

The Past and Future of IMF Reform

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Abstract:

This paper examines changes in the role of the IMF since its inception in 1944, in response to the breakdown of the par value system, the liberalization of capital movements, and financial deregulation. In the 2000s, as IMF lending contracted, the role of the Fund has become less controversial but also less important; with the eruption of a global financial crisis in 2008, IMF lending again assumed a major importance. A need for public goods provision arises out of the major new problems of the twenty-first century: controversies over exchange rates, over the management of reserve assets, the politicized debate over sovereign wealth funds (SWFs), and the management of financial globalization. The paper examines ways in which the new demand for a role of the Fund could be met, and its implications for governance reform.

The Past and Future of IMF Reform

In this paper we first examine changes in the role of the IMF since its inception in 1944, in response to the breakdown of the par value system, the liberalization of capital movements, and financial deregulation. In the 1990s, it became identified in a one-sided way with the provision of large rescue packages for emerging markets. In the 2000s, as IMF lending contracted, the role of the Fund became less controversial but also less important. With the eruption of a global financial crisis in 2008, IMF lending again assumed a major importance. We then examine the needs for public goods provision in the global economy of the twenty-first century: controversies over exchange rates, over the management of reserve assets, the politicized debate over sovereign wealth funds (SWFs), and the management of financial globalization. The paper examines ways in which the new demand for a role of the Fund could be met, and its implications for governance reform. We argue in conclusion that the different tasks need to be seen as part of a package, and that a holistic approach is likely to fare better than a one-sided concentration on either crisis management or surveillance without a capacity for financial action.

History

After over sixty years of existence, in the course of which there have been numerous ups and downs, there is probably today less conflict about the role and importance of the IMF than in previous eras. Even the recent rescue operations for Latvia, Ukraine or Hungary were so obviously

a necessary response to a deep financial crisis, and so supported by other bilateral and multilateral support arrangements, that there was almost no controversy.

The reduced level of debate arises largely because the IMF has been almost completely sidelined from many of the major governance issues of the international financial system. Is there any need for an institution such as the IMF? This paper discusses the case for reviving some part of the original vision of the 1944 Bretton Woods conference, including the additional provision of resources and an enhanced role in reserve management.

The original mandate of the Fund, as laid down in the Bretton Woods Articles of Agreement, was very general: to promote international monetary cooperation, facilitate the growth of world trade, promote exchange rate stability, and to help to create a multilateral system of payments. In order to achieve these objectives, the Fund was supposed to provide short term balance of payments support to countries in need of additional reserves. The best way of thinking about the IMF's functions during the early period, the so-called Bretton Woods system (1945-1973) is not so much as an institution, but rather as the embodiment of a system of rules as laid out in the Articles of Agreement. But in the early 1970s the core of the rule-based system, the requirement on member countries to adopt a par value, disappeared.

The IMF's evolution since the 1970s has reflected both the demand for its services in the light of new and perceived market failures and its willingness to provide those services. There has been a fundamental change of environment: the breakdown of the par value system, and the new mobility of capital, and financial deregulation.

Capital flows have taken a role that no-one expected at the time the IMF was created. The international political system has changed too: there are many new countries, with quite new problems, and the Soviet bloc collapsed economically and politically.

The IMF developed in response to these external challenges. There was an expansion of the scope of policies considered as part of the surveillance exercise. The number and length of duration of stabilization packages increased, but these were only successful in a few cases. In the 1990s, in responses to crises in a globalized capital market, the IMF engaged in liquidity crisis management. A response to the new politics of the 1990s involved an expansion into non-macro-economic policy areas, such as criticisms of military spending, corruption, and non-democratic practices. After the Asian crises in 1997 and since, the IMF also discussed areas such as corporate governance and accounting practices that traditionally lay outside its purview.

The Situation at the Millennium:

Nine years ago we summarized the outcome of the post-1973 order as follows (Bordo and James 2000). IMF surveillance produces highly useful general reports (World Economic Outlook, Capital Markets); but Article IV consultations have a questionable use in that they frequently lack bite when the country concerned is not engaged in an IMF program. In particular, they seem largely irrelevant for most of the advanced industrial countries. A perceived over-extension of the IMF into new areas of policy concern involves unpopular interventions

into national sovereignty. The poorer clients of the IMF often become trapped in a welfare dependency. The management of liquidity crises has contributed to moral hazard and at the same time has not stopped crises spreading.

In 2000 we argued that markets are powerful mechanisms for discipline, but that they can be usefully supplemented by IMF policies and advice. In general, the historical record suggests that the IMF should operate as a traffic policeman as much as a fireman: anticipating and preventing disasters rather than dealing with their painful aftermath. Such a mission would involve:

- a commitment to improve the reliability and timeliness of statistics.
- independence from politics (since the political instrumentalization of the IMF conflicts and harms its core mission, which is aimed at macro-economic stability).
- transparency of operations.
- the establishment of as many rules as possible which are contingent and incentive-compatible. This would enhance transparency. Pre-qualification for crisis lending is desirable, and may become a powerful instrument to achieve better national policies.

However, there will then still remain the possibility of crises with potentially damaging systemic effects arising in non pre-qualified countries. A further problem is that a country might cease to pre-qualify, and that such a development would set off an investor panic, and thus frustrate the whole pre-qualification strategy (Cordell and Levy Yeyati 2006; Kenen 2007).

