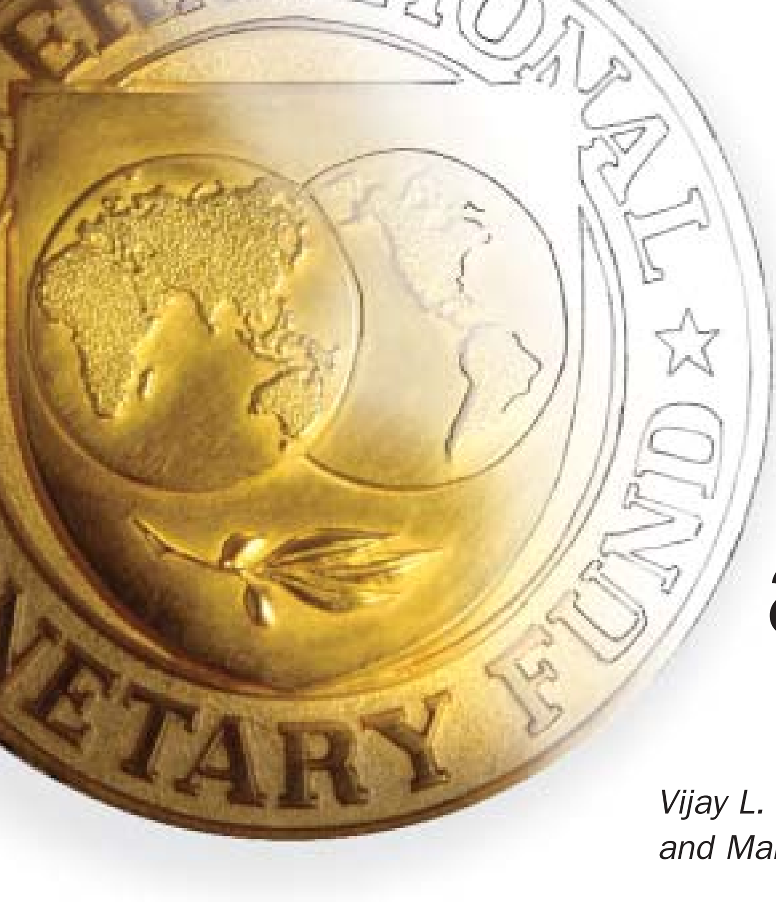

Time for CHANGE at the IMF

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How the institution should be transformed to address new forces shaping the global economy

VIABLE international institutions reflect the historical necessities of a particular period, and the strength of any institution lies in its ability to adapt and serve changing economic and political forces. The International Monetary Fund (IMF or Fund) served the dynamic economic forces that shaped the second half of the 20th century well (see "The IMF at 60," *F&D*, September 2004), but now, with a new set of forces in play, it is time for the IMF to adapt to present needs rather than the geopolitical priorities of the past century. This article sets out an agenda for change, proposing an improvement in both the functioning and the governance of the IMF. A transformed IMF would bolster economic cooperation, enhance economic security, and promote globalization that would benefit all, not just one particular region or group of countries.

New global political economy

The governance of the global political economy requires institutions that reflect the changing distribution of economic power in the international system. For the IMF to be effective, it will have to adapt to meet the challenges of seven key economic forces that are profoundly altering the global economic map and power centers.

- *New technology.* Driven by an expanding knowledge-based economy and intensified competition, new technology is simultaneously boosting productivity and increasing economic globalization and interaction.
- *Private capital flows.* These flows now dominate the global economy, fueling economic growth and sometimes magnifying economic crises when capital is abruptly withdrawn.
- *Shifting global demographic balance.* Populations are aging in advanced economies, while developing economies have high ratios of working-age populations. This shift will result in higher capital flows to countries with younger populations, boosting growth rates in developing countries.
- *Influence of emerging market economies.* Their share in global output and trade has grown significantly and is projected to increase further in the first half of the 21st century.
- *The rise of Asia in the global economy.* Three of the world's four largest national economies in terms of GDP (valued in purchasing power parity [PPP] terms)—China, India, and Japan—are in Asia.
- *Growing regionalism.* As the IMF has been slow to restructure itself, a new debate in favor of regional monetary arrangements has emerged.
- *Greater transparency and accountability in government, companies, and international institutions.* A growing international consensus among policymakers, politicians, and

other elites emphasizes the critical importance of democracy, human rights, transparency, and accountability to the electorate. For the IMF this means the need for greater parliamentarian oversight and greater openness in IMF-sponsored programs.

