

The Future of the IMF

by

Nouriel Roubini

Stern School of Business, NYU

and

Roubini Global Economics¹

and

Brad Setser

Global Economics Governance Center, University College,

Oxford

and

Roubini Global Economics

October 2005 (Updated September 2006)

Paper for the 2007 World Economic Forum

¹ nroubini@stern.nyu.edu; brad_setser@msn.com; Roubini Global Economics: www.rgemonitor.com

IMF warnings are rarely heeded. Voting weights on the IMF board no longer reflect countries' current economic clout, calling into question its legitimacy as a referee of global problems. Calls for regional institutions to address regional financial problems are growing. A key source of the IMF influence in the 1990s and early years of this decade – its ability to lend out its pot of reserves to countries in need – seems less relevant to a world where many emerging market economies have too many reserves, not too few, and spend too little, not too much. No surprise, the IMF is in something of a funk.

There is no doubt that the IMF needs to evolve along with the global economy. There also should be little doubt that a global economy needs an effective IMF. The policy choices of every country, acting on its own, or the actions of individual market participants, looking out for their own immediate interests, can put international monetary and financial stability at risk. A global institution like the IMF is needed to:

- Identify potentially dangerous imbalances in the global economy early on, and encourage countries to take action to reduce those imbalances. If imbalances do reach unsustainable levels, the IMF can help to ensure a coordinated global response to these imbalances. An effective policy response usually requires adjustments in both debtor countries (right now, the US) and creditor countries.
- Serve as referee for disputes over exchange rates. The IMF needs to assure that countries do not use their exchange rate policies to prevent necessary adjustments to the global current account; the likely alternative to a global referee is unilateral action, and growing protectionism.
- Coordinate the provision of crisis liquidity – conditioned on necessary policy adjustments -- when the uncoordinated actions of market participants results in liquidity runs that could give rise to costly crises. Crises in major emerging economies can impact the entire world, not just the individual country and its creditors. Plus, by lending when others cannot and thus helping to shape the policies adopted by a debtor in default, the IMF can help to coordinate a sovereign debt restructuring.

So long as the IMF shareholders, management and staff do not shy away from taking on the core problems of the global economy, the IMF will remain at the center of cooperative attempts to address global financial problems.

In the fall of 2005, Barry Eichengreen, called that IMF a “rudderless ship adrift in sea of liquidity.” The sea of liquidity has only gotten larger since then. Global reserve growth continues at an unprecedented pace, with China and the world's oil exporters in the lead. But the repayment of many of the large loans the Fund extended earlier this decade – both Brazil and Argentina repaid the Fund in full around at the end of 2005 – seems to have helped the IMF find a rudder. Rodrigo de Rato is pushing for essential updates in the Fund's governance structure and a new process for multilateral surveillance has firmly made the Fund an advocate for a coordinated global response to global imbalances.

Most key players in the global economy are likely to conclude that a reformed global institution capable of delivering global solutions is preferable to regional solutions. Countries' financial defenses are not tested when global growth is strong, global interest rates are unusually low and private capital is flowing to emerging economies, but rather when growth slows, interest rates rise and private capital flows out. The IMF should be taking advantage of this period of relative calm to update its lending policies. The world economy has had little need for policy coordination when surplus countries are willing to finance a growing US current account deficit – and when the US economy was growing even as the Federal Reserve was raising US rates. That may change if the American consumer is no longer willing to borrow quite as much to spend as US home prices head south, or if the rest of the world is no longer willing to increase the amount of credit it extends to the US if the Federal Reserve cuts short-term rates in response to a slowing US economy. Disputes over exchange rates will likely become more vociferous should the global economy slow. The orderly resolution of global imbalances likely requires more – not less – multilateral surveillance.

Each of these points is worth exploring in more depth.

Regionalism is an unattractive substitute for reformed global institutions

Asia has been threatening to create an Asian Monetary Fund; the U.S. seems to be disillusioned with multilateral institutions, often preferring unilateralism; Europe is focused on its own neck of the woods. A world where Asian economies work together to take care of financial troubles in Asia, Western Europe protects the accession countries in Eastern Europe and the US unilaterally responds to trouble in Latin America and the strategically important Middle East is not impossible to imagine.

That is a world where global institutions like the IMF would be marginalized. Its remit, in practice if not in theory, would be limited to countries that fall outside the orbit of regional “financial” hegemon. The IMF would set the macroeconomic policy framework for African countries dependent on concessional aid flows from the G-7 and other rich countries, but do little else. The activities of the IMF and World Bank would become harder and harder to distinguish from each other.