In these cases (in order to avoid moral hazard as far

as possible) there may be a case for creative ambiguity, in which the IMF would need some room for discretion, and may not be able fully to announce likely policy responses in advance.

- the willingness to link lending to policy conditionality. Such conditionality, in the past an essential part of the IMF's mode of operations, has been severely criticized by the Meltzer commission in 2000, and it has been too complicated and remains potentially politicized. But it at present still remains the principle lever through which the IMF can effect improvement of members' policies. Its complete abolition would only make sense if the IMF was restricted to strictly rule-based pre-qualified crisis assistance: but such a situation is unlikely in the immediate future.

In general, it was clear that the IMF is best equipped to handle a more limited range of tasks that lie closer to its historical mission. Such a realization implies a retreat to its core area of expertise and responsibility. Such a core includes data standards, liquidity management, and surveillance (the provision of information that markets cannot provide). Longer term concessional lending to very poor LDCs does not fit well into this core, and might be handled better by the World Bank.

Such proposals were consistent with the IMF's mandate. To go further than this could not have been achieved at the insistence of one country alone, even of the most powerful economy in the world. Rather it would have required a new and constructive Bretton Woods conference, which is truly

unlikely in the conditions of the early twenty-first century.

The Post-Millennial Debate:

Since 2000, the debate has shifted considerably. Many of the issues that generated ferocious controversy in the early years of the new millennium have slid into historical oblivion.

1. There is no longer much debate as to whether the IMF should take on an analogous function to a bankruptcy court in domestic law and be able to supervise an orderly reduction of claims while a borrowing country restructures its financial obligations. Such proposals, originally set out by Jeffrey Sachs (1989) and others, were taken up in a modified form by the IMF's Deputy Managing Director, Anne Krueger as the Sovereign Debt Reduction Mechanism (SDRM) (Krueger 2001). They were widely opposed, by banks but also by the U.S. administration.

2. The alternative discussion of collective action clauses in bond contracts, as championed in academic discussions by Peter Kenen (2001) and Barry Eichengreen (2003), and as taken up by the U.S. administration, fared better, but has not really been tested in a large-scale emerging market crisis.

3. The debates about whether IMF conditionality was excessive have also faded, because of the dramatic reduction in the volume of IMF lending.

4. Joseph Stiglitz (2002) and others accused the IMF of being run to bail out the financial system and in particular the big banks. The Fund had been captured in his view by Wall Street. But in 2007 and 2008, as

investment banks in advanced industrial countries began to demand new forms of bailout it was clear that the Fund was not suited to such an operation, and that national fiscal authorities in the big industrial countries would be the last stop of the financial system.

5. In 2003 and 2004 it was often argued that the IMF was inadequately funded to manage big emerging market crises of the future. The coincidence of crises in Argentina, Turkey and Brazil had led to an overstretching of the Fund's financial resources. Commentators saw the likelihood of future crises in some big emerging markets, such as India or China, and concluded that the Fund would be unable to manage. In the case of some big emerging market economies, notably China, there was a massive build-up of reserves. Many countries (especially in Asia) tried to self-insure against crises, with the result that reforms such as the Contingent Financing Facility became a practical irrelevance.

6. In 2008, as the sub-prime crisis expanded and impacted emerging markets, a large number of new programs were concluded, including programs with some surprising new clients of the Fund (Iceland) as well as a number of central and east European former communist countries, including Latvia, Hungary, and Ukraine. The credit outstanding of the IMF rose from SDR 7.6 bn. at the end of September 2008 to SDR 17.5 bn. at the end of the year, and there was an additional rise of commitments by SDR 29.7 bn., leaving the forward commitment capacity at SDR 97.6 bn. But estimates of the cost of the credit crisis in central Europe alone gave a financing gap of some SDR 200 bn. (IMF 2009) By early 2009, it thus appeared quite likely that the IMF would run out of usable resources.

A \$100 bn. lending program from Japan was concluded, and many countries began to push for a massive increase in the Fund's resources, perhaps funded by the issue of new SDRs.

