TWN Briefing Paper 44
Third World Network
www.twnside.org.sg
February 2008

Reform of the international financial architecture

by Yilmaz Akyüz

Note* prepared for the
G-77 Development Platform for the South
18-19 October 2007, New York

A. Issues

Two issues will be taken up under this heading:

- Provision of external financing to developing countries, including development finance and financing needed to achieve globally agreed goals such as the Millennium Development Goals (MDGs) on the one hand, and of international liquidity to countries facing temporary balance-of-payments difficulties, on the other. Despite rapid expansion of private capital flows to developing countries in recent years, this issue continues to be important for a large majority of low-income countries as well as several middle-income countries.

- Securing greater international financial stability. This problem has been put aside in recent years because of the complacency brought about by favourable cyclical global economic conditions since the early years of the decade, including a surge in capital inflows, favourable payments and reserve positions and a relatively high degree of stability of exchange rates in most developing countries. However, the systemic problems have not disappeared. There are serious risks and fragilities in the international economic system including large and persistent trade imbalances, instability and misalignments among reserve currencies and the vulnerability of many emerging markets to a reversal of favourable cyclical global financial conditions.

B. External Financing

Need for more development finance

Collectively, since the early years of the decade, developing countries have been able to generate adequate resources (savings and foreign exchange) for development. This is best reflected

* This note draws on Y. Akyüz, *Reforming the Global Financial Architecture. Issues and Proposals*, Zed Books, London, 2001; 'Reforming the IMF: Back to the Drawing Board'. *G24 Discussion Paper 38,* UNCTAD 2005; and 'Rectifying Capital Market Imperfections: The Continuing Rationales for Multilateral Lending', in *The New Public Finance. Responding to Global Challenges*, ed. by I. Kaul and P. Conceição, OUP, 2006.

TWN THIRD WORLD NETWORK is a network of groups and individuals involved in bringing about a greater articulation of the needs, aspirations and rights of the people in the Third World and in promoting a fair distribution of world resources and forms of development which are humane and are in harmony with nature.

Address: 131, Jalan Macalister, 10400 Penang, MALAYSIA **Tel**: 60-4-2266728/2266159 **Fax**: 60-4-2264505
E-mail: twnet@po.jaring.my **Website**: www.twnside.org.sg

by a combination of strong payments positions and relatively rapid growth. In the past three years developing countries taken together have run a current-account surplus of some $400 billion a year while growing at an average annual rate of more than 7%. Currently their international reserves exceed $3,000 billion.

This picture, however, conceals considerable diversity. A large proportion of resources is concentrated in East Asia and a small number of oil exporters. East Asia, including China, account for more than half of total current-account surpluses and international reserves of developing countries and much of the rest is concentrated in the Middle East and other major oil exporters. Despite favourable commodity prices, the current account in sub-Saharan Africa (SSA) and South Asia has been in deficit. Much is the same for low-income countries and Heavily Indebted Poor Countries (HIPCs). More importantly, despite ample global liquidity there is a shortage of finance for global public goods.

On various estimates, meeting the MDGs by 2015 would require an additional amount of between $50 billion and $150 billion. Where is this to come from? Private flows, multilateral lending or bilateral loans and grants? Private flows are not a reliable source of finance for many developing countries. Multilateral financial institutions are increasingly marginalised as a source of development finance. Bilateral aid does not only fall short of what is required, but also it is driven by political considerations and its quality is dubious. There is therefore a need for a fundamental rethinking. However, a genuine reform should not only be about new sources of development finance for countries in need of it, but also for different mechanisms and modalities for its allocation. In particular, aid should cease to be the central element of multilateral financing and the Bretton Woods Institutions (BWIs) need to be reformed drastically in respect of their mandates and resources as well as governance.

Private capital flows

The post-war era saw two boom-bust cycles in private capital flows to developing countries: the first beginning in the early 1970s and ending with the debt crisis in the 1980s, and the second beginning in the early 1990s and ending with a series of crises in Latin America, East Asia and elsewhere. The first boom was driven by the rapid expansion of international liquidity associated with oil surpluses and growing United States external deficits, and facilitated by financial deregulation in industrialised countries and rapid growth of Eurodollar markets. Excess liquidity was recycled in the form of syndicated bank credits, encouraged by the BWIs fearing a collapse of global demand. However, with increased debt-servicing difficulties brought about by the hike in United States interest rates and global recession, there was a sharp cutback in bank lending, forcing debtor countries to generate trade surpluses to service debt through cuts in imports and growth. The result was a debt crisis and a lost decade for many developing countries.