This vision has serious problems. Its “architecture” leaves truly global problems unaddressed, at a time when a truly global problem – the so called global imbalances – looms over the world economy. The surpluses that finance the unprecedented US external deficit are found all over the globe -- in Asia, in places with lots of oil, and even in Latin America. Coordinated global efforts to stimulate demand in all surplus regions would make it easier to bring down the US deficit – provided, of course, that the US is also willing to take steps to reduce its need for external financing.

Moreover, relying on regional hegemonies and institutions to solve regional financial problems is not without its difficulties. The United States' first impulse when confronted with a crisis in its backyard – Mexico – was to take care of the problem on its own. But the Clinton Administration's plan to have the US government guarantee a large Mexican

bond issue ran into problems on Capitol Hill. The Clinton administration concluded that it was better to share the burden of crisis lending globally -- and worked hard to build up the IMF's lending capacity, not the United States' bilateral lending capacity. Ironically, the Bush Administration, generally no friend of multilateral institutions or standing alliances has through its actions, if not its rhetoric, recognized the wisdom of the multilateral approach. Look at the large IMF loans extended to Argentina, Brazil, Uruguay and Turkey. Europe's own institutions for regional cooperation are well developed, but its institutions for extending rescue loans are not. Neither the Commission nor the ECB is set up in ways that would make the financial "bailout" current and future accession countries easy.

An Asian regional response to financial troubles in a major Asian economy poses even larger problems. Asia's potential financial hegemon -- Japan and China -- are themselves strategic rivals. Their capacity to act jointly remains untested. Asia likes to complain about IMF conditionality, but it is not clear that either Japan or China -- both traditionally stingy lenders on a bilateral basis -- would be prepared to lend \$20 billion to an Asian country in distress without strict conditions; yet concerns about regional solidarity may make imposing tough conditions on one Asian country by another difficult. Continuing to outsource crisis conditionality to global institutions remains a better alternative to developing effective regional institutions, as the world needs institutions able to reach agreement on the hard questions.

IMF Governance Reform

All three key regions in the global economy have reason to prefer effective global financial firefighting to purely regional solutions. And fortunately, the reforms needed to give the IMF renewed global legitimacy are relatively easy -- at least compared to the reforms needed in the other key post-war international institutions. The needed reforms do not require changing the fundamental principle of IMF governance, which is one dollar (one SDR) one vote, not one country one vote or one person one vote. They simply require shifting the distribution of IMF "chairs" and "shares" so that they reflect countries current economic clout, not their economic clout in 1950, 1970 or even 1990. Right now, Europe is clearly overrepresented, and Asia is clearly under represented.² The basic outlines of a solution are well known: Asia's voting weight needs to be increased; and both Europe's voting weight and the number of chairs occupied by European countries need to be reduced. Even if the Eurozone is not willing to consolidate its representation into a single chair, there is no reason, for example, why the Benelux countries should have two chairs on the board.

The US is not overrepresented, but revitalizing the IMF would clearly be far easier if both the US and Europe show a bit of flexibility. Europe needs to recognize that it will not maximize its real power if it maintains an overweight position in an institution that plays a smaller and smaller global role. And the US needs to recognize that changing the way

² Europe (including Russia) accounts for 40% of IMF's voting weight, and holds up to 10 of the 24 seats on the IMF's Executive Board (Spain and Mexico rotate sitting on the Board). Japan, China, India and the rest of East Asia account for only 16% of the IMF's total vote, and hold only 5 chairs.

the existing pie is divided is politically far harder than divvying up a growing pie in slightly different way. The recent agreement on an “ad hoc” increase in the quotas of China, Korea, Mexico and Turkey was easy. The Fund’s total size increased only modestly, by around \$5 billion, and no one had to give anything up. The next step of this two-step reform will be far harder. Letting the IMF’s resources to grow in line with a growing world economy -- a generalized increase in quotas - would make the redistribution of relative quota share from Europe to Asia far easier.

IMF should remain prepared for a more unstable world

The case against a bigger IMF is simple: the IMF currently has as much money as it needs. That view, however, is short-sighted. Capital is not going to flow from relatively poor emerging markets to the United States forever. High-savings Asia may be able to finance its own development – though traditionally, rapidly growing Asian economies have not also financed the US. But low savings regions like Latin America and Africa are unlikely to be able to sustain the investment needed for rapid growth without drawing on the world’s savings. Private flows to emerging markets are already back at their pre-crisis levels, though right now, that private flow is financing the extraordinary levels of reserve accumulation in emerging markets, not large current account deficits.

