structure; and reforms in US housing finance.

the Fund is whether it can coordinate and guide macroeconomic policy actions to mitigate the depth of the global economic slowdown. A third issue, as already noted, is the Fund's role in the provision of financial assistance to members and related services in case of needed debt restructurings. The Fund broadly defined will be judged by how well it addresses these three issues.

Beyond the immediate crisis management phase of the global financial crisis is the question of the future role of the IMF in the international financial system. Should the IMF's role be enhanced? If yes, in which respect? The answers to these questions depend in large part on one's diagnoses of the sources of the crisis. On this matter, there are views in two dimensions. Was it primarily a crisis that was made in the United States? Whether or not the crisis was made in the United States, was it the result of failures of macroeconomic policies, regulatory policies or both?

In my view, macroeconomic policies in the United States and the rest of the world, to a substantial degree, were jointly responsible for the crisis we are now experiencing. In the United States fiscal policy contributed to a decline in the US savings rate and monetary policy was too easy, too long. However, it was also too easy, too long in Japan. Many other countries have had very easy monetary policies in recent years. Moreover, the accumulation of foreign exchange reserves to an impressive extent in many countries distorted the international adjustment process taking the pressure off of the macroeconomic policies of the United States and other countries. The result was not just a housing boom in the United States but also a housing boom in many other countries to a greater extent than in the United States. (See, for example, IMF 2008g for a broader treatment of recent housing booms.) However, in addition to a housing boom, many countries have seen a broader credit boom fueling increases in prices equities other manifestations of financial excess.

I have no doubt that financial sector supervision and regulation, or lack there of, played a role in the global financial crisis. However, one contributing factor was benign economic and financial conditions and the belief that "this time it is different," in other words cheerleading for the remarkable run of economic growth until early 2008 with few signs of a dramatic rise in inflation. Benign conditions lead to lax lending standards, just as the night follows the day. In principle, financial sector supervision could help to curb the excesses associated with lax lending standards, but it did not do so in the United States nor in many other countries around the world. This is not to say that there was no competition in laxity among supervisors. The US Treasury's (2008) Blueprint for a Modernized Financial Regulator Structure released on March 31 started out as an initiative to bolster the competitiveness of US capital markets – to further deregulate them.

Moreover, in some cases, including importantly the United States in this regard, but again elsewhere, regulation and supervision were incomplete. The rise of what is now known as the shadow financials system has been going on for decades in many countries: money market mutual funds, special purpose investment vehicles, hedge funds, private equity firms, etc. In many cases, these entities are highly leveraged and use short-term funding to finance longer-term investments. When the funding dries up, the structure collapses and de-leveraging begins.

Part of the overall picture was new forms of financial engineering, but new forms of financial engineering have been a feature of international finance, again, for decades.

In many cases, the associated innovations are poorly understood resulting in a failure of risk recognition, which is a necessary precondition for good risk management. However, it was not US financial institutions, US financial engineers, or even US-trained financial engineers that produced and distributed all of the innovations. It was a global phenomenon to which market dynamics also contributed once it got underway.

Finally, some argue that the problems faced by the global financial system today reflect the fact that 30 to 50 large financial institutions are global in their scope and no single financial supervisor or regulator could possibly understand the full picture of their operations. True, some global financial institutions have failed, or the authorities have decided to rescue them. However, the cause of their failures was not that they had multiple national supervisors. Moreover, I would argue that the technical aspects of the failures themselves have had remarkably little impact on the evolution of the crisis compared with the fact that they failed. Size has been a problem and complexity led to some decisions to rescue particular institutions in whole or in part, but global scope has not been a major contributing factor.

These are my views. All observers decidedly do not share them. My point, however, is that there is no consensus among observers on either the role of the United States or on what went wrong in the global financial crisis. Until there is such a consensus, it would be unwise to start to prescribe what should be done to mitigate such crises in the future and the role of the IMF in that process.

