

DRAFT
**Assessing the IMF's Future:
It's Role, Relevance and Prospective Reform**
John Lipsky
Vice Chairman, JPMorgan¹

That the International Monetary Fund is ripe for fundamental reform is an idea whose time has come. The G-20 Finance Ministers and Central Bank Governors issued a "Statement on Reforming the Bretton Woods Institutions" at their October, 2005 meeting that asserted "more innovative approaches and renewed commitments are needed". While some critics claim that the Fund itself is an anachronism, the G-20 authorities anticipate that a reformed Fund will retain a critical role in international governance: "The IMF should primarily focus on national and international macroeconomic and financial stability, exercising enhanced surveillance of the global economy, international capital markets and strengthening crisis prevention and resolution." The Fund itself is actively engaged in the reform process: The Fund's Managing Director, Rodrigo de Rato, recently issued a "Report on the Fund's Medium-Term Strategy"², while a blue-ribbon, IMF-sponsored panel is preparing a review of the Fund's work on financial markets.

Despite the widespread consensus on the need for IMF reform, there is no parallel consensus regarding the specific content of that reform. Not surprisingly, this lack of consensus in large part reflects diverging views on the Fund³. Nonetheless, there is a critical, practical and systemic role that the Fund can fulfill uniquely: To create the legal foundation for the international financial system, and to exercise surveillance of members' adherence to the obligations of Fund membership. At stake is the preservation of a multilateral, non-discriminatory rule-based financial system that seeks to support global growth and to preserve financial stability -- while accommodating systemic change. The challenge at present is to adopt the institution to a series of developments that in many ways have superseded the Fund's original organization and standard procedures.

Thus, innovations are needed in both the Fund's existing structure and processes to insure its future relevance and effectiveness, even taking into account the innovations introduced in the past few years. In the broadest terms, the basic goal of Fund reform should concentrate its resources on those issues and circumstances where it uniquely can make a positive contribution; to create a format for cooperation on those issues where its

¹ The opinions expressed in this paper are those of the author, and do not necessarily represent the views of JPMorgan. This paper was written in November 2005 and first published in February 2006. As of September 2006, the author has become the IMF's First Deputy Managing Director.

² International Monetary Fund; "The Managing Director's Report on The Fund's Medium-Term Strategy"; Washington, D.C., September, 2005.

³ For an excellent summary of the issues and of alternative views regarding IMF reform, see. Edwin M. Truman "International Monetary Fund Reform: An Overview of the Issues", in "Reforming the IMF for the 21st Century" Institute for International Economics, Washington, D.C., April 2006.

contribution is not unique; and to eliminate those activities that have lost their effectiveness.

To accomplish these goals, the Fund needs to adjust its governance to recognize powerful shifts in the global economy. At the same time, the Fund needs to increase sharply its understanding of and interaction with international financial markets. New amendments to the Fund's Articles of Agreement may not be required to attain the needed changes, but the Fund's operations and focus inevitably will shift in many important ways.

What is the Fund for?

To put the current reform momentum into perspective, it is worth reviewing the essential aspects of the Fund's original role, and to summarize the forces that have created the sense that change is necessary. While it is often claimed that the Fund's most basic original responsibility was to operate the post-World War II dollar-based fixed exchange rate system, in fact the Fund's central purpose was much broader⁴:

Thus, the Fund's Articles of Agreement formed the legal basis for creating a multilateral and non-discriminatory international monetary system. No equivalent agreement existed previously. Critically, accepting Fund membership also included a commitment to eliminate, over time, all restrictions on current payments for balance of payments purposes⁵. When the Fund was created, such restrictions were the rule, even in the largest economies. The notion that foreign exchange would be available freely for all permitted international trade and debt service transactions – something taken for granted today almost everywhere – was at the time a distant memory from the late 19th century. Moreover, even the pre-World War I gold standard lacked a formal basis – it was merely a pragmatic arrangement.

