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IMF at 60

Reflections on reform at the IMF and the demands of a changing world economy

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ANNIVERSARIES are a time for introspection. For the IMF, July 2004 marked the 60th anniversary of the conference in Bretton Woods, New Hampshire, when delegations from 44 allied countries drafted and agreed upon the IMF's charter. The world economy has undergone a sea change in these 60 years, and the IMF's membership has expanded to 184 countries. The IMF's role and work have evolved in response, but, like any large organization, its ability to change has been limited by its own rules and mandate and has been held back by inertia. That inevitably leads to some mismatches between the reality and the ideal, and this year's anniversary—coupled with the arrival of a new Managing Director—offers an opportunity to reflect on how those gaps might be closed in the coming years.

Turbulent birth

The IMF was founded toward the end of World War II to establish a multilateral framework for trade and finance that would help countries avoid the failings that had characterized the interwar period of the 1920s and 1930s (see time line, pages 14–15). During those two turbulent decades, there had been no agreed upon system for adjusting exchange rates or for linking exchange rates to economic fundamentals. Governments had drifted toward autarky and had implemented "beggar thy neighbor" policies in efforts to gain a competitive edge over other countries. A proliferation of preferential bilateral and regional trading arrangements had undermined multilateral trade. And many countries had restricted the international convertibility of their currencies as a means of stabilizing and limiting capital movements.

Largely as a result of these and other weak and self-defeating policies, international mobility of private financial capital had been limited in the 1930s. When finance officials from around the world gathered at Bretton Woods in 1944, they expected private capital movements to remain limited in the postwar years. Moreover, largely because of the differential economic impact of World War II on the Americas and other regions, one country—the United States—held a predominant position in trade and even more so in finance. The goal of the founders at Bretton Woods was to reestablish multilateral finance gradually and in a way that would support and not destabilize international trade as the world economy regained its bearings.

Cumulative change

For the first two decades after Bretton Woods, the world economy did change gradually, but the cumulative effect was dramatic. The first major change to affect the IMF was the

Photos from the 1944 conference in Bretton Woods and from the first Board of Governors meeting, Savannah, Georgia, 1946.

growth in economic and financial strength of countries outside North America. At the end of World War II, the United States accounted for 22 percent of world exports and held 54 percent of official international reserve assets. Those percentages were reflected in a 33 percent quota share for the United States in the IMF, and it was broadly accepted that the Fund would not make any major decisions without U.S. approval. (The Articles of Agreement were formulated so as to require an 85 percent majority for certain major decisions and 50 percent for most others. In practice, management normally deferred to the United States on any controversial issue, including ordinary lending decisions.) The extent of U.S. power and influence in the IMF was bound to decline as other countries regained their footing.

Western **Europe** gradually fulfilled expectations by restoring currency convertibility in the 1950s, replacing bilateral trade arrangements with open multilateral trade, and achieving strong economic growth. The Federal Republic of Germany, which joined the IMF in 1952, enjoyed a particularly rapid ascent. Following the formation of the Common Market in 1957, a series of increasingly tight monetary arrangements enabled a European currency zone to emerge. Europe thus strengthened its position in the world economy and maintained its position in the Fund hierarchy.

"The expansion of IMF lending to mitigate capital account crises in the 1990s was both inevitable and inherently controversial."

A less expected and, ultimately, even more significant development was the rise of **Asia** as an economic power. That development began with Japan, which also joined the IMF in 1952. By the late 1960s, the three largest economies in the world were the United States, Japan, and Germany. Many elements of Japan's success were later emulated by other rapidly developing economies in East Asia, including various economic regions of China, the Republic of Korea, Malaysia, and Thailand. Although Japan eventually (in 1992) obtained the second-highest quota in the Fund, and China's quota was raised sharply after the People's Republic assumed the China seat in 1980, Asian quotas generally lagged well behind the economic importance that these countries were reaching.

The **Middle East** gained economic importance with the rise in petroleum prices in the 1970s. Saudi Arabia, in particular, saw its IMF quota rise sharply. In the 1980s, Saudi Arabia became the Fund's principal creditor through a series of large loans.

