

Point of View

Reform or Risk Irrelevance

Raghuram Rajan



Eight decades after Bretton Woods, the IMF must professionalize and depoliticize its decisions



If the IMF didn't already exist, we would have to invent it. After two once-a-century catastrophes in quick succession—the pandemic and the global financial crisis—countries have borrowed massively to help their people and institutions survive. More disruptions threaten as the planet warms and new pathogens emerge. Meanwhile, rising barriers to trade and investment hamper the usual mechanisms to bridge opportunity gaps between aging industrial countries and young developing economies. That growing disconnect has spurred millions of migrants to brave dense jungles and open seas to find a footing in the developed world, in turn increasing calls against global integration.

To better meet these challenges, we need an IMF that steers countries toward policies that support the fair international exchange of goods, services, and capital, and complements the World Trade Organization by underscoring the harm from not doing so. The Fund should also offer an independent voice on national

policies—especially those that threaten the country's macroeconomic stability—and serve as lender of last resort for countries that lose the trust of the markets. Unfortunately, while we do have an IMF, its anachronistic structure leaves it ill-positioned to carry out all these functions.

Legitimacy

The IMF requires legitimacy to meet the needs of its members. The Fund was established when the United States was the only superpower, endowed with economic strength that allowed it to remain largely above the fray and enabling it to be a credible, mostly impartial, enforcer of the rules governing exchange. Other countries did not begrudge its power to veto key decisions or its control, together with allies Canada and western Europe, of managerial appointments and operational decisions. This Western alliance has remained largely unchallenged until recently; in its heyday during the Cold War, the Soviet Union (and its satellite countries), although a military superpower, was still an economic midget and largely outside the global trading system. At its peak in the late 1980s, Japan, while a substantial economic power, was too dependent on the United States to challenge its hegemony—indeed, it is effectively part of the Western alliance today. Western control has been challenged only recently by China's rise as it becomes both an economic and military superpower.

Of course, complaints about underrepresentation of countries outside the Western alliance have been growing for a while. IMF member quotas represent their voting rights and the amount of their capital subscription payment to the Fund. The maximum a country can borrow under various circumstances from the IMF is also proportional to its quota. Japan's 6.47 percent quota exceeds China's 6.4 percent, even though the latter is now an economy more than four times

as large. Similarly, India's quota is less than those of the United Kingdom and France despite its economy having overtaken both in size. It is hard to see the rationale for such underrepresentation today, other than the Western alliance's desire to hold on to power.

The case for redistribution

The IMF needs perceived legitimacy and good governance, not just to facilitate negotiation of rules and to enforce those rules impartially but also so that it can decide how to deploy its resources correctly. There are reasons the Western alliance is no longer fit for purpose.

Unfortunately, US fears of being overtaken economically and, eventually, militarily, combined with its shrinking fiscal space, mean that domestic politics have moved toward greater isolationism. The United States has moved steadily from being the referee, generally motivated by the idea that openness benefits everyone, to becoming a player, wanting openness on its own terms. Yet it still wants to referee in organizations like the IMF. Politically, also, it is very difficult for any US or European administration to give up any of the powers they have, no matter how much their holding on diminishes IMF effectiveness.

With fiscal capacity tight across the world, the IMF increasingly must lend to troubled countries without additional support from the Western alliance. Because potential IMF loan losses are not visible on any government's books in the short run, and the Western alliance bears only a fraction of eventual losses (proportional to its quota share), it is tempting for it to use Fund resources to help friends or neighbors in need, even if lending is not economically viable. Although there has always been a political component to IMF lending, the IMF has had a greater chance of designing a successful rescue program and recovering its loans because of outside assistance from the Western alliance. For example, the United States contributed a hefty share of the 1994 rescue package for Mexico's crisis. The IMF may increasingly have to go it alone,

“The United States has moved steadily from being the referee to becoming a player, wanting openness on its own terms.”

with the Western alliance exercising control though with much less of its own money at stake.

Finally, the Western alliance itself is fraying. Donald Trump's administration had serious trade differences with Canada and western Europe, and it is not unthinkable that as the political makeup of governments changes, there will be less and less consensus in the alliance on economic direction. This could result in unpredictable decision making if the alliance still controls the IMF.