The Fund therefore was intended to promote structural changes in the global economy: Its key role was to create a financial system based on international law that would reliably support the liberalization of global trade, while preserving financial and economic balance. Critical to the Fund's systemic role was its unique and unprecedented responsibility for conducting surveillance. That is, the Fund's Articles created legal obligations for its members, and the Fund was charged to make sure that these obligations were being fulfilled, with the prospect of sanctions for non-compliance.

The Fund's lending facilities – originally created somewhat as an afterthought, with no clear vision of exactly how or when they would be used – were intended to provide an incentive for member countries to avoid “beggar-thy-neighbor” policies in correcting balance of payments deficits. At the time the Fund's Articles were drafted, the availability of such public international funding was novel. Both private and official cross-border capital flows were rare, while international capital markets as we know them

⁴ After all, how big a staff is needed to “oversee” a system of fixed exchange rates operated by national central banks?

⁵ In other words, the Fund's Articles set current account convertibility as an obligatory goal of Fund membership.

today simply did not exist. Even short-term trade finance often was subject to severe restrictions. Direct foreign investment was minimal by modern standards, and often controversial. Moreover, the percent of global output accounted for by international trade transactions in the Fund's early existence was the lowest since prior to World War I.

New Challenges

Several key developments have altered fundamentally the challenges facing the Fund. These include:

- The move to nearly universal Fund membership, expanding from the original 40 countries in 1945 to 184 today. In the process, the trading and monetary systems the Fund helped to create also have become universal. While this means that Fund membership is now virtually complete, the rapid growth in Fund membership led naturally to a sharp increase in Fund technical assistance – including to formerly centrally planned economies.
- The elimination of current payments restrictions in most economies – or at least substantial progress toward their elimination. In other words, one of the Fund's critical original missions is well on the way to having been achieved. This represents a monumental accomplishment, but one that is rarely remarked upon in the discussion of potential Fund reforms. In an important sense, one justification for the current re-examination of the Fund's role is that one of its principal systemic goals by and large has been accomplished. One important caveat: Relevant remaining payments restrictions are concentrated in large, formerly centrally-planned economies that are becoming systemically relevant, and in the poorest economies.
- Private sector cross-border capital flows have become massive. Today, such flows take place in the more traditional form of direct investment, and bank lending, but increasingly through the explosive growth in cross-border trade in marketable securities and derivative instruments. Cross-border securities transactions often involve new institutions, including hedge funds and private equity funds. One result has been the increasingly tight linkage between international and domestic financial markets. At the same time, both public and private entities in major economies can access international capital markets to a degree that was never contemplated by the framers of the Articles.
- Monetary and exchange rate policies in several cases have taken on a regional character that was not contemplated in the Articles, nor that is reflected clearly in the Fund's governance. Most important has been the euro's creation. In addition, the nascent movement of key Asian economies away from pegged exchange rates has evoked proposals for some new form of regional cooperation. The dramatic growth in global trade that was viewed by the Fund's founders as a key contribution to

increased economic well-being has tended to be more rapid within principal regions than between them. Put another way, globalization in large part has meant regionalization – at least so far.

- The dramatic decline in inflation globally during the past decade or so -- particularly in emerging market economies – has reflected an improvement in monetary and fiscal policy management, in addition to the forces of globalization. At the same time, the profound demographic shifts underway in the developed economies are creating powerful longer-term challenges to their fiscal policies. In other words, the most striking policy challenges increasingly are medium- and long-term in nature, but they are potentially very serious.
- The emergence in the past few years of a record US current account deficit -- and the unprecedented form and ease of its financing – has produced strongly divergent views regarding the Fund's role. Many analysts claim that a US current deficit equivalent to nearly 7% of GDP provides *prima facie* evidence that the Fund has failed to forestall a serious threat to systemic stability. At the same time, other observers interpret the ease with which the US deficit has been financed as evidence that the Fund's systemic role needs to be re-examined and re-interpreted to allow for a more up-to-date view on what constitutes systemically worrisome payments imbalances.
- The increase in transparency in many economies -- both in terms of data availability, and in terms of policy clarity -- has made it easier to analyze and understand policy alternatives, and to gauge risks more accurately than in the past. The Fund itself has played a major role in improving the quality and availability of economic and financial data. Much more could be accomplished. Of course, it must be asked whether data reporting requirements need to be created in the interest of transparency, even if none exist now.