The second boom came after almost 10 years of suspension in private lending to developing countries. It was encouraged by the success of the Brady Plan for sovereign debt restructuring, liberalisation, privatisation and stabilisation in developing countries, and rapid expansion of liquidity and cuts in interest rates in the United States and Japan in conditions of economic slowdown. Unlike the first boom, a large proportion of private inflows was in equity and portfolio investment, rather than international lending. In most cases these were driven by prospects of quick capital gains and short-term arbitrage opportunities. When they were reversed, many developing countries in Latin America, East Asia and elsewhere were again faced with negative net transfers, suffering sharp declines in income and employment.

A third cycle started at the turn of the millennium with a swift recovery in private flows, driven by a combination of extremely favourable conditions including historically low inter-

est rates, high levels of liquidity and, again, oil surpluses. Capital inflows in the current cycle have exceeded the peak observed in the previous boom, reaching some $500 billion, and most middle-income countries have shared in this recovery. The majority of such flows are short term in nature, driven by interest arbitrages (carry trade) and increased private sector borrowing from international markets. They are also attracted by asset acquisition in emerging markets. The result is again increased financial fragility, as asset prices and exchange rates in many countries have been raised beyond levels justified by economic fundamentals. Price bubbles have pushed the return on financial assets to double-digit levels, more than twice the growth rate in the real economy. The inflows have also made it relatively easy to finance current-account deficits, promoting unsustainable exchange rates in some emerging markets. Certain speculative elements driving the recent global financial boom including excessive risk taking and leverage have been laid bare by events in recent months. The boom now appears to be nearing its end under circumstances characterised by a combination of persistent and growing global trade imbalances, increased volatility of the dollar and growing tensions in the trading system. Once again countries dependent on external private capital flows for balance-of-payments financing face the risk of collapse of growth as global financial conditions tighten while others excessively dependent on foreign markets may experience a sharp slowdown in economic activity.

Foreign direct investment (FDI) is often promoted as a more reliable source of development finance. Much of it going to developing countries has been in the acquisition of existing assets rather than new (greenfield) investment to expand productive capacity. Initially this was driven by privatisation of public assets but more recently there has been increased acquisition of private assets in the developing world by multinational companies from industrial countries. Greenfield investment in manufacturing goes primarily to countries with strong and sustained growth potentials – it tends to lag rather than lead growth. Despite the claim of the BWIs that the recent upturn in FDI to poor countries reflects improving performance and better investment climate and growth prospects, evidence shows that a chunk of this has been going to the exploitation of rich minerals and oil reserves in a handful of post-conflict countries or to countries with newly discovered oil and mineral resources.[1]

Quite apart from generalised global boom-bust cycles, private capital flows to developing countries tend to be pro-cyclical. Many countries find their access to short-term liquidity and trade credits curtailed at times of adverse movements in commodity prices and terms of trade – that is, when they are most needed. Rapid withdrawal and exit of funds at such times force countries to pursue pro-cyclical monetary and fiscal policies in an effort to accommodate external shocks and to regain confidence of financial markets, thereby aggravating deflationary impulses generated by external shocks.

Multilateral lending

Multilateral financial institutions are increasingly becoming a burden, rather than a relief, for developing countries. In every year since 1991, net transfers (that is, disbursements minus repayments minus interest payments) to developing countries from the International Bank for Reconstruction and Development (IBRD) have been negative. Since 2002, net disbursements have also become negative. In effect, taken as a whole, the IBRD is not making any contribution to development finance other than providing finance to service its outstanding claims. It is much the same for regional development banks. The problem here is that, for reasons related to conditionality and bureaucracy, countries which are eligible for IBRD loans are generally unwilling to borrow as long as they have access to private markets, even when this means paying higher rates. On the other hand, many poorer countries which need external financing are not eligible for IBRD loans. These difficulties underline the recent initiatives taken by the Bank to reduce charges on loans to middle-income

countries and to make a substantial transfer from its income to its concessional financing facility, the International Development Assoication (IDA).