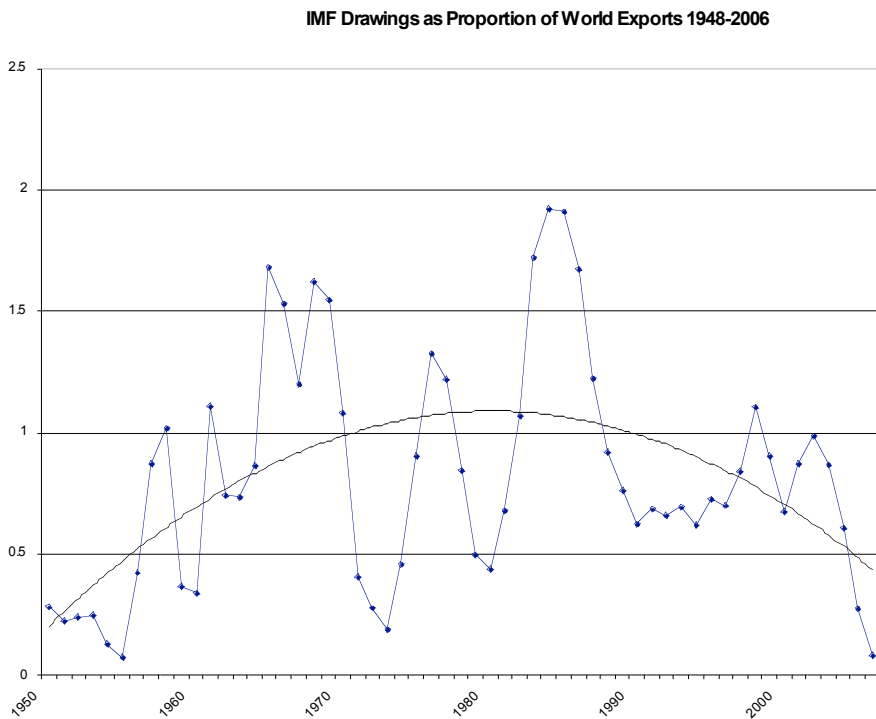
The main cause of the decline in controversies about the Fund was the result of the shrinking of the IMF's lending activities. But the new programs of 2008-9 did not ignite the same measure of ideological controversy as the big programs of a decade earlier. They raised, however, some issues that had come up during the 1994-5 Mexico crisis, when many European governments argued that the IMF was unduly open to Mexico because of the geographic proximity of Mexico to the United States, and because of U.S. worries about the social impact of large migration flows were Mexico to collapse. In 2008-9 this debate was replayed, with a different cast: it was now west Europeans who were worried about the collapse of their near neighbors, and who called for the most radical programs of IMF expansion.

From the post-millennial perspective, we can clearly see some long-term trends in IMF lending: relative to world exports, drawings on the Fund increased, reaching a high point in the 1980s Latin American debt crisis. Since then there has been a decline, interrupted by a surge of lending in the wake of the 1997-8 Asia (and Russia and Brazil) crises. But since 2003, the outstanding drawings have been repaid, and there was almost no new lending until 2008 (Figure 1). Such low levels of lending had been seen before, in the mid-1950s and the early 1970s.

Decreased lending also led to a debate about the funding of IMF operations, since the day to day activities have largely been paid through charges applied to

borrowers. Following precedents from the 1970s (when there had also been a sharp decline in Fund lending and income), the IMF's Executive Board in April 2008 set out a new income model including an endowment funded by IMF gold sales.

FIGURE 1:



Source: IMF *Annual Reports*; trade from *International Financial Statistics*.

The question then arises of whether and how the IMF can be relevant again. There are issues relating to the IMF's performance and role that are still alive, as well as a new type of problem. At the end of the 1990s, concern with governance issues was not usually presented as a central part of critiques of the IMF. De Gregorio

Eichengreen Ito and Wyplosz in 1999 called for a structure that resembled more of an independent central bank, but this demand was generally regarded as politically infeasible and also undesirable, in that it would remove any element of accountability (while central banks are subject to national legislation). In the course of the 2000s, criticism mounted in two influential critiques from the Bank of England and the Bank of Canada (Dodge 2006; King 2006; see also Santor 2006).

Two parallel problems are critical for the governance debate: first, the issue of the degree of control of the staff and management by the Executive Board that represents the member states; and secondly, the out-dated basis on which shares and votes are determined, and which has only been slowly modified in the light of persistent critique of the over-representation of Europeans and the under-representation of Asian emerging market economies. This paper will propose a solution that would both make the IMF more representative and more flexible, through the addition of a separate and parallel voting system based on reserve assets deposited at the Fund. The Fund's ownership would thus reflect the international distribution of reserves.

There may on some occasions be a conflict of interest between a staff that sees itself as dedicated to furthering global public goods, and an Executive Board that is dominated by the political agendas of member states, especially the more powerful states with the larger quotas. The Managing Director is poised between the staff and the Executive Board. Critiques of the Fund have pointed out how a Managing Director might feel under pressure to satisfy the large shareholders who appointed him. The First Deputy Managing Director is by convention a U.S.

appointee and on occasions appears to follow the general lines set by the U.S. administration. But on some prominent issues, most recently over the question of the IMF's involvement in debt reduction, the U.S. administration shot down initiatives that came from the staff and the FDMD.

One of the most persistent problems of the IMF in the past decade has arisen from the belief of rapidly growing Asian members that they are relatively neglected. In 1997, there was even a short-lived discussion of the idea of establishing a separate Asian Monetary Fund, which was aborted by the United States. Since then, Asian countries have cooperated in establishing an Asian bond market; and some also discuss the prospect of closer currency cooperation in a manner analogous to Europe's slow evolution of monetary union. The IMF by contrast has always insisted that its task is a global one, and that regional institutions are less well equipped to handle global questions of confidence and liquidity.

At the moment, the U.S. has 16.79 percent of the votes in the IMF, which because a majority of 85 percent is required for many crucial decisions, can constitute a veto on Fund policy. The European Union has 32.09 percent of the votes (and members of the Euro currency zone 22.57 percent), so that if either the EU or the Eurozone were a single member, it would be the largest member. By contrast, China has 3.68 percent of the votes, Saudi Arabia 3.18 percent, Russia 2.70 percent, India 1.89 percent, and Brazil 1.39 percent. The politics of recalculating quotas has meant that the process of rebalancing the Fund is excruciatingly slow. It took very long negotiations for China to be awarded a "special" quota increase when it

reabsorbed Hong Kong, even though it was already abundantly clear that China was a systemically important country. In spring 2008, the Board of Governors agreed to a process of modest but continuing reform, which would eventually reduce the U.S. vote being reduced slightly to 16.73 percent, while increasing that of China (3.81 percent) and India (2.34 percent) but reducing that of the Russian Federation (2.39 percent).

