11-14-2008

A New Role for the International Monetary Fund in a New World Economic Order

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[At the time this paper was written, the proposed IMF governance ("voice and quota") reforms described in the paper had not been adopted. On April 28, 2008, the IMF's Board of Governors adopted by a large margin the proposed reforms of the institution's quota and voting share structure. The reform package will increase the voting shares of more than two-thirds of the 185 member countries. See 37 IMF Survey 84 (May 2008)]

The International Monetary Fund ("the Fund"), an international organization created in Bretton Woods, New Hampshire, USA in 1945 by the allied nations and its constitutive treaty agreed to in Savannah in 1946 was given by its founder's tasks which were in one way or another linked to the war-immobilized world trading system.[1] That trading system was, of course, profoundly different from the one we know today. The GATT, predecessor of today's WTO, was concerned primarily with trade in goods. (In 1946 the idea of opening up national economies to trade in services, while perhaps dreamed of by utopians, was a nonstarter for those engaged in postwar reconstruction of the international economy. It would remain for Morocco and the agreement of the WTO to add the General Agreement on Trade in Services----GATS----to the postwar GATT.) In a talk given in 1999 at the American Society of International Law Annual Meeting[2] by Sean Hagan, then a member of the Fund's legal staff and now General Counsel, Mr. Hagan stressed that the original role of the Fund was to work with its members to encourage them to remove "restrictions on payments and transfers for current international transactions".

This phrase (Fund terminology for exchange controls that are not, as the Fund defines such matters, capital controls) in essence meant (at the time when trade in

[1] For an excellent synopsis of the work of the Fund, see Head, Seven Deadly Sins: An Assessment of Criticisms Directed at the International Monetary Fund, 52 U. Kan. L. Rev. 521, 524 et. seq. (2004) and Note 4 therein for a list of courses for the institution's history and functions.

[2] . Proceedings of the 93rd Annual Meeting of the ASIL, March 24-27, 1999 (Washington, DC) pp. 115-116.

goods was the major component of international transactions) restrictions on payments for goods. Liberalisation of trade in the GATT and now the WTO was complemented by the corresponding prohibitions in the Fund Agreement on exchange controls. Originally, Fund financial support was envisioned as enabling countries with balance of payments difficulties----on “current account”---to avoid the imposition of exchange restrictions.

Gradually, over time, this provision of funding by the IMF to countries with balance of payments difficulties became, at least to the public, the primary function of the Fund. Thus we find in a Fund public information office story (in 2001) on the setting up of the Fund’s Independent Evaluation Office a list of the Fund’s major categories of activities:

- Surveillance
- Fund-supported programs and related issues
- Technical assistance and training
- Internal Fund processing
- Research[3]

The list is obviously diffuse and unwieldy; it is hard to make out in 2001 any resemblance (except possibly in whatever “surveillance” turns out to be) to the tasks intended by the founders. As important, the world of international monetary relations had morphed into a world of international financial relations with highly developed interconnected capital markets. Clearly the needs of the international economy by 2001 had changed drastically from 1946 and the Fund needed a new vision.[4]

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[3] "Progress in Making the Independent Evaluation Office (IED) Operational," http:/www.imf.org/external/np/eval/2001/103101/.hmtl (October 31, 2001).
[4] The Fund was also under attack on a number of fronts for its alleged ineffectiveness, lack of transparency and "democratic deficit" in its governance. Hence the title of the Head 2004 article cited above in n. 1. See also the Fund's own document "Common Criticisms of the IMF: Some Responses" http://www.imf.org/external/np/exp/cerit/eng/crans.htm, last updated, May 30, 2006.

In June,2004, a new Managing Director of the Fund, Rodrigo de Rato of Spain, was appointed and one of his first acts was to institute Fund wide study groups along with consultation with officials of member countries and other outsiders with a view to creating a "Medium -Term Strategy" (MTS) for the Fund. As Mr. de Rato said in a speech to the Aspen Institute in Rome: "The world is changing and the IMF needs to change with it. Twenty-first-century globalization, with massive movements of capital and abrupt shifts in comparative advantage, is presenting all countries and the global community with new challenges. The Fund must help our members meet these challenges, and it will need to adapt to do so."[5] By September 2005 the Managing Director's Report on the MTS had been endorsed by the Fund's main advisory committee of governors, the International Monetary and Financial Committee (IMFC). On April 5th and April 20th, 2006, Managing Director de Rato presented his Report on Implementation of the MTS to the IMFC.