Indeed, the IDA is the only source of net finance for developing countries from the World Bank. However, quite apart from the problems associated with the dependence of the Bank on a handful of donors, IDA disbursements are small, averaging at some $6 billion a year during the past five years for IDA-eligible countries as a whole. Putting the IDA and IBRD together, the contribution of the World Bank to the external financing of developing countries has been negative. Net flows to SSA have also been negative from the IBRD. For a sample of poorest developing countries, financing provided by the World Bank as a whole is in the order of $3 billion compared to private grants of some $10 billion.[2]

Lending by the International Monetary Fund (IMF) from the Poverty Reduction and Growth Facility (PRGF) adds very little to development financing for poor countries. In the past the Fund support focussed heavily on financial rescue operations in emerging markets, bailing out international investors in and creditors to crisis-stricken countries. At the end of 2004 outstanding PRGF credits were less than SDR7 billion or some 10% of total outstanding IMF credits. At present total outstanding PRGF lending is less than SDR4 billion even though it represents a higher proportion of outstanding IMF credits because of significantly reduced resort of middle-income countries to the Fund.

The Fund is being marginalised in the provision of international liquidity to developing countries. All major emerging market economies, except Turkey, have now paid in and exited from Fund supervision, leaving only the poorest countries as its only regular clientele – barely a strong rationale for an institution established to safeguard international monetary and financial stability. This situation also poses the question of the Fund's financial viability. Poverty lending does not generate enough income to run the institution, and the Fund relies primarily on crisis-lending to emerging markets to generate some $800 million per annum to meet its administrative expenses. Ironically, the financial viability of the Fund has come to depend on instability and crises in emerging markets.

Donor aid

Donor aid made available either directly or through the BWIs as concessional loans and grants is the only major source of official finance for development. Here the problem is not just about its adequacy. There is also a bigger political problem. Aid is primarily a post-colonial, Cold War instrument, and its availability and allocation are governed by political considerations rather than expediency, generally serving the interests of donors rather than recipients. As noted, a very large proportion of development financing provided by the BWIs relies on aid rather than on the regular resources of these institutions. In contrast with the trading system where bilateralism is widely seen as a potential threat to the multilateral system, in finance it is taken for granted that bilateral and multilateral arrangements are complements. This approach also dominates debt initiatives such as HIPC, which combines multilateral debt with bilateral debt owed to donors in the Paris Club, enhancing the room for political leverage.

The dependence of the BWIs on the discretion of a small number of donors is a main source of shortcomings in their governance structures. The practice of combining IMF money with contributions from major industrial countries in financial bailout operations in emerging markets hit by crises has enhanced the room for political leverage in IMF lending decisions by its major shareholders. The establishment of the IDA has played an important role in reducing the autonomy of the World Bank secretariat, increasing its dependence on donors and subverting its governance by widening the scope for political leverage. This dependence on donor contribution would be increased if the IDA remains in the World Bank, particularly if an increased proportion of it is made available as

grants – a step that needs to be taken since many IDA countries are already highly indebted and in need of a substantial debt write-off.

Reforming official financing

Thus the first step should be to separate bilateral and multilateral arrangements for development finance and debt. Certainly, it is up to sovereign nations to enter into bilateral agreements on debt and financing, but these should be kept outside the multilateral system. This means taking the donor-driven facilities out of the BWIs; that is, the IDA from the World Bank and the PRGF from the IMF. The amounts involved are quite small, but the impact on the governance of these institutions could be important.

The European Union has created a trust fund to disburse the European aid to finance African infrastructure without depending on the World Bank, on grounds that its aid money should be spent according to European policies but the EU does not have the influence it should in the World Bank. This move demonstrates once again the predominance of political considerations in the provision of aid. It is a welcome initiative in so far as it helps separate bilateral from multilateral lending, but it should also accompany steps to make the World Bank a genuinely independent multilateral development finance institution.

There is no justification for the Fund to be involved in development and poverty alleviation. It should focus on the provision of short-term liquidity to countries experiencing temporary payments shortages, including poorer countries which are particularly vulnerable to trade shocks, in order to enable them to weather temporary adverse movements in balance of payments without suffering from large losses of output and employment. This is very much needed in view of the pro-cyclical behaviour of international financial markets. The Fund should thus revive the Compensatory Financing Facility as a low-conditional facility. There should be greater automaticity in access to the Fund, and limits should be determined on the basis of vulnerability and need rather than contributions. Consideration should be given to introducing a global counter-cyclical facility, such as the two oil facilities established in the 1970s to prevent oil price hikes from triggering a global recession, to be used, *inter alia*, at times of hikes in international interest rates and drying up of private flows to developing countries. The Fund should stay away from structural conditionality and focus on macroeconomics. It should refrain from promoting pro-cyclical macroeconomic tightening but provide adequate liquidity.