At the same time as the old issues are fading from debate, the IMF has become very vulnerable because its financing model depends largely on revenue generated by its lending activity, which is also fading fast. In consequence, questions about the IMF's viability and role are being asked with much greater urgency.

Three big issues have developed instead as focuses of international debate: the design of the exchange rate regime and the appropriateness of exchange rates; the question of reserve management; as well as the management of financial globalization. The first two (but not the third) of these topics had been major elements of the initial Bretton Woods vision. But none of these issues has been at all central to the recent focus of the IMF.

1. *Exchange Rates:*

With the reemergence of large U.S. deficits, corresponding to surpluses in emerging Asia and in the oil producers, a discussion emerged as to whether Asian economies were artificially holding down their exchange rates in order to achieve rapid export-led growth, and to absorb large quantities of discontented rural labor. The

so-called Bretton Woods II thesis (Dooley Folkerts-Landau Garber 2003) saw China and other Asian states behaving in a fashion analogous to Germany and Japan in the 1960s, which had also had export-led growth and big surpluses, and had been highly resistant to proposals for parity changes. Concern about currency manipulation emerged in a political form as a potent source of new trade protectionism, as when Senator Charles Schumer proposed to subject Chinese goods to a special tariff as a compensation for the exchange rate manipulation.

In the global imbalances debate, it was always unclear where the adjustment should be taking place. Some commentators, notably Cheung Chinn and Fuji, have produced arguments that would support the Chinese position, namely that in the light of a number of institutional factors, including the large extent of non-performing loans, public sector corruption and inefficiency, the renminbi is actually not overvalued. However, no one in China is likely to make explicit their support for this interpretation, and no one in the U.S. is likely to believe such an argument given the size of the bilateral trade deficit. Since a large part of the problem of the 2000s lay in the U.S. current account deficit, it was equally plausible to argue that the correction should lie in U.S. adjustment. Such adjustment, which has been taking place slowly since 2005, and very quickly since 2008, is however likely to depress world economic growth and may prove to be extremely costly.

In a few isolated historic cases, the IMF had taken up exchange rate issues and in "special" consultations issued rulings against Korea and Sweden for exchange rate dumping. Some other Scandinavian countries had complained about the

extent of the Swedish devaluation of October 1982; and in 1987 the United States criticized the large current account surplus of Korea which it attributed to the undervaluation of the Korean won. But in the 1980s, while the IMF was prepared to deal with Korea, the Fund shrank from involvement in the much more highly politicized question of the Japanese exchange rate. Clearly in the 2000s, there is no mechanism that would simply require China to adopt a new exchange rate policy at the demand of importing or competing countries. The issue of the Chinese exchange rate does appear in Article IV consultations, where the topic is dealt with in a sane and largely unpolitical way. The advice given may have convinced Chinese officials to embark on a limited move to more exchange rate flexibility since 2005. But the IMF has no greater standing in these Article IV reports than the coherence of its intellectual case. In this sense, the Fund is no more powerful than some of the eminent academic economists such as Ronald McKinnon, Robert Mundell and Jeffrey Frankel, who have offered (contradictory) opinions on the appropriate course of Chinese currency policy.

A more promising vehicle is the multilateral surveillance mechanism agreed by the International Monetary and Financial Committee in April 2007 as a way of addressing the global imbalances issue. Kenen (2007) went much further and proposed that the IMF staff should be given greater latitude to publish specific country recommendations without the endorsement of either the Fund Executive Board or of the International Monetary and Financial Committee. Such a development would clearly be an important step in the establishment of a more autonomous or apolitical Fund.

As to the United States, adjustment is taking place but not as a consequence of any policy initiative generated through discussions with the IMF or through Fund surveillance.

But there is a difficulty in the way of the market-based view. Large emerging markets have acquired such high levels of reserves that any changes in their reserve holdings may dramatically affect market expectations. In this sense exchange rate issues have become ever more closely bound up with the controversial topic of reserve management.

2. Reserve Management

One way of understanding the interwar situation, to which Bretton Woods was the policy response, is of a world in which reserves were highly unstable because of the substitution of a gold-dollar standard for a pure gold standard. The Fund as a kind of credit cooperative (in an analogy popularized by Peter Kenen) was a solution to the reserve problem. Its lending facilities could be a substitute for absent reserves.

The world of the early twenty-first century is also characterized by instability and worries about reserve positions. On the face of it, the new development of very substantial international reserves is a signal that something was wrong in the international economy long before the present outbreak of credit market panic. John Maynard Keynes and the other makers of the 1944 Bretton Woods conferences had seen central bank management of reserves as a significant part of the instability of the pre-1939 system, and proposed to replace reserves by

collective assets or quotas held at the new institution, the International Monetary Fund. Today's greatly increased reserves held by single countries can be understood either as a misallocation of assets, or alternately as the use by financially under-developed economies of the United States as a global financial intermediary (analogous to the banking role of the U.S. described by Despres Kindleberger and Salant 1966). In this view, emerging market savings are successively recycled through their central banks, then the U.S. bill market, U.S. banks, U.S. corporations back to emerging markets. Such complex financial intermediation is costly and potentially destabilizing.