Quotas and oversight

If the Western alliance cannot be relied on to continue providing good governance, the case for redistributing IMF quotas based on the relative size of economies becomes even more important. But it also may have unintended consequences. As geopolitical differences fragment the world, could a hypothetical China-centered alliance, for example, block loans to countries tied closely to the Western alliance, or vice versa? Isn't dysfunctional governance better than absolute paralysis?

It might be, which is why a change in IMF governance should accompany quota reform: the executive board should no longer vote on every operational decision, including every lending program. Instead, independent professional management should make oper-

ational decisions for the benefit of the global economy. Board members should set broad objectives and periodically examine whether they are being met, perhaps with the help of the Independent Evaluation Office. In other words, the executive directors should focus on governance, much as corporate board directors do. They should set operational mandates, appoint and change management, and monitor overall performance, leaving day-to-day decisions to management.

In short, the way to avoid paralysis is to professionalize decision making and depoliticize it. When the IMF was established, John Maynard Keynes, fearing the undue influence of the United States, wanted a nonresident board. In the immediate postwar period, when long-distance communications were costly and travel, largely by steamship, took time, this implied a non-executive board and empowered management. Keynes was overruled by Harry Dexter White, the US negotiator at Bretton Woods. It is time to reexamine Keynes's idea, but given the improvements in communication and travel, to explicitly require that the nonresident board be decidedly nonoperational.

The board would select top IMF officials based on which candidates enjoy the broadest consensus, rather than giving certain countries or regions the right to appoint. Such a process would be unavoidably political, but as long as the board sets some basic qualifications for appointees, politicking will help forge consensus behind candidates, ensuring they can function effectively.

New versus old

The political impediments to dramatic IMF reform are sizable, including dominant members unwilling to cede power if they see it as potentially signaling political weakness domestically. It is far easier for member countries to take incremental steps, such as the recent quota review, and tell themselves that this is progress. Tough decisions can be kicked down the road to the next government and inevitably postponed again. If this is how the future evolves, the organization will carry on, but will be less legitimate

and relevant to the world's needs. The IMF will still be of value to developing economies but will have much less influence when it comes to helping the global economy adapt.

If quotas do shift to reflect economic strength without any other change in governance, China may eventually have the largest quota. Then, under the IMF's Articles of Agreement, IMF headquarters would have to move to Beijing. The politicization Keynes feared would continue, but potentially with a new set of political players and rules and a new set of dissatisfied and disengaged countries.

If, however, members reform quotas and governance simultaneously, an independent IMF could bring a fragmenting world together on key issues. To be palatable to the rest, such comprehensive reforms should happen soon, else the rest could well believe this is an attempt by the Western alliance to hold on to some influence just when power is finally shifting.

A reformed IMF could help determine new rules for international exchange, for instance by setting out a preliminary list of issues to be negotiated, taking the changes in the world economy into account. Given the complexity of the issues, it could bring together a small set of countries to do the initial negotiations under its *multilateral consultations* framework. If the IMF gains sufficient broad trust, it could shape these new rules and enforce their implementation. And it could sharpen its analysis and better advise countries on macroeconomic and external sustainability while lending more effectively to set countries back on track.

Eighty years after Bretton Woods, the world must decide whether to reform the IMF to better engage with members and address their challenges—or fail to act and let the Fund fade away. **F&D**

RAGHURAM RAJAN is a professor at the University of Chicago Booth School and previously served as governor of the Reserve Bank of India and economic counsellor at the IMF.



Special Drawing Rights Reconsidered



Edwin M. Truman

Countries could better address the world's economic challenges with help from the IMF's global reserve asset

Congratulations to members, staff, and leadership on the 80th anniversary of the IMF's foundation at Bretton Woods, New Hampshire. The Fund is the crown jewel of the post-World War II international architecture. It was designed by idealists determined to construct a set of institutions to deter aggression among the major powers and prevent resumption of the interwar economic and financial unilateralism.

The IMF's principal purpose, according to its Articles of Agreement, is to promote international monetary cooperation by providing "the machinery for consultation and collaboration on international monetary problems." In the turbulent period following the end of US dollar convertibility to gold in August 1971, members demonstrated that principle and quickly completed the Smithsonian Agreement by December. The agreement's new par values for fixing currencies to the US dollar did not hold, though, and within two years, the Bretton Woods exchange rate regime dissolved into a system of managed floating exchange rates.