In the IMF's original Articles of Agreement, **Latin America** was granted a special status that afforded it the right to elect 2 of the Fund's 12 Executive Directors separately from the other electing members. That provision was dropped in 1978 on the grounds that it was no longer necessary. The region then had quotas that were large enough to enable it to elect two Directors under the normal voting provisions, plus a third directorship that was shared on a rotating basis among Mexico, Spain, and Venezuela. By that time, **sub-Saharan Africa**, too, was (barely) able to elect two Directors.

The combination of these sweeping changes in relative economic importance and the tendency for most quota shares to be adjusted only marginally in the course of general quota reviews have resulted in a weak correspondence between quota shares (and voting power) and the size of a country's economy, international trade, and finance. While the U.S. share has declined by half in the past 60 years, that of Europe has changed but little, and Asia's has grown by less than most formulas would have suggested.

Another consequence of the narrow geographic locus of economic influence in the 1940s was an informal understanding that the United States would nominate the President of the World Bank (expected to be the larger and more important of the two Bretton Woods institutions) and would leave the nomination of the IMF Managing Director to the other members. Because the other members were dominated by Europeans, a tradition developed that this group would pick one of its own to be the Managing Director, subject, of course, to acceptance by the full membership. Again owing to inertia and the force of tradition, this situation has not evolved despite the rise in economic strength and influence of other regions. Non-European candidates have been considered or proposed on at least three occasions, but European governments have always coalesced and gathered sufficient support from other members in time to see the Managing Director elected from among their own ranks.

More fundamentally, the rise of multiple centers of economic power has brought changes in the world economy, to which the IMF has tried to adapt. By the 1960s, the Bretton Woods system of fixed but adjustable exchange rates anchored on the U.S. dollar had become a high-maintenance operation, propped up by ad hoc arrangements among the Group of Ten (G-10) industrial countries—swap agreements among central banks and the creation of a reserve pool to stabilize the price of gold—and by the creation of Special Drawing Rights in the IMF. Those temporizing arrangements failed to stem the tide, and the system collapsed in the early 1970s. In the aftermath, the effort to restore stability to the exchange rate system was extended well beyond the G-10 to include the full membership of the IMF, in the form of the ministerial-level Committee of Twenty (the forerunner of today's International Monetary and Financial Committee). Nonetheless, the outcome—a compromise in which the choice of exchange regime was left to each member country and the IMF was given a vague mandate to oversee the system—was negotiated separately by two of the original postwar powers, France and the United States.

Cold War divisions

The Soviet Union sent a delegation to Washington in January 1944 to negotiate provisions in the proposed postwar mone-

tary institutions that would make it possible for it to join. The delegation participated in the Bretton Woods conference that summer and signed the IMF and World Bank Articles of Agreement *ad referendum*. But when the deadline approached for ratifying the Articles in December 1945, the Soviet government opted out. The subsequent hardening of ideological differences into the Cold War induced the Soviet Union and its allies, along with the People's Republic of China and its allies, to remain outside the IMF for decades. The Fund staff's basic theoretical and ideological orientation around a liberal, mainstream economic policy strategy thus went largely unchallenged in internal debates, and much of the IMF's operational work could be directed toward supporting market-oriented outcomes.

The end of the Cold War—marked by the dismantling of the Berlin Wall in 1989 and the dissolution of the Soviet Union in 1991—affected the IMF in three ways.

- It led to a rapid increase in the number of members and to a near universality in membership.
- Servicing this increased membership required a large increase in the size and diversity of the staff: not just passport diversity, but diversity in backgrounds and expertise to cope with the structural issues associated with integrating the new members into the world economy and fostering a transition toward market economies.
- The nature of the political interests that influence IMF lending decisions shifted from those based on East-West conflicts to those based more on regional or internal security issues or on economic alliances.