The rapid growth of reserves of emerging markets since the turn of the millennium - one of the major policy developments of our time - presents a puzzle. Between 2002 and 2006 they have more than doubled in terms of SDRs, the IMF's international unit of account, and almost tripled in dollar terms. Reserves are supposed to facilitate international transactions, in that they help countries deal with unanticipated declines in export revenues, or increases in import prices, or sudden withdrawals of foreign credits. Since there are continuously local shocks, and ups and downs in the international economy, the size of reserves should also be expected to fluctuate (as the length of a cab rank grows and falls as new taxis arrive and lined up taxis are hired).

In the global economy of the last decade, world reserves did not really fluctuate but instead moved in a mostly linear direction. Industrial countries needed reserves less, while poorer and emerging countries wanted them more. The United States never had or needed very extensive foreign exchange reserves (in April 2008, the

level stood at just \$ 75 bn. while China had \$1760 bn. and India \$313 bn; by contrast the European Central Bank held \$ 63 bn. and the Eurosystem as a whole \$542 bn.) In particular, the bad consequences of not having reserves in a crisis had appeared in 1997-8 in the Asia crisis. The crisis was a cruel reminder of the vulnerability of very dynamic economies with big capital imports and inadequate foreign reserves. China, and other Asian economies, then tried to ensure that they would not be vulnerable again. The costs of the crisis were so great that countries (especially poorer countries) were powerfully motivated to build additional reserves. But then they went on and on accumulating. In the 1960s, the distinguished international economist Fritz Machlup formulated a different view of reserves, which he called the theory of "Mrs. Machlup's wardrobe." Mrs. Machlup apparently always liked to buy new dresses, while resisting giving away old ones: so the stock of dresses went on increasing. Since the millennium, the reserves of Japan, Taiwan, Korea, and Malaysia have all more than doubled, while that of China more than quintupled. Are the reserves really needed and when is the optimal point reached? One Korean central bank official said that: "There is no limit to the amount of reserves that are needed." (Cheung and Qian 2007) Asian reserves now look more like Imelda Marcos's shoe collection than Mrs. Machlup's wardrobe.

Because reserves are held mostly in short dated and very low risk securities (traditionally treasury bills issued by a few industrial countries), the world pile up of assets has driven down short term interest rates, and prompted a global expansion of liquidity that then helped to power asset price bubbles, especially in the housing

markets of countries with current account deficits and higher interest rates, especially the United States, Australia, or the United Kingdom.

The rapid accumulation of reserves follows from high savings rates, both in the private and the public sector, in oil producing and emerging Asian economies. While overall savings in non-industrialized countries have fallen, the countries classified by the IMF as "developing Asia" have had big increases in savings: from 32.9 percent in the 1990s to 42.2 percent in 2006. Especially quickly growing but politically unstable and insecure countries experienced dramatic rises in the savings rates, as citizens felt unsure about their future and were unable to rely on state support mechanisms. The private choices are a response to the unavailability of insurance for old age and sickness, and the rapidly increasing cost of education: individuals need to save so much because they are dependent on their own resources. The paradigmatic case again is that of China, where consumption rates have actually fallen as incomes rose: by 2005, Chinese households consumed less than 40 percent of GDP, and Chinese households moved to very high savings rates (of around 30 percent). With simultaneous high saving by the government and by enterprises, the outcome is a large amount of capital in search of security. But the savings surge, and the accompanying positive current account balance is not just a Chinese peculiarity, but can be found in most Asian, South Asian and Gulf States economies. For the Middle East, the savings rate rose from 24.2 percent in the 1990s to 40.4 percent in 2006. In the latter case, the surge in oil prices has been responsible for the growth in savings, but in Asia it reflects the combination of stronger growth and

increased precautionary saving (IMF, *World Economic Outlook* April 2007, Table 43). Reserve growth represents one way, though not a particularly cost effective one, of investing the savings generated, in more apparently secure (and foreign) economic and political settings.

The surprising savings behavior is not just the outcome of private decisions. Public policy has played a central role. The emerging market states have chosen to build up large levels of reserves, in part to avoid an appreciation of their currencies that would make their highly dynamic export sector less competitive.

But the countries that are building up these enormous reserves are setting themselves a new kind of trap that relates to their composition, in terms of choice of currency but also of the class of securities chosen. The accumulations are so large that even the announcement of a small shift in assets, for instance, a declaration that there may be a shift to more euros and fewer dollars, is enough to move markets and to cause disruptions and panics. In the past, reserve regimes in which there was a choice of assets brought an inherent instability. For instance in the interwar period the world had a choice of the dollar, the pound and gold and reserve currencies, and was deeply destabilized by the sudden loss of confidence in the pound in 1931. In the run up to the financial crisis, private speculators, but also other central banks, rapidly tried to convert pounds into dollars or gold. After the pound was decoupled from gold, speculation turned against the dollar, until Franklin Roosevelt followed Britain and left the gold standard. This feature of the old order reserve system was exactly why Keynes and his Bretton Woods colleagues were suspicious of the prewar order, and felt that it led to the

possibility of devastating speculative attacks on central banks, who could only defend their currencies and their reserves by taking measures that would be highly damaging to the domestic economy.