My diagnosis would point to improved surveillance over macroeconomic policies by the Fund, including with respect to bubbles and credit expansions, but it is naïve to speak of early warning systems as do some Europeans, in particular the British. We went down this road after the emerging market crises of the 1990s. All the serious research pointed in the direction of looking at multiple indicators, but also at not fooling oneself that the results could be used as an early warning system that identifies all crises early without producing a large number of false positives.

With respect to financial regulation, it is sensible to incorporate more elements of so-called macro-prudential supervision in the surveillance processes and procedures used by the IMF. Again, the result will fall far short of an early warning system.

Is it sensible to contemplate at this point a global regulatory or supervisory regime located in the IMF, or located anywhere else, that replaces and dictates national regulatory and supervisory structures? No. The world is no more ready for that than it is ready for a global currency and associated monetary policy. However, as was the case in the wake of the financial crises of the 1990s, it would be appropriate to revisit international standards and codes with a view to updating or improving them. It would also be appropriate to consider whether additional norms, principles, or standards could be designed and turned over to the IMF for it to use in its surveillance activities.

Is the IMF Worth Funding?

In early August of this year, my answer to the question of whether the IMF is worth funding specifically via US Congressional action on the four items that I summarized at the start of this paper was a specifically qualified yes. As long as the actions by the other members of the IMF and its management with respect to members' exchange rate obligations, in particular in the case of China, were sufficient to provide the Congress the political cover it needs, that body should vote for $7.6 billion in additional US funding for the IMF and for the sale of 12.5 percent of the IMF's gold.

Although the package of IMF reforms that will be put before the Congress is meager and the Fund's records on other reforms during the past several years is mixed, in my view, it was not in the interest of the United States to block the four elements that will be before the Congress when close to 85 percent of the weight voting power in those institutions have already given them preliminary approval. Other countries have to consent to the package through various legal steps, with the exception of the gold sales, but in most cases that process is less contentious than in the United States.[22]

The Congressional approval process will now be complicated by the global financial crisis. On the one hand, the crisis will push the Fund back into the lending business and some in Congress having been more directly involved in domestic rescue operations (also known as bailouts), might be more tolerant of those lending activities than they have been on similar occasions in the past, for example, in 1983 when the IMF quota legislation just squeaked through the House of Representatives and in 1998 when the administration had to accept multiple unattractive, to them, conditions such as the International Financial Institutions Advisory Commission that was chaired by Alan Meltzer.

[22] A more difficult question is whether the Congress should at the same time vote to accept the fourth amendment of the IMF Articles of Agreement that would provide for a special one-time allocation of SDRs. The IMF governors approved it in September 1997. The initial motivation was to provide allocations of SDRs to members that had joined the Fund since the first allocations in 1970-72 or the second allocations in 1979-81, in particular to Russia but also to other countries. The United States was a strong supporter of the initiative. After the collapse of the Russian program in 1998, the US administration lost interest and never submitted the amendment to the Congress. The IMFC, most recently on October 10, has repeatedly called for acceptance of the amendment. It is an embarrassment that the United States has not done so, and I would favor adding it to the Congressional package, but I would jettison that element if it became a deal breaker.

On the other hand, the global financial crisis again has led to calls for reform of the international financial architecture including its governance. If these initiatives take off and look like they are likely to produce meaningful results, for example, improving the package on IMF quotas and voting power and movement toward consolidating the European seats on the executive board, I would not blame the administration for waiting to present the new package to the Congress with or without additional elements that require Congressional approval. Thus, my answer to the question of whether the IMF is worth funding is now more qualified.

In any case, the new president and Congress will have a full plate. Action on the current IMF package should not be expected until the second session in 2010. On the other hand, if that were all that is on the plate of the Congress in this area, because the calls for further reform of the international financial architecture have not produced anything requiring Congressional approval, not to approve the current package would be a tragedy and massive setback to US leadership and international monetary cooperation.

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