Based on the changing circumstances of the 21st century, we are suggesting that, while maintaining the founders' spirit, the IMF should make fundamental changes in the following areas.

Capital base

The first and foremost requirement for managing the new wave of globalization is to strengthen the resource base of the IMF. The capital available to the IMF today is too small compared with global GDP, the levels of global trade, international capital flows, or any other comparable indicators for global liquidity.

A relatively small number of large players dominate the global capital market and, at times of crises, their procyclical herdlike behavior can severely destabilize a national economy or regional economies. The IMF could be the needed countervailing power. The IMF needs the ability to act speedily so that the concerned economy or region can get back on track. To do so, the resource base of the IMF must be increased. The potential loss to the global economy of failing to act is much higher than the opportunity costs of a larger Fund size.

No precise formula exists to determine the optimal Fund size, but there are risks attached if it is too small. Its size, measured in the IMF's Special Drawing Rights (SDRs), compared with any relevant parameter, has shrunk significantly. There has been no general increase in quotas since 1998. Traditionally, the level of aggregate quotas is assessed in relation to key economic indicators included in the quota formula. Given the greater prevalence of flexible exchange rates, especially compared with the immediate period after Bretton Woods, and the growth in private capital markets, the Fund today does not need to be as large, relatively, as when it was set up. Nevertheless, although the capital base of the IMF increased from SDR 61.1 billion in 1978 (Seventh Review of quotas) to SDR 212 billion in 1998 (Eleventh Review), since 1978, the size of the Fund has shrunk significantly when compared with a variety of global indicators. Total quotas fell from 8.5 percent to 1.8 percent in relation to global current account transactions, from 1.4 percent to 0.8 percent in relation to GDP, from 33 percent to 9 percent in terms of foreign exchange reserves, and from 9 percent to 4 percent in relation to world imports.

In addition to an increase in quotas, the IMF could also increase the amount it has for addressing crises by borrowing from capital markets and by creating self-liquidating temporary SDRs to meet liquidity needs. This would be accompanied by a revision of its access policy and a strengthening of bilateral and multilateral economic surveillance. Access to IMF loans, such as a Stand-By Arrangement or the Supplemental Reserve Facility, ought to be guided by the financial requirements of the member country and not determined by its quota size as now. While the 2002 United Nations Development Program's *Human Development Report* rightly acknowledges that rich countries will always influence decisions of the international financial institutions, an increase in the size of the IMF will create room for smaller economies to increase their participation.

Voting rights

Another area for reform is country representation and voting power. The IMF is essentially governed by a quota regime, as it is the quota that decides a country's voting power on the Executive Board. IMF members receive 250 "basic votes" plus one vote for each SDR 100,000 of quota. The basic vote is designed to protect the interests of smaller states, but successive general increases in quotas have reduced the share of basic votes to 2 percent from 11.3 percent in 1945. We propose an adjustment that would return the basic vote to its 1945 level and redistribute voting power through a set of weighted averages for GDP valued at PPP (88.7 percent) and basic votes (11.3 percent). Calculated this way, the results would appropriately reflect the economic weight of the developing countries without removing the veto power of the United States. The voting share of the advanced economies would drop from 62 percent to 51 percent; Asian, Latin American, and African countries would have a greater voice. The voting share of Middle Eastern countries, excluding the creditor Saudi Arabia, would remain about the same. The voting share of smaller European states would decline significantly, but the European Union (EU) would retain veto power. The proposed reform of the quota regime has a realistic chance of securing approval as it creates far more "winners" than "losers."

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The redistribution of voting power would not only redress the IMF's current imbalance among industrial, emerging, and developing countries, it would also create greater dialogue between members. In our view, veto power determined by different coalitions of states would encourage cooperation. EU countries and a coalition of Japan, China, and India ought to have veto power. Similarly, a coalition of Asia, Africa, and Latin America would enjoy a veto. This empowerment need not lead to deadlock because of the shared interests from growing global interdependence. As a political institution, the prescribed quota reforms would increase legitimacy and participation in the institution, promoting dialogue about the governance of the global economy.