Taken together, these changes have altered substantially the environment in which the Fund operates. Many issues that previously absorbed substantial amounts of Fund staff effort – in terms of intellectual effort, manpower and financial resources – have faded in importance, while others have increased in their relevance.

The Momentum for Reform

The Fund's efforts in its first decades were focused on establishing a standard framework for analyzing member country's economies -- including the creation of conceptually consistent data and developing standards for member country's policies that were in line with the demands of Fund membership. At the same time, the Fund developed the now-standard procedures for the use of Fund resources, including Stand-By Arrangements and subsequent innovations. Several large industrial countries were early users of Fund

Arrangements, dominating the overall use of Fund resources in the institution's first decades.

The only previous period of fundamental Fund reform occurred in the early 1970s, following the collapse of the fixed-exchange rate system, and its replacement by a system of floating rates. This shift was accommodated by amending the Fund's Articles. However, it wasn't the debt crises of the 1980s, or the wide swings of key exchange rates and the associated record payments imbalances at that time that created a consensus that the Fund needed serious restructuring. Rather, it was the emergence during the 1990s of massive securitized private international capital flows – and the repeated, unnerving demonstrations that the Fund simply was not able to cope within its standard procedures with the implied systemic strains – that led to the current reform consensus.

In the wake of the 1994/95 Mexican crisis, the Fund's Interim Committee – itself created following the abandonment of fixed exchange rates in 1973 – endorsed at its September 1997 meeting amending the Articles to make capital market liberalization a formal goal of Fund membership. Implicitly, the proposal would have given the Fund authority to guide the capital account liberalization process in a fashion analogous to its earlier responsibilities with regard to current account liberalization.

The rapid-fire unfolding of the Asia crisis of 1997-98, the Russian debt default of 1998, the Brazilian devaluation of 1999 – plus the market crisis generated by the failure of LTCM in 1998's third quarter – left the proposed Amendment moot. In the wake of these repeated crises, it became accepted virtually universally that the crisis prevention and resolution mechanisms embodied in the Fund's Articles and the Fund's practices had become dysfunctional. In its place came a widely-supported – but vague -- call for a "New International Financial Architecture". What ensued was commonly referred to as a "repair of the plumbing", but not a "new architecture."⁶

Assessing the "Repairs"

The failure to agree on a new architecture was not for lack of trying. Numerous reforms were proposed, including the Fund's own plan for a Sovereign Debt Restructuring Mechanism (SDRM). In the event, five important changes were adopted, although none of them required an amendment to the Fund's Articles of Agreement. Perhaps the most important of these was the *defacto* agreement among governments that henceforth all sovereign debt issues denominated in foreign currency – even those by G-8 members – would contain collective action clauses.⁷

Once a transition period is complete, future sovereign debt restructurings no longer will take place in the wake of a formal default, as the debt contract itself will spell out the procedures by which the terms could be renegotiated. In theory at least, the use of

⁶ For an excellent description of the New Architecture effort, see Barry Eichengreen, "Toward a New International Financial Architecture" 1999, Institute for International Economics.

⁷ The case for collective action clauses was made first in this context in; Barry Eichengreen and Richard Portes, "Crisis? What Crisis? Orderly Workouts for Sovereign Debtors" 1995, Centre for Economic Policy Research.

collective action clauses virtually will eliminate the Fund's facing a case of "lending into arrears". Moreover, a set of voluntary Principles⁸ (often referred to as a "Code of Conduct") has been negotiated between private creditors and official borrowers and endorsed by the Group of 20 authorities. The Fund's prospective role in a debt restructuring conducted under the CACs remains undefined in many important respects.