An appropriate source of funding for the provision of international liquidity by the Fund is the Special Drawing Right (SDR). The case for creating SDRs to provide funds for current-account financing is much stronger than that for using them to back up financial bailout operations associated with a potential lender-of-last-resort function advocated by the Fund after the East Asian crisis. Current arrangements would need to be changed to allow the SDR to replace quotas and General Arrangements to Borrow (GAB) and New Arrangements to Borrow (NAB) as the source of funding for the IMF. The Fund should be allowed to issue SDR to itself up to a certain limit which should increase over time with growth in world trade. The SDR could become a universally accepted means of payments, held privately as well as by public institutions. Countries' access could be subject to predetermined limits which should also grow with world trade.

Several issues of detail would still need to be worked out, but once an agreement is reached to replace traditional sources of funding with the SDR, the IMF could in fact be translated into a technocratic institution of the kind advocated by Keynes during the Bretton Woods negotiations. Its funding would no longer be subjected to arduous and politically charged negotiations dominated by major industrial countries. Such a move would also be an important prelude to a fundamental reform of the governance of the Fund.

Many of the problems encountered in multilateral development finance and policy advice could be addressed if the World Bank went back to its original operational modalities and concentrated on facilitating capital investment through project financing, rather than trying to fix all kinds of policy and institutional shortcomings in developing countries through structural adjustment and development policy loans. It should cease to be an aid institution and become a development bank, intermediating between international financial markets and developing countries. As originally envisaged, its financing should be provided in loans rather than grants, and made available only to countries which do not have access to private capital on reasonable terms.

Such arrangements would still leave a key problem unanswered: provision of financing for global public goods including concessional loans and grants to the poorest countries. Here the issue is twofold - institutional arrangements and resources. Considerations could be given to pooling and allocating aid through a development fund placed under the United Nations, run by a competent secretariat without day-to-day interference from its contributors, reporting to the General Assembly and audited regularly by an independent body. Such a course of action would be desirable not only because of increased involvement of the UN in development goals and social issues closely linked to world peace, but also because of its democratic nature.

Poverty reduction has been declared as a global public good in several UN summits and conferences in recent years. There is thus a strong case for establishing global sources of development finance. This could be achieved through agreements on international taxes, including a currency transactions tax (the so-called Tobin tax), environmental taxes and various other taxes such as those on arms trade, to be applied by all parties to the agreement on the transactions and activities concerned and pooled in the UN development fund. A common feature of these is that they are all sin taxes which would provide revenues while discouraging certain *global public bads* such as currency speculation, environmental damage or armed conflict and violence. While universal participation is highly desirable, such agreements do not always necessitate the participation of all countries. Certain sources of revenue, such as the Tobin tax, would need to be introduced globally in order to avoid arbitrage against countries adopting them, but others, including environment taxes, could be introduced on a regional or plurilateral basis.

A fund established through international taxes could also be supplemented by voluntary contributions from governments, in both the North and the South, private foundations and wealthy individuals. Even existing IDA resources could become part of the endowment provided that the donors agree to hand them over to an independent secretariat. A relatively small endowment of some $80 billion could generate more sources for grants to poorest countries than the IDA and the PRGF put together.

An advantage of such arrangements over present aid mechanisms is that once an agreement is reached, a certain degree of automaticity is introduced for the provision of development finance without going through politically charged and arduous negotiations for aid replenishments and national budgetary processes often driven by narrow interests. This is exactly what distinguishes IBRD financing, which relies on once-and-for-all guarantees given by its shareholders, from the highly politicised IDA.

Establishing a genuinely multilateral system of development finance is a complex issue that would require reflection, engagement and debate among all the parties concerned. In the end it is down to the political will and clout of the international community. But the first step should be to put the issue squarely on the global agenda. This has unfortunately not been the case despite the proliferation of UN summits and conferences on development finance and poverty.

C. International Financial Stability

There is a growing recognition that financial instability is global and systemic, afflicting even countries with a record of good governance and macroeconomic discipline. Accordingly, improvements in national policies and institutions in developing countries alone would not be sufficient to deal with the problem. Strengthening of institutions and arrangements at the international level is essential for reducing the likelihood of financial crises and for managing them better whenever they occur.

