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February 7, 2006

REFORMS NEEDED TO REINVIGORATE THE IMF

Washington, DC—A package of reforms is needed to reinvigorate the International Monetary Fund (IMF) as the principal multilateral institution responsible for international economic and financial stability. Concrete action on IMF governance is the most critical component of this agenda. However, a complete package of IMF reforms should also encompass better policing of the policies of systemically important countries, including the United States; restoring the IMF's role as the lender of final resort; refocusing its engagement with low-income members; increasing attention to capital account and financial issues; and the IMF's potential need for additional financial resources. This is the central message of *A Strategy for IMF Reform* by Edwin M. Truman, an analysis published today by the Institute for International Economics.

Among the key recommendations are:

- At least 10 percent of IMF voting power should be transferred promptly from the industrial countries to the emerging-market economies.
- The IMF must be more proactive in its policy prescriptions—for example, it should indicate not only the direction but also the extent of needed exchange rate changes.
- The Fund should identify a set of reference exchange rates for the systemically important countries that is consistent with external and internal balance for them and the global economy.

The IMF faces an identity crisis. It is alternatively viewed as weak, ineffective, and asleep at the wheel or ominously powerful, offering advice that ranges from dangerous to irrelevant. The Fund is in danger of losing the support of many of its key members among emerging-market as well as industrial countries. Consequently, the global system risks the loss of the international public goods the IMF supplies. To reverse these trends, Truman advocates that the IMF management and the leaders of those key members must invest the necessary political capital to put in place a package of reforms encompassing six major areas.

IMF Governance

Substantial progress on IMF governance is crucial to enhancing the Fund's legitimacy and restoring trust in the institution by the vast majority of its membership. This urgent need is widely recognized, but leadership has been lacking. To fill this void, Truman makes three recommendations.

First, the members of the European Union should commit to combining over time their representation on the IMF Executive Board into a single seat. They should initiate this process by the end of 2006 by consolidating their representation from 10 to 7 seats. Truman argues that the United States should use its persuasive powers and legal leverage to accelerate this process.

Second, IMF voting shares must be substantially realigned by promptly transferring at least 10 percentage points from the traditional industrial countries to emerging-market countries, primarily in Asia. Truman thinks that this realignment will be possible only in the context of an increase in IMF quotas. He endorses a comprehensive approach involving the use of a revised, simplified quota formula to guide the political process.

Third, but less time critical, the United States and Europe should propose an open and transparent process to choose the next managing director of the IMF and president of the World Bank, dropping the convention that the former be a European and the latter be a US citizen.

Policing Economic Policies

The IMF is behind the curve on the central issue of the early 21st century: promoting macroeconomic and exchange rate adjustments to resolve global imbalances. Unless the IMF can more effectively discharge its responsibilities for the resolution, not merely the identification, of those imbalances and other systemic threats to global prosperity, it will become increasingly ignored. Truman agrees with the view of the IMF management that the IMF's influence over the policies of the 20 or 30 systemically important countries must start with sound analysis and quiet persuasion, but he would enlarge the IMF's toolkit in four ways:

- introduce stronger elements of “naming and shaming” into IMF reviews of important members’ policies including by being more concrete in Fund policy advice, for example, by not only calling for greater exchange rate flexibility but also stating how much exchange rates must change to accomplish the needed global adjustment;
- establish an overall framework for IMF surveillance of systemically important countries based on the achievement of external and internal economic balance in those countries and the global economy and by identifying an associated set of reference exchange rates;
- with respect to exchange rate policies, issue semiannual reports, make more frequent use of special or ad hoc consultations, and review Fund guidelines for surveillance over members’ exchange rate policies; and

- embark now on a collective special consultation with the major Asian economies as a group on their macroeconomic and exchange rate policies.

Global Lender Of Final Resort

The IMF must reassert its role in external financial crises. Truman recommends that the Fund actively explore new lending policies to give greater confidence to emerging-market countries that may have a potential need for IMF lending in capital account crises. In addition, the Fund should revert to its previous central role in all sovereign debt negotiations. It should publicly establish estimates of the “resource envelopes” available to a member following appropriate policies consistent with a sustainable trajectory for its external debt. The Fund should also indicate, at least to the country, its view of the parameters of a comprehensive settlement.

Refocused Engagement with Low-Income Members

The IMF cannot successfully be all things to all countries. Its principal mission is not poverty reduction, and it should not become another development institution. Therefore, Truman argues that the IMF’s engagement with its low-income members should embrace a thoughtful division of labor with the World Bank and limit its lending to low-income members to circumstances of short-term balance of payments assistance. In effect, the IMF’s Poverty Reduction and Growth Facility (PRGF) should be substantively transferred to the World Bank.

Capital Account and Financial Issues

Capital account and financial issues are central to the IMF's role in the 21st century. Truman endorses the consensus that the Fund should upgrade its capacity to provide analysis and policy advice on members' external and internal financial policies. Although it is not essential to clarify the IMF's role with respect to capital account policies, its members should accept the implicit long-run objective of full capital account liberalization. In reforming its activity with respect to financial issues, the Fund should concentrate on surveillance and the identification of members' vulnerabilities and leave most technical assistance in financial-sector issues to the World Bank.

IMF Resources

The IMF does not face an immediate need for additional financial resources. However, today's benign global economic and financial conditions will not continue indefinitely, and at some point the IMF will need to augment its resources. Consequently, the United States and other industrial countries should modify their message on IMF resources to state that they will support an increase in IMF quotas when the case is made, acknowledge that the case even might be made by early 2008 when the next review of IMF quotas is scheduled to be completed, and begin to lay the groundwork with their parliaments. They should also recognize that an increase in IMF quotas might well be a necessary element in addressing the overriding issue of IMF governance. In the meantime, the IMF should consider putting in place a mechanism to borrow from the private capital market in parallel with its consideration of how to provide the Fund with a stable source of income to finance its nonlending activities even if they are scaled back.

About the Author

Edwin M. Truman, senior fellow since 2001, was assistant secretary of the Treasury for international affairs (1998–2000). He directed the Division of International Finance of the Board of Governors of the Federal Reserve System from 1977 to 1998. From 1983 to 1998, he was one of three economists on the staff of the Federal Open Market Committee. He has been a member of numerous international working groups on international economic and financial issues. He is the author of *Inflation Targeting in the World Economy* (2003) and coauthor of *Chasing Dirty Money: The Fight Against Money Laundering* (2004).

About the Institute

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A Strategy for IMF Reform

Policy Analyses in International Economics 77

by Edwin M. Truman

ISBN Paper 0-88132-398-5

February 2006 • 124 pp. • \$23.95