But even today, not all emerging markets are in great shape. Some emerging market economies – above all China -- clearly have more reserves than they need. But others -- Brazil, Turkey, Philippines, and Indonesia for example -- do not. At least not yet. All these countries have still relatively large stocks of domestic debt and comparatively small reserves, and one of the lessons of recent crises is that if a country’s own citizens lose confidence in their own government’s ability to honor its financial commitments, a crisis soon follows.

We should not forget that IMF lending peaked in 2003 – not in 1998 and the IMF had a larger stock of outstanding loans in mid-2005 than it did in mid-2000. Forecasts that the IMF no longer needs to be ready to lend to countries temporarily short of hard currency are rather premature. The IMF should be using the current lull to draw lessons from this experience and to put in place policies that clarify when it should lend, and when it should not. Neither large bailouts loans to countries (temporarily, one hopes) short of foreign currency nor major sovereign debt restructurings are likely to disappear.

But without the impetus of an actual crisis, pressure to develop a more realistic IMF lending policy has disappeared. The IMF’s major shareholders (The G-7 countries) are in theory committed to trying to get the IMF to go back to its traditional lending limits - limits that have not been upheld in major crises since Mexico. The irony is clear: the G-7 wants to scale back emerging economies ability to borrow reserves from the IMF at a time when emerging economies have concluded that they need far more reserves to navigate through the turbulence created by volatile international capital flows. The stewards of global financial order want to scale back the insurance provided by the IMF just as emerging markets – by their decision to build up their reserves, a form of self-insurance – decided that they needed far more insurance.

The absence of a greater willingness to engage in an honest dialogue about the IMF's lending role is unfortunate. There are plenty of important issues to resolve. Not only is there a large gap between the amounts the IMF in theory says it will lend and the far larger amounts that it has actually lent in recent crises, but it is also clear that the IMF – in times of crisis – has been pushed to do far more than just lend out reserves to meet short-term financing needs, the classic role of a lender of final resort. In some cases, the IMF has acted more like a long-term financier of last resort to strategically important countries. Turkey is a prime example – IMF financed a long-term program of fiscal consolidation to let Turkey grow out of a debt problem. Turkey looks to be a success, but it is still not clear to us that the IMF should be in the business of long-term financing for middle-income countries.

The G-7 claim (without much credibility) that IMF should never lend out large sums again. Emerging economies often say the IMF should always lend out large sums to help avoid debt restructuring (or change in its exchange rate regime). Neither is right: a sensible compromise would raise the IMF's lending limits to reflect country's need for more borrowed reserves, but also set out stronger expectation that IMF funds would be lent out only for short-term needs.

An IMF structured to lend out large sums, but that only lent those large sums for truly short-term needs would not be in a position to give every emerging market the credit line needed to avoid any debt restructuring. A key lesson from Argentina is that if country starts out with high levels of debt (particularly in conjunction with an overvalued exchange rate), IMF funds should be used to “soften the blow” from the restructuring, not to finance a futile attempt to avoid any restructuring – and in Argentina's case, maintain an overvalued exchange rate. After Argentina defaulted, the IMF – in part because it lacked support from the U.S. Treasury -- largely abdicated its role as crisis manager, and did not work to set out an economic framework that would guide Argentina's debt restructuring. The United States wanted to leave economic policy negotiations to Argentina and its private creditors; in practice, this “hands-off” policy meant that Argentina unilaterally decided how much it wanted to adjust, and how much it could pay. The IMF remains needed to perform a debt sustainability analysis and help a debtor in default (or needing a debt restructuring) set out an economic adjustment program that creates the basis for rapid agreement on a debt restructuring and quick economic and financial recovery.³

Managing the international monetary system

Right now, the most pressing issues facing the Fund do not center around Fund lending – but rather the Fund's capacity to encourage countries to take the steps needed to prevent

³ U.S. Under Secretary Tim Adams seems to have backed away from the “hands-off” policy of his predecessor, though his commitment to a stronger IMF role in future debt restructurings remains largely untested. For a more systematic discussion of the role of the IMF in crisis resolution see Nouriel Roubini and Brad Setser “Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies” Institute for International Economics, 2004.

financial vulnerabilities from rising to levels that risk a major crisis. And even more unusually, the biggest risk of a crisis comes not from the emerging world, but rather from the Fund's biggest shareholder – the United States.