There are also problems relating to the management of the domestic economy. Reserves are often sterilized to prevent an impact on the domestic money supply and inflation. But there is a limit to such sterilization, as governments cannot issue debt indefinitely without crowding out private sector investment. In consequence, the outcome of rapid reserve accumulation is often inflationary, as it was in Germany and Japan in the 1960s; and as it appears to be in China's recent past (Sohmen 1964; Yongding 2007; Humpage and Schenk 2008).

In recent times, a number of solutions have been put forward to the threat to stability posed by the big build up of reserve assets. The most obvious is to follow the path of central banks in the rich industrial countries and look for a broader range of reserve assets. Why should central banks only hold low yielding Treasury bills? Why should they in effect subsidize the U.S. government by holding its debt liabilities? The emerging Asian economies have indeed gradually looked to longer term assets in place of short Treasury bills, and have also moved to buy other government agency securities, and even some corporate bonds. Asian governments are also tempted to look to equities as a way of obtaining higher yields, but by doing this they expose themselves to more volatility.

In practice, the attempts by the new surplus countries to look for alternative reserve assets have been highly problematic. Most of the attention has been fixed on China's more than one trillion dollars in reserves, and its

nervous search for ways of maintaining the value of those assets. Diversification from U.S. Treasury bills by investing some \$3 bn. in the Blackstone private equity fund this summer was swiftly followed by an embarrassing collapse in value.

When assets are managed in an alternative way, through sovereign wealth funds (SWFs), there are even greater difficulties. On the receiving end, industrial countries' governments are increasingly anxious that SWFs will be used strategically, rather than simply following the logic of the market. They might be used as a way of gaining control of key sectors of the economy, especially since the credit crunch has made the world's largest banks look for new injections of capital. In November 2007, Abu Dhabi recapitalized Citigroup with \$7.5 bn., and in December the Government of Singapore Investment Corporation took a CHF 19.4 bn. (\$17.2 bn.) stake in the Swiss bank UBS. The more activist Singapore institution, Temasek, has acquired stakes in Standard Chartered, Barclays, Bank of China, and the China Construction Bank. Since the second quarter of 2007, SWFs have put at least \$46 bn. into financial companies in developing countries (*Financial Times* 2007). Other investments have attracted substantial attention: such as the failed attempt of Dubai Ports World to buy the British company P & O which managed six major U.S. ports; or the blocked bid in 2005 of the China National Offshore Oil Company for the Californian oil company Unocal. Even the highly successful model for the sovereign wealth funds, Singapore's Temasek, which for a long time went largely unnoticed, is now attracting an attention which from the point of view of its owners and managers is highly undesirable and has announced that it intends to avoid

stakes at "iconic" companies. It is possible to imagine a voluntary code of good management by SWFs, in which they apply a self-denying resolution not to purchase commanding shares in key industries, but even that will not be enough to satisfy the nerves of the old industrial countries. Norway has adopted such a code, but few recipient countries are likely to see Norwegian investment as a threat. The IMF has recently tried to formulate a new role in creating a code of conduct, but the debates are highly contentious.

Even without the politics, the simple size of the SWFs makes them a major actor in financial markets. With a capital of at least \$2.5 trillion, they are larger than the world total of hedge funds, and are large enough to move global markets. They have in part funded the big expansion of global stock markets over the past five years. The total world stock market capitalization was only \$20.4 trillion in September 2002, but is currently \$63 trillion (October 2007) (World Federation of Exchanges 2007). In effect, the flow of savings from emerging markets has driven the global equities boom that followed the collapse of the dot.com bubble (Bernanke 2005).

Since the summer of 2008, the SWFs have become less of a perceived danger to ownership structures in industrial countries, and more of an embarrassment to the countries that own and operate them. In particular, the investments in major western financial institutions proved to be catastrophically misguided. Singapore's funds, GIC and Temasek, were more open than most about the catastrophe. GIC, which had taken the stakes in Citigroup and UBS, saw its value fall by over a quarter, and its general director, the strongman of Singapore politics, Lee Kuan Yew, issued a mea culpa. His daughter in law, Ho Ching, who was also

wife of the Prime Minister, stepped down from the direction Temasek (whose portfolio had fallen by 31 per cent) in order to make way for an outside professional. (MSN news, February 10, 2009)

The capital markets are no longer effectively an arena in which outcomes result from the interplay of millions of independent guesses, decisions or strategies. Instead the central banks of emerging markets and new sovereign wealth funds provide so much of the market that they might dominate it. When entities of such a size make decisions, they are bound to act in a strategic way. All the parties begin to suspect political manipulation.

Both the problems of the owners of the new assets and the targets of ownership can be resolved, and the political venom inherent in the accumulation of strategic ownership interests neutralized, through the operation of institutions that have a commitment to and an interest in an overarching general good. They should not be in a position where they may be suspected of a particular strategic manipulation.