The second of the five changes involves the 2003 adoption by the Fund's Executive Board of a policy of more formal limits on access to Fund resources. In essence, by establishing criteria for exceptional access and by requiring that the Fund issue an "exceptional access report," a more effective budget constraint has been created, as "the IMF, rather than official creditor governments, is [now] responsible for large scale loan financing."⁹ At the same time, it was agreed to seek greater clarity regarding the division of responsibilities between the Fund and the World Bank, and that the Fund would focus on its core responsibilities of supporting macroeconomic balance through its surveillance of monetary, fiscal, financial and exchange rate issues. Finally, it was agreed in April 2005 that the Fund would create "program monitoring arrangements", in which a member country could receive formal Fund endorsement of its economic program, but without drawing on the Fund's financial resources.¹⁰

Looking Forward

As the support for some sort of Fund reform builds, it is worth pausing to take stock of the Fund's probable future, and whether the current challenges call for "New Architecture", or rather for another round of "repairs" to the "plumbing"¹¹.

The prospect for future demands on Fund resources remains murky. Even if the international economic environment turns less favorable, the call on Fund resources likely will recede sharply, unless the largest borrowers again experience serious difficulties. Implicitly, the relevance of the new policy on exceptional access is still to be tested. If the countries representing the largest current users of Fund resources have graduated from Fund support – much as the G-7 countries have for the past 30 years – the practical importance of the Fund's financing role will diminish.

In this case, issues that have been raised repeatedly – such as whether the Fund should create a true "lender of last resort" facility, a "conditional lending facility" or even a

⁸ Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets.

⁹ John B. Taylor, "Recent IMF Reforms: Are They Working in Practice?" Remarks at the Conference "The IMF in a Changing World"; Frankfurt Germany, June 8, 2005.

¹⁰ This creation of so-called "non-borrowing" arrangements essentially harks back to the origins of the Fund's Stand-By Arrangements, in which the use of Fund resources was optional to the member country, so long as their policies remained in compliance with the Arrangement.

¹¹ As of August 2006 the Fund has 45 active programs, involving the use of SDR18 billion in Fund resources. However, 60% of the use of Fund resources is limited to 3 cases (Turkey, Indonesia and Uruguay). Moreover, only 9 new programs have been approved during 2006.

Deleted: Hungary

“deadbeat’s refinancing facility”¹² – almost certainly will remain moot. However, the Fund’s traditional role as the primary official international lender of final resort¹³ will seem less controversial, if the amounts remain modest relative to recent experience. In this case, calls for a substantial increase in Fund quotas are not likely to find a sympathetic audience, at least not where it will make a difference. Moreover, the pending issue of a new allocation of the Fund’s Special Drawing Rights (SDRs) likely will remain pending, as will the issue of whether the Fund will undertake new gold sales in the interests of providing new support for its poorest members.

Two Approaches to Evaluating Reform Needs

Starting from the current situation, there are two basic approaches to the issue of Fund reform. One is to begin with the structural and systemic issues facing the Fund, and to assess the changes needed to confront them. The other is to examine the Fund’s probable operational needs, starting from a typology of the Fund’s member countries.

Beginning with the former approach, it seems clear that the prospect for many proposed structural reforms will depend on a set of interlocked issues that have no clear answer at present, but likely will depend critically on whether a redistribution of voting power within the Fund takes place¹⁴. Progress on this issue has proven to be very difficult, and it is uncertain whether forward movement is imminent. Related directly to this issue is the possible expansion of the Fund’s quotas, and a possible new allocation of the Funds’ Special Drawing Rights.

Regardless of whether there is new progress on these structural issues, there is little doubt that improving the Fund’s effectiveness will require new advances in the organization’s work on international capital markets. The issues of systemic stability, debt sustainability and capital market liberalization all lie directly within the Fund’s area of responsibility and expertise. There is little doubt that the Fund is uniquely equipped to take a leadership role in this critical area.