These reforms will effectively address a major criticism of the IMF regarding its "democratic deficit." As the IMF works to set standards and harmonize rules to strengthen the banking and financial sectors of member countries, the ability of different states to participate will become increasingly important if the IMF wishes to remain relevant. The legitimacy conferred on mutually agreed rules represents an important means of reducing transgression or compliance that is only nominal. Enhancing democratic practices within the IMF can increase inputs from smaller members and alternative perspectives, thereby contributing to crisis prevention and management.

Restructuring the Executive Board

Currently, Europe has 10 chairs on the IMF Executive Board while Asia has only five and Africa has two. The Western Hemisphere has five chairs and Australia has one chair. Europe's share of global GDP, valued at PPP, is 29 percent while Asia's is 32 percent. Given present trends in growth rates, this difference between Asia and Europe will only move further in Asia's favor. Hence, there is little doubt that the IMF's governance structure, in terms of voting and number of chairs on the Board, requires restructuring if the Fund is to reflect current realities.

Merely changing the quota shares or reallocating chairs will not be enough to improve governance. The IMF's shareholders should fully empower the Board by making it truly independent to better manage the global economy. Consider the parallel demand for independent central banks to better manage national economies.

One solution is that every member of the Executive Board is elected by the parliaments or other representative bodies of the member countries. No one should be nominated to the Board even if he or she represents a single country constituency. The tenure of the Executive Board members should be fixed; it could be a six-year term, while every two years one-third of the Board is elected, providing continuity. To ensure the independence of Board members, there should be a one-term limit. Such reforms will make the Board truly independent, and the IMF will be able to attract eminent professionals to the Board; this would increase objective bilateral and multilateral surveillance and improve crisis management.

The Executive Board also needs to be made more accountable. One way to do this is to establish a set of benchmarks or memorandum of understanding, agreed on by shareholders, against which to measure Board performance. Another way of enhancing the IMF's accountability is by actively engaging parliaments, including those of creditor countries. After all, the IMF's accountability has to be to its shareholders, who in turn represent their parliaments, if they have them. The added advantage of engaging the parliaments would be improved policies and coherence, particularly among the large economies. In other words, economic surveillance would be more effective. The previous IMF Managing Director, Horst Köhler, had already begun the practice of briefing the elected bodies of major shareholders.

Economic Security Council

Because of the IMF's failure to represent the interests of all its 184 constituent members, some regions have considered acting on their own. In the case of Asia, this is no idle threat. The Asian central banks have accumulated more than $2 trillion in foreign exchange reserves. During the 1997–98 Asian crisis, there was talk of establishing an Asian Monetary Fund. Asia contains almost 55 percent of the world's population and some of the world's most dynamic economies. Although the case for an Asian Monetary Fund seems legitimate, such a fund would probably lead to the proliferation of regional financial institutions that would eventually prove counterproductive for the global economy. The spread of multiple financial institutions would create greater instability in the international system with respect to effective crisis management.

To avoid proliferation of regional financial institutions, the IMF should become an "Economic Security Council" for the world and act as the* universal *lender of last resort. The central role of the IMF would be to manage the present wave of intensified globalization in such a way that it promotes stable growth of the global economy, providing economic security to all. The Economic Security Council is an extension at the global level of the concept of better risk management through risk sharing by states. Studies show that for modern market-based economies to perform well, one of the most important roles of the government is the effective management of risks at both macro and micro levels as an integral part of its public policy framework. In this age, international organizations will have to help mitigate and share risk. After all, the Meltzer Commission in the United States has already proposed far-reaching reforms, suggesting that the IMF focus on short-term liquidity crisis assistance and eliminate long-term loans for structural reforms.

Conclusion

The dynamic economic forces of the second half of the 20th century were well served by the IMF, but it now needs to undergo institutional reforms so that the architecture of the international financial system reflects the new underlying forces. By putting decision making in the hands of a few rich countries, international institutions such as the IMF and the World Bank have done little to ensure that the concerns of the disenfranchised are heard. Reform at the IMF can go a long way toward revitalizing the institution and giving the developing world a greater say. It is perhaps high time to accept the proposal of British Chancellor of the Exchequer, Gordon Brown, calling for a new Bretton Woods Conference to undertake the needed transformation of the global financial architecture and create an IMF for the 21st century. ■

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