In the aftermath of the Asian crisis a number of proposals have been made for reform in various areas as it became increasingly clear that the existing multilateral system lacked effective mechanisms to prevent financial crises and manage them well when they occurred. Some of these proposals have been discussed in the IMF, the Bank for International Settlements (BIS), the Financial Stability Forum, and among the G-7 countries. Despite their growing role in the international economy and closer linkages with financial markets in industrial countries, developing countries have generally been excluded from these deliberations. Consequently, while certain initiatives have been taken as a result, the reform process, rather than focussing on international action to address systemic instability and risks, has placed emphasis on what should be done by developing countries.

Crisis prevention

Following the Asian crisis, the Fund intensified its surveillance of policies of developing countries, but this has not been effective in preventing crises in Russia, Argentina and Turkey in large part because it has failed to diagnose and act on the root causes of the problem. Preventing unsustainable surges in private capital inflows, currency appreciations and trade deficits holds the key to preventing financial crises in emerging markets, but none of the standard policy measures recommended by the Fund for this purpose, including prudential regulations, counter-cyclical monetary and fiscal policy and exchange-rate flexibility, is a panacea.

Direct measures of control over capital inflows that go beyond prudential regulations may be necessary to prevent build-up of external financial fragility in countries with large stocks of foreign exchange liabilities. According to a recent report by the Independent Evaluation Office, 'the IMF has learned over time on capital account issues' and 'the new paradigm … acknowledges the usefulness of capital controls under certain conditions, particularly controls over inflows', but this is not yet reflected in policy advice because of 'the lack of a clear position by the institution'.[3] It is true that the Fund has little leverage over policies in emerging-market economies enjoying surges in capital flows. But it has also been ambivalent even towards market-based measures adopted by countries such as Chile and Colombia for slowing capital inflows. It refrains from requesting policy changes and effective capital-account measures to slow down speculative capital inflows even in countries with standby agreements. This was certainly the case in the 1990s when it supported exchange-based stabilisation programmes relying on short-term capital inflows. More recently Turkey has also been going through a similar process.

Current arrangements do not give the Fund clear jurisdiction over capital-account issues. The issue now faced is how to include capital-account measures to the arsenal of policy tools for effective management of international capital flows. Guidelines for IMF surveillance should specify circumstances in which the Fund should actually recommend the imposition or strengthening of controls over inflows. It should also develop new techniques and mechanisms designed to separate capital-account from current-account transactions, to distinguish among different types of capital flows from the point of view of their sustainability and economic impact, and to provide policy advice and technical assistance to countries at times when such measures are needed.

The failure of IMF surveillance in preventing international financial crises also reflects the unbalanced nature of the procedures which give too little recognition to shortcomings in the institutions and policies in major industrial countries with large impact on global economic and financial conditions. Its surveillance of the policies of the most important players in the global system has lost any real meaning with the breakdown of the Bretton Woods exchange-rate arrangements. Standards and codes have been designed primarily to discipline debtor developing countries on the presumption that the cause of crises rests primarily with policy and institutional weaknesses in these countries. Since these are based on best practice in industrial countries, the latter have no obligations to undertake new action to meet such standards.

Little attention has been given to the role played by policies and institutions in major industrial countries in triggering international financial crises, even though the post-war financial cycles which ended up with crises have invariably been associated with major shifts in interest rates, exchange rates and liquidity positions in the major industrial countries. Indeed, it is now increasingly agreed that the global economy will not achieve greater systemic stability without some reform of the G3 exchange-rate regime, and that emerging markets will continue to be vulnerable to instability and crises as long as the major reserve currencies remain highly unstable.

As seen during the crises in Latin America, East Asia and elsewhere, developing countries as debtors in foreign currencies are highly vulnerable to the sharp swings in the exchange rates of the currencies in which their debt was denominated. Today, many of the developing countries holding large stocks of international reserves face a similar threat as creditors. They have in effect lent large amounts to the United States, not in their own currencies but in the United States dollar. Consequently, they face the prospects of significant losses on their assets as the dollar comes under pressure due to persistent deficits in the public, private and external sectors in the United States economy.