3. The Management of Financial Globalization

As part of the response to the new problems and threats posed by liberalized global capital markets, the IMF established a Capital Markets Division in 1999, which has produced high quality semi-academic reports on major developments. These reports gave warnings about the potential for destabilization from financial innovation, and saw hedge funds as a source of potential threat.

In responding to the 2007-8 financial crisis, the IMF's new Managing Director, Dominique Strauss-Kahn, has complained that the IMF has been effectively sidelined. In particular, the US never signed onto the joint IMF-World Bank initiative of 1999 (Financial Sector Assessment Program) designed to alert countries to financial vulnerabilities. Strauss-Kahn was quoted as saying that "What is interesting is that ... the United States had refused to have an FSAP. We can't be responsible for lack of supervision... owing to the fact that our main instrument to make that kind of supervision was not used in the country." (*Financial Times*, 2008) The FSAP mechanism was largely intended, as might be deduced from the date of inception, to deal with ways of examining the financial sectors of emerging market economies, which had been one of the central problems in the 1997-8 Asia crisis. Strauss-Kahn's comment sounds rather like a rather regrettable instance of international institutions trying to build legitimacy by sounding a cheap anti-American note.

But the IMF is completely right to think that it is largely on the sidelines as far as financial stability issues are concerned. It never evolved in the direction of the "large IMF" sketched out by one of the authors in 1996 (James 1996, pp. 618-619), and instead remained resolutely a "small IMF". The major institutional involvement of the Financial Stability Forum is with the BIS. Given that the major task is to formulate monetary policy as well as regulatory responses to financial developments, it is appropriate that financial stability issues should be handled by an institution that is owned by central banks, rather than by governments (as is the Fund). Indeed the strikingly rapid growth of capital markets was in general a

development that had not been predicted at Bretton Woods, and had not been desired by the makers of Bretton Woods, who wanted to move away from the interwar world of central bank-based international cooperation. At that time they had seen central banks as insufficiently committed to mandates to achieve macro-economic stabilization and growth.

Possible Solutions

In any dramatic crisis, a range of solutions are offered. They range from piecemeal tinkering to radical overhauls of governance.

1. The adequacy of the IMF's resources to deal with emerging market crises could be tackled by the conclusion of particular lending programs with countries that have surpluses available. In 1974 Saudi Arabia provided resources to fund the first Oil Facility (together with Canada and the Netherlands), and in 1977 Saudi Arabia and Kuwait also funded the Supplementary Financing Facility. In 1981, with a SDR 8 bn. loan, the Saudis agreed what was then the largest loan in history. Japan also concluded some big lending agreements, notably a SDR 3 bn. arrangement in 1986. (Boughton 2001, 864-894)

Such particular lending is also an immediate response to a possible shortfall in the current crisis. In early 2009, Japan agreed to loan an additional \$100 bn. for IMF lending to crisis economies. These packages have not been tied to any increase in leverage over IMF policy. While Japan might accept such an arrangement in 2009, it is

unlikely that many other countries will both want to and be able to follow Japan's example.

The 1974 precedent is quite interesting in regard to the question of how many countries can and should be involved in lending. Saudi Arabia did not want to be on its own in lending, and insisted on the participation of some industrial countries (hence the involvement of Canada and the Netherlands) in order not to give the impression that the loan was a penalty for the big oil price hikes. In the same way, China is unlikely to be sympathetic to an approach for borrowing that is presented as some sort of reprimand for allegedly mercantilist trade policies.

2. The regular borrowing arrangements of the IMF could be extended. In 1962, the General Arrangements to Borrow were concluded with the G-10 (and Switzerland) as a way of arranging for additional resources, potentially in support of the two largest reserve currencies of the time, the dollar and the pound. The New Arrangements to Borrow were set up in 1997 as a response to the Asia crisis, "when supplementary resources are needed to forestall or cope with an impairment of the international monetary system, or to deal with an exceptional situation that poses a threat to the stability of the system." The NAB now, after a second five year renewal, include 26 lenders, among them some emerging market economies. As well as Saudi Arabia and Kuwait, Chile, Hong Kong, Korea and Thailand are now participants in the NAB. But the overall resources available under the GAB and the NAB are quite small (SDR 34 bn. or \$50 bn.) In March 2009, the U.S. proposed to increase the NAB to \$500 bn. It is not clear that all the participants would be willing or able to participate in this extension.

3. The members of the IMF could agree on an increase in their subscriptions ("quotas"). Some European governments have suggested such a mechanism as a way to enlarge the capacity of the Fund. But this proposal does not deal with the question of the distribution of quotas and of influence in the Fund (the governance issues).

4. The IMF could itself create additional resources by a new issue of SDRs. The original vision of the SDR envisaged their increased availability at a time when there was a general global and long-term shortage of liquidity. Article XXIV Section 1 specified: "In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world." Since it was widely believed that the transition to floating exchange rates removed the liquidity constraint, this provision has never come into effect. A small SDR allocation was made in 1978 simply to make up for the dwindling importance of SDRs in reserve holdings, although there existed at the time no danger of deflation (indeed this was a generally inflationary moment). The discussion of the SDR instead shifted to debate about a "link" that could associate SDR allocations with increased development finance. It is conceivable that the circumstances of the credit meltdown of 2007 and 2008 do correspond precisely to the eventuality of a general liquidity shortage, although clearly one which arose in very different circumstances to those envisaged in 1969.