More low-income members

When the IMF was founded, most of the continent of Africa was under European colonial rule. Only Egypt, Ethiopia, and South Africa were among the 40 original members of the Fund. Most other African countries gained independence and joined the IMF between the late 1950s and the early 1970s, and the rest joined by 1990.

Operationally, the first main effect of the rise in African membership was to generate a large group of potential borrowers that had very low per capita incomes and that could ill afford to borrow from the IMF on standard terms. To accommodate their needs, the IMF established a temporary Trust Fund in 1974, financed by sales of a portion of its holdings of gold, to lend on concessional terms for the first time. Repayments of Trust Fund loans eventually financed the Structural Adjustment Facility (SAF) starting in 1986. The Enhanced SAF, introduced in 1987, and its 1999 successor, the Poverty Reduction and Growth Facility (PRGF), enabled the IMF to continue offering longer-term concessional loans to low-income countries—mostly but not entirely in sub-Saharan Africa—through these administered accounts. More recently, the Heavily Indebted Poor Countries (HIPC) Initiative has enabled the IMF to support international debt relief efforts for many of these countries.

Money dealers exchanging orders from client banks at a foreign currency brokerage in Tokyo during the first trading day of the year.

A second and closely related effect was to immerse the IMF more deeply in issues of structural reform. The primary need of most African countries was sustained financing for development, which in turn required these countries to demonstrate a sufficient commitment to economic and governmental reform, stable implementation of sound macroeconomic policies, and economic openness to be able to attract donor support. The IMF had neither the resources nor the mandate to provide sustained financing, but it could and did try to adapt its financing and its policy advice to support the necessary strengthening and reform of economic policies. The scope of program design and policy conditionality expanded greatly in the 1990s, but the benefits were limited. In 2002, the IMF adopted tighter guidelines to streamline and better focus its structural policy conditions.

Globalization of financial markets

The growth and globalization of private financial markets have also had major effects on the IMF. At the close of World War II, the role of private international financial flows was very limited. Cross-border portfolio flows were circumscribed by national controls and currency regulations, with the effect that currency speculation was, for the most part, restricted to leads and lags in settling trade credits. The

founding fathers of the IMF were quite content to see that situation continue, as they believed that speculative flows served primarily to destabilize exchange rates.

This combination of limited activity and general distrust had important effects on the design of the IMF, but those effects have largely been overtaken by events. Consequently, actual practice has differed from the original plan.

- First, Article VI of the Articles of Agreement was drafted to prohibit the Fund from lending to a country "to meet a large or sustained outflow of capital." A country that failed to take action to prevent such an outflow was not to expect the IMF to bail it out. Once private capital markets began to grow and spill across borders, however, the distinction between IMF lending for current and capital account transactions became meaningless. The expansion of IMF lending to mitigate capital account crises in the 1990s was both inevitable and inherently controversial.
- Second, the IMF was empowered by Article VI to compel a country suffering a capital outflow to impose capital controls as a condition for borrowing from it. Since countries came to view either devaluing or borrowing from the Fund as preferable to imposing capital controls as a means of stemming a capital outflow, the IMF has never invoked this provision.
- Third, the IMF's jurisdiction over exchange controls and its responsibility for overseeing their dismantling were restricted to controls related to payments on the current account. Countries would be in compliance with the provisions of Article VIII once they had eliminated controls over currency exchange for current account payments and had agreed not to reimpose such controls, irrespective of any controls on capital flows. Nonetheless, although the Fund lacks formal jurisdiction over the liberalization of the capital account, it has regularly used its surveillance and technical assistance roles to encourage and assist country officials in this direction.

The increase in the breadth and depth of international private capital markets has also altered relationships between the IMF and its member countries by creating a class of members that have no likely prospect of ever drawing on Fund resources. The IMF was designed as a rotating fund on which any member might draw in time of need. Starting in the early 1960s, however, the more advanced economies developed various financing alternatives, starting with swap agreements among central banks but later relying primarily on borrowing in private markets. The combination of access to private international credit markets enjoyed by the advanced economies since the 1970s and their reliance on flexible exchange rates to absorb the strain of payments imbalances has eliminated their need for IMF financing. Consequently, the membership today is divided into permanent creditors and two different groups of quasi-permanent borrowers. Some 40 countries provide virtually all of the IMF's usable resources; around 80 countries are eligible for concessional financing but are unlikely to qualify for large-scale loans; and a less well defined middle group has some access to private international capital but might occasionally face a financial crisis that could result in quite large borrowing from the IMF.