A stable system of exchange rates and payments positions calls for a minimum degree of coherence among the macroeconomic policies of major industrial countries. But the existing modalities of multilateral surveillance do not include ways of attaining such coherence or dealing with unidirectional impulses resulting from changes in the monetary and exchange-rate policies of the United States and other major industrial countries. These also mean that the existing multilateral system lacks coherence between trade and finance. Unlike trade and the so-called trade-related areas that are constantly pushed onto the agenda of the World Trade Organisation (WTO) by advanced countries, there are no multilateral disciplines over exchange-rate and macroeconomic policies even though it is generally recognised that exchange-rate stability and discipline is a prerequisite for open and expanding trade.[4] Attempts to balance lack of specific exchange-rate obligations with greater emphasis on policy surveillance by the IMF have failed to secure international monetary and financial stability. The Fund is unable to exert meaningful disciplines over the policies of its non-borrowing members, including all industrial and some developing countries, and prevent unsustainable exchange rates and persistent payments imbalances. For its borrowers, by contrast, the policy advice given by the IMF in Article IV consultations often provides the framework for conditions to be attached to any future Fund programme and lending. Thus, even though, as stipulated in Article IV, all countries have the same de jure obligation 'to assure orderly exchange rate arrangements and to promote a stable system of exchange rates', the Fund's policy oversight is confined primarily to its poorest members who need to draw on its resources because of their lack of access to private finance and, occasionally, to emerging markets experiencing interruptions in their access to private financial markets.

So far neither IMF surveillance nor consultations within the G7 have been effective in securing an appropriate mix and stance of macroeconomic policies in leading economies, and removing global payments imbalances and currency misalignments. The failure in policy coordination underlines the decision of the Fund to initiate a new collective action by supplementing its surveillance consultations with individual members with multilateral consultations involving major actors including the United States, Japan, the EU, China, Saudi Arabia and other so-called 'systemically important countries'.[5] Whether or not this initiative would be more successful in securing coordination remains to be seen, but the first signs are not very encouraging because of reluctance by some leading countries to fully engage in these consultations. Compared to these efforts, tasks to be undertaken for 'an orderly unwinding of global imbalances' are formidable: 'steps to boost national saving in the United States, including fiscal consolidation; further progress on growth-enhancing reforms in Europe; further structural reforms, including fiscal consolidation, in Japan; reforms to boost domestic demand in emerging Asia, together with greater exchange rate flexibility in a number of surplus countries; and increased spending consistent with absorptive capacity and macroeconomic stability in oil producing countries'. [6] Thus, developing countries need to be vigilant about international capital flows, and put in place self-defence mechanisms until effective multilateral arrangements are introduced.

This is all the more so because little attention has been paid by the Fund and industrial countries to how instability of capital flows on the supply side could be reduced through regulatory measures targeted at institutional investors or how transparency could be increased for institutions engaged in destabilising transactions such as the hedge funds and other highly leveraged institutions. These funds, mostly located in and managed from industrial countries such as the United States and the United Kingdom, have been growing rapidly with assets managed by them rising from $400 billion at the time of the Asian crisis to over $1,500 billion at present. Not only do they continue to be lightly regulated in the countries they are located in, but their lack of transparency effectively limits policy options in developing countries in which they have been operating.

Since effective multilateral arrangements for a stable international monetary and financial system are not on the agenda, regional mechanisms could provide a way out for developing countries. Indeed, there is now a growing interest in East Asia and South America in regional monetary and financial cooperation in providing collective defence mechanisms against systemic failures and instability and for securing intra-regional stability. Such arrangements should have at least four ingredients: intra-regional currency arrangements to secure stability and orderly adjustments of intra-regional exchange rates; mechanisms for intra-regional coordination of macroeconomic and financial policies, including capital-account regimes; surveillance of regional financial markets and macroeconomic conditions to provide early warning signals; and regional credit mechanisms for currency-market interventions. The European experience holds useful lessons in these respects even though it may not be replicable in its entirety. Progress in regional monetary cooperation among developing countries could also play a catalytic role for the reform of the IMF.

Crisis management and resolution

There is a consensus that balance-of-payments, currency and debt crises will continue to occur in emerging markets and the IMF is likely to be involved in their management and resolution. However, there is considerable controversy over how the Fund should intervene.

Until recently the Fund's intervention in emerging-market crises involved *ad hoc* financial bailout operations designed to keep countries current on their debt payments to private creditors and to maintain capital-account convertibility. Crisis lending was combined with monetary and fiscal tightening in order to restore confidence, but this often failed to prevent sharp drops in

the currency and hikes in interest rates, thereby deepening economic contraction.