5. The IMF could acquire more assets by redesigning itself as a reserve manager. The IMF could again become a very powerful financial stabilizer if it managed a significant part of the reserve assets of the new surplus countries. It would be in a powerful position to take bets against speculators. The stabilizing action would ultimately benefit both the world economy and the interests of the owners of the reserve assets, who have (simply by the fact of the accumulation of the surpluses) a similar interest in world economic and financial stability. At the same time, the management of reserve assets by an internationally controlled asset manager would remove suspicions and doubts about the use of assets for strategic political purposes.

In order to reorient the focus of the IMF in this manner, some simple principles would need to be followed:

First, the IMF's new function as an asset manager would need to be handled separately from the much smaller traditional quota resources used to provide the classical balance of payments assistance through the so-called "General Department" of the Fund. Some portion of the new assets could perhaps be invested adventurously in long-term infrastructure projects for poorer economies, not simply as a public good but in the expectation of long-term returns. The management of assets could be subject to specific guidelines as to which assets might be inappropriate for investment by the IMF. But the fundamental aim of the new Asset Department would be to generate satisfactory and stable returns that would make the reserve assets financially more rewarding (and actually less risky) than under the current system as it is emerging with the problematic growth of SWFs. The Asset Department would

thus be subject - like other asset managers - to a clear financial measure of its performance.

Secondly, but only in exceptional circumstances of a generalized threat to global financial stability, the IMF's new resources would be used to stake out positions to defeat speculative attacks in situations where the fundamental position might be judged to be sound. Like a traditional lender of last resort in a domestic context, it would then lend against collateral at a normal, non-crisis, valuation. But, as in its traditional mission, it might also impose policy conditionality in the case of crisis lending to governments.

Third, the new operations would be separated from the existing regular assessment of country policy (the so-called Article IV consultation process or surveillance). Otherwise there would be the suspicion that judgments are influenced by the financial stance of the IMF. This is of course a problem that private sector institutions also face, and which they deal with by establishing "Chinese walls" between research and investment banking activities.

Fourth, in order to carry out this completely new task, the IMF would need to regain the trust of its members. This would require a reform of IMF governance, and in particular of the highly contentious issue of the voting arrangements.

Conclusions

In the 1970s, the IMF's engagement with large industrial countries came to an end, and in the 1980s and 1990s it became principally an institution engaged in emerging market economies (as well as in very poor

countries). The problem with the one-sided approach to that new mission is that by the 2000s, some emerging markets graduated, and looked as if they no longer need the IMF. As a consequence, until the new crises erupted in 2008, all that was left of the original mission of the Fund is the poor country issue (where the micro-economic nature of many of the problems makes the World Bank look like a more suitable agency) and surveillance. Surveillance without the association of financial power that characterized the IMF's modus operandi in the 1960s and 1970s is likely to be rather toothless. If the IMF is forced to focus solely on rescue packages, or solely on surveillance, it takes on a lop-sided character, and is less effective in either of these missions. The involvement of the IMF in reserve management would provide a powerful set of new financial teeth. A more encompassing or holistic approach toward the mission of the IMF is likely to be more satisfactory contribution to the provision of global public goods.

The various reform proposals highlight a dilemma about IMF governance. The more piecemeal proposals (1,2, or 3 above) do not require extensive governance reform, which might be highly complex to implement. On the other hand, the more elaborate measures (4 or 5) would demand some measure of bold reform.

For some time, there has existed a substantial consensus, even from fundamentally sympathetic critics, that IMF governance is out-dated and in need of reform (for sober assessments see Van Houtven 2002; Woods 2005; Kenen 2007). The rise in reserves in many Asian countries was a deliberate response to the 1997 Asia crisis, in which there was a substantial disillusionment with the IMF.

A precondition of the more extensive reforms outlined above would be a governance reform in which the new surplus countries were able to exercise a substantive influence through the IMF. They would need to feel absolutely secure that they were not being the subject of some politically motivated manipulation. In particular, if the IMF were to be in a position of an asset manager who could shift assets from one market to another, it would need to be at a longer distance from U.S. influence and attempts at control: otherwise, it would be seen as a device for propping up the dollar for political rather than economic reasons.

In the past, the IMF has frequently run into precisely this sort of difficulty. In the early 1970s, the IMF's Managing Director Pierre-Paul Schweitzer was thought to be pressing for a devaluation of the dollar, and the U.S. insisted on removing him. In later high profile country cases, involving countries such as Egypt or Russia or even Argentina where the U.S. saw a strong security interest, the U.S. pressed against the advice of technical experts from the IMF (see Blustein 2001, Blustein 2005).

Above all, while reports of the IMF on aspects of U.S. economic and financial management were often critical, the IMF has no real leverage over the U.S. Unlike in the case of Great Britain in the 1960s and 1970s, it is unable firmly to press American governments for policy reform or fiscal adjustment. But part of the theory of the usefulness of international institutions involves the ability of a commitment via an externalized and depoliticized process to act as a lever for policy reform that brings long run collective benefits, even though there are short term political costs associated with adjustment. Reference to the external pressure - as in the relation of

member countries to the European Union - can be a very effective way of overriding the shorter run political opposition in order to bring about the needed economic adjustment.

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