At this point, it would seem, institutional necessities, otherwise known as the difficulty of changing the mission of a hugh treaty based organisation with entrenched turf for those nations historically in power, stepped in. While the IMFC endorsed the Managing Director's Report on Implementation, the emphasis shifted from change to meet the new economic world order to what might be achievable by the time of the Annual Meeting of the Fund to be held in Singapore in September 2006: beginning reform in the <u>governance</u> of the Fund to fix the problems that had emerged with the addition of so many new nations as members and the growing financial strength of the emerging market countries. This reform is referred to in Fund literature as "quota and voice", changes in the representation of member countries in the organization. As the Press Release on the adoption by the Board of Governors of the Fund of its Resolution on Quota and Voice Reform puts it: "These reforms aim to better align the IMF's quota shares with members' relative positions in the world economy and to make it more responsive to changes to the global economy while, and equally important, enhancing

[5] 35 IMF Survey 100 (April 17, 2006).

the participation and voice of low-income countries in the IMF."[6]

In an interview with the Financial Times just before the Annual Meeting in Singapore, the Managing Director said he had agreement "to launch a fundamental overhaul of control and governance of the IMF..." But even this reform, he said, would be a two-stage process, taking two years. Moreover, he noted, while he expected the Singapore meeting to have agreement on increases in quota for China, South Korea, Turkey and Mexico, these increases would be "initial ad hoc". More far-reaching reform would follow in a second stage. He added that while agreement had been reached on the need for a new formula, "no consensus had been reached on weight to give each factor".[7] Indeed, in the event, the Resolution adopted by the Board of Governors at the Singapore meeting simply requested the Executive Board to reach agreement "on a new quota formula to guide the assessment of the adequacy of members' quotas" by the Annual Meetings in 2007[8] and to complete the reforms by the 2008 Annual Meetings.[9]

Underneath the radar, however, the Managing Director and his staff have been addressing one aspect of the substantive (as contrasted to procedural—governance—issues) role of the Fund. The Fund long since has been engaged in what is called in Fund language "surveillance", that is, oversight of international monetary relations. However, it has carried out this function in the past by sending teams annually to its member countries for review of the countries' economic policies under the Fund's powers of consultation under Article IV of the Bretton Woods Agreement. The MTS stressed the need to improve surveillance so as to increase the Fund's capacity to "address risks to economic stability stemming from payments imbalances, currency misalignments, and financial market disturbances." [10] Part of this improvement process has been to add to the bilateral consultation process a "new multilateral consultation

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[6] "IMF Board of Governors Approves Quota and Related Governance Reforms", Press Release No 06/205, September 18, 2006, http://www.imf.org/external/np/sec/np/2006/pr06205.htm.
[7] The Financial Times, Aug 30, 2006 USA, p.1, cls2-3.
[8] Id,
[9] 35 IMF Survery 276 (October 2, 2006)
[10] "Reassessing the role of the IMF in a rapidly changing world", 35 IMF Survey 349 (December 11, 2006)

vehicle” to “facilitate discussions within groups of countries on issues of systemic importance....”[11] The Annual Meetings in September did endorse this multilateral consultation initiative,[12] although at the time of this writing, it is not possible to determine how the initiative will play out.

The emphasis in the run-up to the 2006 Singapore Meeting on procedural reform did not go unnoticed among commentators. Just prior to the Annual Meeting, Rachel Lomax, Deputy Governor of the Bank of England and Tiff Macklem, Deputy Governor of the Bank of Canada, published a commentary piece in the Financial Times entitled “The global monetary fund must reform its surveillance”[13] in which, while admitting that “[A] deal on quotas is needed to strengthen the Fund’s legitimacy”, took the view that the quota reform would be meaningless without reform of the way in which the Fund conducts its [bilateral] surveillance. By this, they seem to mean that rather than working with debtor countries to improve the domestic economy so as to enable getting out of debt, the Fund should concentrate on country policies that “spill-over” so as to affect the operation of the international monetary system. The piece was clearly published to encourage the Singapore Meeting to endorse the MTS on surveillance and the multilateral initiative. More importantly, it was not the first of important voices raised to stress the importance of a reformed role for the Fund in the new global order. In the interest of brevity, rather than catalogue all of recent commentary on substantive reform of the Fund, this piece will conclude with a description of one commentary the author believes should be particularly remarked upon.[14]

That commentary is a speech given on February 20, 2006 by Mervyn King, Governor of the Bank of England, to the Indian Council for Research on International Economic Relations (ICRIER) in New Delhi, India.[15] King, after noting that the Fund had initiated its own strategic review (the MTS), says that he wishes to ask three questions:

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[11] Id,

[12] 35 IMF Survey 298 (October 16, 2006).

[13] Lomax and Macklem, "The global monetary fund must reform its surveillance", The Financial Times, September 12, 2006, p. 13, col.6.

[14] This commentary, Mervyn King's speech, n. 15 below, was described in detail at the Athens Conference where this paper was given.

[15] http://www/bankofengland.co.uk/publications/speeches/2006speech267.pdf (hereafter "King").

first, how is the world of today different from that of Bretton Woods? Second, what role do we want an international monetary institution to play in this new world? And third, what changes are needed in the Fund to enable it to play that role? I commend the entire piece to my readers, but will attempt here to put King's explanation and answers to his questions in my own words. The answer to the first question is the openness of so-called "capital accounts". It will be remembered that in the opening of this paper, the term "on current account" was used. The term was used in connection with a description of balance of payments difficulties. What was meant was that if a country had a trade and services deficit, it purchased more than it sold and hence its "current account" was in deficit. Since its external payments had to be made in a currency acceptable to its sellers (usually not its own currency), it needed access to funds its sellers would accept.