Whether or not support will reemerge for the 1997 proposal to amend the Articles of Agreement to give the Fund a direct, formal role on capital market liberalization, the Fund’s knowledge and involvement of financial market issues needs strengthening. The recent G-20 statement left no doubt of the Fund’s mandate in this area. To accomplish this, however, the Fund will need to increase its formal cooperation with other international bodies, such as the Basel Committee, the Financial Stability Forum and the various organizations of supervisors and regulators of specialized financial markets.

¹² The latter is a serious proposal (albeit with an ironic title) by former IMF Research Director Michael Mussa. See, Mussa, “Reflections on the Function and Facilities for IMF Lending”, in “Reforming the IMF for the 21st Century”, Institute for International Finance, April 2006.

¹³ Following Mussa’s terminology, op.cit.

¹⁴ Details discussions of this issue can be found in Truman, op.cit., and in “Rearranging the IMF Chairs and Shares”, Lorenzo Bini-Smiaghi, “IMF Governance and the Political Economy of a Consolidated European Seat”, and Miles Kahler, “Internal Governance and IMF Performance,” all in “Reforming the IMF for the 21st Century”, Institute for International Economics, April 2006.

In fact, the scope and effectiveness of the Fund's multilateral surveillance activities, and even the authority with which it can address issues of appropriate exchange rate policy will depend to a large degree to its ability to speak with real authority on financial market developments. The challenge here is palpable, as it is not as if the Fund has been commanded to master an already well-understood body of knowledge. Rather, the Fund needs to take a vanguard role in understanding better the forces that govern international financial markets, and to advance analysis on the appropriate role for public intervention in what have become by and large private markets. The intellectual and practical challenges are daunting, but they will have to be met if a reformed Fund is to be successful.

Viewed from a different perspective, four categories of Fund members can be discerned:

1. Countries that can access international capital markets in their own currency;
2. Countries that can access international markets in foreign currencies;
3. Countries that do not have market access at present, but that can aspire to attain access in the near term;
4. Countries not likely to enjoy market access for some time to come.

In each case, the Fund's role will be different. Obviously, the G-7 economies can access international markets in their own currency. The prospect that Fund bilateral surveillance will be welcomed or heeded in these cases seems unlikely. Moreover, the prospect that these countries might fail to honor their own local currency debt is remote. The efforts of Fund staff with regard to these economies would be more useful if focused on issues of systemic stability and financial market developments, rather than on conventional consultations.

For countries that already can access markets in foreign currency, greater Fund financial market expertise could be important to keeping the Fund's policy advice relevant. Issues of debt sustainability will be important, as many observers worry that the current large users of Fund resources could face significant new problems in the future. It is worth noting that the "cutting edge" in emerging markets is investors' growing interest in the local currency debt of major and/or well-managed emerging economies. This new interest might not survive a less favorable international environment, but for now it surely reflects the better macro-economic outcomes registered in recent years by many key emerging economies, and improvements in their domestic financial markets. If sustained, this trend toward local currency financing would be striking, and potentially could boost systemic stability. It also would imply a reduced role for Fund finance. In any case, the use of CACs by these countries also should diminish their need to draw on the Fund's financial resources in the future.

For countries without current market access, but with plausible near-term prospects of gaining such access, the Fund needs to be able to support that process. Here again, the Fund will require reliable expertise regarding the necessary and sufficient conditions for market access. Of course, that will require the Fund to have a point of view regarding the

country's macro-economic policies, but also regarding their financial system, regulations, and other considerations, such as those reviewed in the Fund's Financial Sector Assessment Programs (FSAPs).

For those countries whose market access is a distant prospect, international institutions are likely to play a large role on a sustained basis. Broad issues – such as whether assistance should be in the form of grants or loans – no doubt will be relevant. It is reasonable to ask whether the Fund's current targeted programs – such as the Poverty Reduction and Growth Facility (PRGF) represents a useful innovation, or a confusing overlap with the World Bank and/or regional development banks. In any case, these countries require a cooperative approach by the relevant official institutions, and a separate assessment of their needs is warranted that would extend far beyond the Fund's prospective role.

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