In recent years, innovations in IMF surveillance have largely been motivated by the need to do a better job of identifying potential vulnerabilities in emerging market economies. The Fund is paying more attention to the health of country's banking systems – as it must if its lending is often used to allow a national central bank to act as a lender of last resort in dollars (or other foreign currency) to its local banking system. The Fund has refined its analysis of debt sustainability – as it must if it wants to differentiate between temporary liquidity problems that can be financed with short-term money and deeper solvency problems that cannot be financed. And it is looking more at so called balance sheet vulnerabilities, like the currency mismatches that remain pervasive in many emerging economies. Indeed, its analysis of the balance sheet vulnerabilities of some key emerging markets – like Lebanon and Turkey – far surpasses typical market analysis in its depth and quality.

Now it is hardly the time to stop worrying about these vulnerabilities. One of the advantages of a global institution is that it can learn from the problems of a wide range of countries, and help countries in one part of the globe avoid making the same mistakes countries in another region have already made. Many emerging market economies remain a long way from a truly clean financial bill of health. Large external deficits and growing external debt loads are clearly less of a concern than in the past. But domestic debt levels remain high – and in a globalized world, if a country's citizens lose confidence in the country's government or the local banks, they will quickly shift their funds abroad. If the global housing bubble bursts (slowing global growth), if the growth of credit derivatives concentrates risk in the hands of leveraged institutions rather than dispersing it or if US interest rates rise suddenly, some of these latent vulnerabilities may come to the forefront.

Increasingly, though, Fund surveillance needs to do more than just strive to identify financial vulnerabilities in emerging markets early enough so that they can be corrected without a crisis. The Fund also needs to identify national policies that act as impediments to the global adjustments needed to bring about an orderly rebalancing of the world economy. And it needs to do so in forums that count. The IMF's research department has not hesitated to highlight the risks posed by widening imbalances in the World Economic Outlook. But too often the Fund's actual dialogue with its member countries left out the need for national policies to support global adjustment.

Important steps have been taken to try to address this weakness. Agreement to launch a new multilateral surveillance process that would bring surplus and deficit countries together to discuss how both can take constructive steps to promote global adjustment was enough to turn Morgan Stanley's bearish chief economist Steve Roach bullish. We aren't quite as optimistic. The Fund has identified the right people to gather around the table. The Gulf Cooperation Council countries and China are now as important sources of the global current account surplus as Japan. A fall in the US deficit clearly would be

far easier if Europe's current import boom continues, helping to support global demand growth during the adjustment process.

But getting the right group around the table is the easy part; getting those countries to agree to change established policies is likely to prove to be far more difficult. Consider the most prominent deficit and surplus countries. The United States continues to argue that fiscal deficits have little link to current account deficits, and refuses to countenance higher taxes to help close its structural fiscal deficit (and restrain demand growth). China continues to argue that its exchange rate peg isn't the reason for its soaring current account surplus. And it has shown little willingness to allow the RMB to appreciate meaningfully. The nominal appreciation in the RMB in the first six months of 2006 was less than 1% -- barely enough to make up for lower Chinese than American inflation and not enough to offset the dollar's depreciation against the euro in the same time period. China's willingness to allow a faster rate of appreciation of its currency remains unclear.

The Fund has not hesitated to call on the United States to implement a more ambitious program of fiscal adjustment, one that aims to eliminate the fiscal deficit over the course of the economic cycle. It has been less willing to identify the policy changes needed in surplus countries. IMF surveillance has been somewhat asymmetric. The IMF has, correctly, argued that the US fiscal adjustment program is insufficiently ambitious, but it has not said anything similar in public about China's (tiny) renminbi revaluation and it remains largely silent -- at least when it counts -- on the Gulf countries policy of pegging their currencies to the dollar. Yet the recent growth in China's surplus has been every bit as impressive as the recent increase in the US deficit, and it hardly makes sense for the Gulf's real exchange rate to depreciate even as the real value of their oil exports has increased. The fact that many surplus countries -- China and Saudi Arabia included -- have tied their currency closely to the currency of the world's biggest deficit country is clearly an impediment to effective global adjustment.