What next?

Just as the world has evolved in the 60 years since Bretton Woods, the next few decades will doubtless bring new challenges. The number of successful, mature economies has grown from a handful at the end of World War II to around 30 today. The number of "emerging markets"—countries with substantial international trade and at least some access to private international capital—has also grown from a small handful to more than 50. With good economic management and a little luck, these numbers will continue to grow. Some countries will no longer need to borrow from the IMF, others will occasionally need to borrow quite large amounts, and still others will graduate from borrowing on concessional terms to drawing on the Fund's ordinary resources on market terms. Both the private markets and official agencies such as the IMF will have to be prepared for these and other developments.

> Fundamental reforms to give all countries a voice in proportion to their role in the world economy will depend on the willingness of those countries that currently hold power to embrace a more flexible system of sharing it.

On this 60th anniversary, the core principles and mandate of the IMF remain intact, but the need for constant adaptation to an evolving world economy is undiminished. Four key issues stand out as calling for attention in the years ahead.

First, ***the IMF's surveillance over its members' economic and financial policies must be strengthened*** so that the institution can provide more effective early warnings when economic trouble looms and so that countries will have more incentives to heed those warnings before trouble actually hits. Traditionally, the Fund has conducted surveillance by serving as a confidential advisor to member governments. In the past decade, the Fund has become more open and transparent and has taken steps to strengthen its surveillance. Most surveillance reports are now published and provide signals to market participants as well as to country officials. The challenges now are to find the right balance between confidential advice and public signaling and to ensure that surveillance reports are unbiased and forthright for all countries.

Second, ***the IMF needs to ensure more effectively that its lending to help resolve financial crises restores countries'***

access to capital markets and supports a revival of economic growth. One way to link IMF lending more clearly to a country's implementation of strong economic policies and to increase the confidence of creditors and investors in the country would be for the Fund to preapprove countries' policies on a contingency basis. Countries with strong policy implementation could thereby have ready access to IMF credits if and when they are needed. Although previous efforts to establish such practices have not succeeded, this general approach may still be worth trying. Another facet of the problem is the difficulty of rejecting requests for assistance from countries with only a marginal ability to implement effective policies. The credibility of IMF approval requires an appropriate degree of selectivity.

Third, ***the IMF must do more to ensure that its policy advice and financial support for low-income countries are appropriately directed toward helping those countries emerge from poverty.*** The primary international agency for development and poverty reduction is, of course, the World Bank, not the IMF. The IMF's responsibility is to help its members achieve and maintain macroeconomic and financial stability by implementing policies that are capable of sustaining strong economic growth. The challenge here is to provide macroeconomic policy advice to low-income countries that is consistent with the country's requirements for growth and the reduction of poverty, not just with the requirements for stability. The commitment by the international community to the achievement of the Millennium Development Goals provides an opportunity for the IMF to formulate its support for low-income countries within the context of specific medium-term targets for growth and poverty reduction.

Finally, ***reform of the IMF must address the equity and effectiveness of the way the institution is governed.*** As the economic importance and role of various countries and regions ebb and flow, and as their dependence on the IMF for financing and advice varies, so should their role and influence within the IMF if the institution is to retain its political credibility and legitimacy. An open and meritocratic selection process for the position of Managing Director will help, as will the IMF's more general shift toward transparency since the mid-1990s. But governance of the IMF is ultimately under the control of the international community. Fundamental reforms to ensure that the voices of all countries and regions are represented and heard in proportion to their role in today's world economy will depend on the willingness of those countries that currently hold power to embrace a more flexible system of sharing it. ■

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