In today's world, access to currencies that a country's sellers will accept is achieved through inward foreign investment or through external borrowing, either from a consortium of international banks or, today more likely, by the issuance of bonds on the international capital markets. Now a country's inward foreign investment is shown on the country's "capital account" as is its issuance of bonds. Equally, the sums its own citizens invest abroad (or the securities it buys for its own reserves, for example, China's holdings of U.S. Treasury bills) are shown on the "capital account". King makes the argument (I believe correctly) that what is important in terms of gauging a country's financial health is its "balance sheet", its external assets and liabilities. It is its balance sheet that the international underwriters of its bond issues on the capital markets will be looking at in determining how to price its bonds. That is why, as King points out, that emerging market and industrialized countries, even though they may be running large current account deficits, do not go to the Fund.

In King's words: "The single most important difference between the old world and today's world is that in the former the financial position of a country was captured by the size of its current account surplus or deficit; now the financial position is best measured by the size and composition of its national balance sheet."[16]

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[16] Id. at 6.

Now the information King expects to get from country balance sheet analysis is key. As he explains, the claims of one country on another will help to reveal how international capital flows respond to news. The "balance sheets contain information about the potential speed of any likely adjustment. That speed is crucial in determining the intensity of the resulting changes in capital flows and hence, the costs associated with reallocating resources."[17] To translate, since external investors are constantly monitoring country balance sheets, in a world without capital restrictions and free withdrawals, the apparent strength of the balance sheet will help determine whether or not the country will suffer a liquidity crisis. "These balance sheet linkages have altered the risks we face but they are an inevitable consequence of the free movement of capital, which has brought with it new opportunities for us all."[18]

So in this new world, is there a need for an international monetary institution? King answers yes. He argues that national economic policies should be boring, all of them, so that the individual economic actors' expectations of future economic policy and their transactions taken on those expectations will not be surprised. "It is in each of our national interests to avoid sudden or large changes in capital flows induced by volatile or unpredictable changes in economic policy."[19] But even if countries do pursue consistent "boring" policies, there still remains the problem of the interaction of national economic policies. King insists that in the international economic "game", as he calls it, "it is important to know about the objectives, strategies...and policy decisions of other countries."[20] He does not think that these objectives and strategies can reliably be determined from market prices. "Policy makers, therefore, are more likely to make incompatible choices if they make decisions independently relying solely on international prices as their guide for the consequences of their actions."[21]

Once this view of the new world of international capital markets and capital flows is

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[17] Id.
[18] Id.
[19] Id. at 7.
[20] Id. at 8.
[21] Id.

understood, what King thinks should be the role of an international monetary institution in it inevitably follows: "....even if countries are not willing to cooperate in the formal sense that they agree jointly on macroeconomic policies, a forum which improves knowledge and understanding of other countries' objectives and policy reaction functions may lead to more compatible policies."[22] This author would add, a "forum" that is trusted not to manipulate the game for its own interests. Secondly, King adds "....such an institution might provide the public good of a dispassionate and independent analysis of the spill-over effects of one country's policies on others."[23] In short, King envisions the new role for the Fund in the new economic order as that of an umpire, an umpire with "an independent, respected and clear voice."[24]

King says that the Fund requires an "independent, respected and clear voice" because by holding countries to account for their national policies and those policies "spill-overs", the Fund "can indirectly support global monetary stability"[25] It "...should provide and share information about the balance sheets of all major countries, their composition and size, and the links between them."[26] [Fn 26] The operative word here is "share", as this would be a new function. To date the Fund has only released the information gathered in its country consultations if authorized to do so by the particular country. The interesting point about the multilateral surveillance initiative is that if the consultations are multilateral, by definition the data being worked on is shared.

King, one gathers, is a proponent of multilateral surveillance since he insists that "[B]alance sheet analysis should be at the heart of the surveillance process. That analysis should lead to an assessment of the risks to the world economy as a whole." This analysis can only be done by an independent and expert secretariat. The speech over and over repeats the same mantra: to carry out the tasks that King believes the Fund should do, acting as an impartial umpire of the nations' clashes of international economic policy, it needs " greater focus, independence and legitimacy."[27] The focus

[22] Id.
[23] Id.
[24] Id. at 9.
[25] Id.
[26] Id.
[27] Id. at 12.

can be achieved by the Fund's own statement of its remit.

Interestingly, the piece then shifts back to King's own view of the governance issue and his thought that management should be given more independence. (King would have the Executive Board, in contradistinction to its present presence in D.C., meet only occasionally to review management's initiatives). But he has made his most important point: the focus of the Fund's surveillance should be not the domestic economic management of debtor countries, but on the economic policies of the systemically important countries and the consequent risks to the global financial system. A tall order, but perhaps the Fund with its MTS can pull it off.