The Fund traditionally has been uncomfortable acting as a referee that calls out inappropriate exchange rate pegs, and, ironically given its mandate, is generally far less comfortable doling out advice on a country's exchange rate policies than on a country's fiscal policy.⁴ That was true when a country like Argentina intervened heavily to maintain an overvalued exchange rate, and it remains true when countries like China, Malaysia, Russia and Saudi Arabia intervene heavily to keep their currencies from appreciating. Argentina's steadfast defense of its own exchange rate put its own financial health at risk. China's steadfast support for the U.S. dollar has not directly put its own financial health at risk -- China's external balance sheet is strong. But the surge in domestic money growth associated with China's rapid reserve growth is one reason why China has had trouble controlling domestic credit growth and preventing its economy from over-heating. Yet even with strong domestic growth, China's current account surplus is surging -- it will likely top \$225b, or 8% of China's GDP in 2006.

⁴ The Fund's articles allow a country to pick its own exchange rate regime -- every country clearly has the right to peg its exchange rate if it so wants. But that does not mean a country can peg its rate at any level it chooses and not be subject to external criticism. The Fund's articles explicitly give the fund a role in identifying exchange rate policies that are an impediment to effective global adjustment.

Reigning in domestic demand to curb over-heating without letting the exchange rate adjust would likely lead to an even larger surplus.

The IMF needs to be more willing to call out countries with undervalued exchange rates as well as countries with inappropriate fiscal policies, but it also must act with care. The IMF should focus on all exchange rates that impede global adjustment – not just those that are most politically salient in the US. If oil prices stay as high as the futures markets now predict, the oil exporters' dollar pegs are probably as big an impediment to global adjustment as China's peg. And the IMF needs to continuously remind the US that if surplus countries adjust, deficit countries like the US will be forced to adjust too. Finally, the IMF needs to be aware that calling China's exchange rate regime an impediment to global adjustment may have a larger impact than calling US fiscal deficits an impediment to global adjustment. In fact, the United States big creditors – right now, China, Russia and Saudi Arabia -- have not cut back on their financing of the US after the US signaled that it plans to ignore the IMF's fiscal advice. But the US might well start a process that would lead to much higher tariffs on Chinese goods if China ignores a clear IMF signal that it is pegging to the dollar at too low of a level.

The Fund's reluctance to go beyond vague calls for greater flexibility, and to identify countries with undervalued currencies, reflects its desire to avoid being a club that beats up on Asia – particularly at a time when Asia is underrepresented inside the Fund. But the alternative to having the IMF act as an umpire that identifies when countries' exchange rate policies are acting as an impediment to global adjustment is not a continuation of the status quo. Trade tensions are rising. They could well boil over, particularly if the US economy slows – as now seems likely. If the IMF does not act, the US eventually will take the law into its own hand and charge China of currency manipulation, and acting as plaintiff, judge and jury in that trial. Such unilateralism would not be a good outcome for the international financial system.

A renewed focus of IMF surveillance on exchange rates, exchange rate regimes and the global balance of payments is not simply a necessary response to the current conjuncture. Looking ahead, it is reasonable to expect large changes in the world's monetary and exchange rate arrangements over the next few years. Hong Kong is unlikely to combine a de facto monetary union with the US and a political union with China for ever. Asia more generally is likely to find another way to maintain stability in intra-Asian exchange rates other than by linking their currencies, either formally or informally, to the U.S. dollar. Oil exporters would be better served pegging to the Canadian dollar or another "commodity" currency than the American dollar. Africa probably has too many currencies. New monetary unions may form. Some existing monetary unions may come under pressure. Some smaller countries may dollarize or euroize. As exchange rate arrangements evolve, the IMF needs to work to make sure national choices are consistent with global interest in financial stability, and countries do not solve national problems by pushing their costs onto the rest of the world.

Conclusion

A globalized world may finance domestic imbalances for longer – but it does not eliminate the risks created by sustained exchange rate misalignments or poor macroeconomic policies. Global imbalances and national financial crises that can spill over into global markets are best addressed by a global institution like the IMF. But the IMF's ability to act in the global interest hinges on a governance structure that is up to date, and reflects current global realities. A global institution like the IMF can learn from all countries' experience, and draw on that experience to help assess country's debt sustainability – as well as to look for weaknesses on national financial systems and balance sheets. But crises in emerging markets will not disappear; the IMF's ability to lend in a crisis makes it the central institution for crisis resolution. The IMF can work to try to ensure that financial and current account imbalances are addressed rather than ignored – and that they are addressed by policies that are not destructive of global prosperity. The core insight of Keynes and Dexter-White – a global economy needs global institutions – will continue to stand the test of time.