There have also been suggestions to turn the Fund into an international lender of last resort with a view to helping prevent crises. There are difficulties in transforming the IMF into a genuine international lender of last resort, including lack of discretion to create its own liquidity and the terms of access. But the most serious problem is that rescue packages tend to aggravate market failures and financial instability by creating moral hazard, particularly on the side of creditors. Debt bailouts undermine market discipline and encourage imprudent lending since private creditors are not made to bear the consequences of the risks they take. The same difficulties surround the newly proposed Reserve Augmentation Line designed to replace the failed Contingent Credit Line.

There has been growing agreement on the need for orderly debt workout procedures drawing on certain principles of national bankruptcy laws, including temporary standstills and exchange controls. Accordingly, IMF crisis lending should aim to support trade and growth, and there should be strict limits to such lending to ensure that it does not amount to bailouts for private creditors and investors. The Fund appeared to be moving in this direction at the end of the previous decade. However, the proposal for the Sovereign Debt Restructuring Mechanism (SDRM) prepared by the Fund secretariat fell short of what is needed – *inter alia*, it excluded provision for statutory protection to debtors for standstills and gave considerable leverage to creditors in seeking their permission in granting seniority to new debt.

Even this diluted version of the SDRM proposal could not elicit adequate political support. Many developing countries facing fragile external financial conditions also opposed the proposal instead of translating it into an effective and fair instrument of sovereign debt restructuring. Attention has subsequently shifted to contractual and voluntary mechanisms including, notably, collective action clauses (CACs) in sovereign bond contracts. While CACs can provide a solution to the collective action problem and creditor holdouts, they do not prevent currency and balance-of-payments crises, resolve conflicts among different classes of creditors or secure orderly, efficient and fair resolution of debt problems. To achieve these objectives, there is a need for arrangements for an independent assessment of debt sustainability; a dispute- settlement body placed beyond the reach of the IMF and its major shareholders; granting automatic seniority for new debt; and protection of debtors against all kinds of litigious investors and creditors through an internationally sanctioned stay on litigation.

The impetus for reform for orderly debt workouts has generally been lost as a result of recovery of capital flows to emerging markets. This could prove to be problematic in the event of a rapid deterioration in global financial conditions and recurrence of balance-of-payments and currency crises in emerging markets. Under such conditions if the consensus against large-scale bailout operations is adhered to, countries that may be facing rapid exit of capital would be forced to undertake action for unilateral standstill, creating considerable uncertainties and confusion in the international financial system and messy defaults. If not, we will be back to square one.

The IMF governance

The debate over governance of the IMF has focussed mainly on issues raised by exercise of power by its major shareholders. The most frequently debated areas of reform include the procedures for the choice of the Managing Director and the distribution of voting rights. Shortcomings in transparency and accountability are also closely related to democratic deficit within the governance structure of the Fund resulting from the quota regime.

The post-war bargain struck between the United States and Europe for the distribution of the

heads of the Bretton Woods institutions between the two shores of the Atlantic has survived widespread public criticism. The latest selection of the Managing Director was again business as usual with Europe claiming the position once again. The agreement between the EU and the United States almost guaranteed the outcome since the majority of votes cast in the Board was sufficient for election, and developing countries chose not to nominate a candidate either individually or collectively.

There is a consensus that the present distribution of voting rights lacks legitimacy not only because it does not meet the minimum standards for equity due to erosion of 'basic votes', but also because it no longer reflects the relative economic importance of the members of the Fund. The existing distribution of voting rights, together with the special majority requirements for key decisions, effectively gives a veto power to the United States in matters such as adjustment of quotas, the sale of IMF gold reserves, balance-of-payments assistance to developing countries, and allocation of SDRs. Such a degree of control by the United States may have had some rationale during the immediate post-war years when it was the single most important creditor to the rest of the world and effectively the only creditor of the Fund. However, now not only is the United States the single largest debtor country in the world, but it is only one of the 45 creditor countries at the IMF.

In theory the Fund appears to be a consensus builder since decisions by the Board are taken without formal voting. But there has been hardly any consensus on proposals for change favoured by developing countries in areas such as quotas, voting rights or SDR allocation. The influence of developing countries is further weakened by the practice of arriving at decisions through consensus among Executive Directors, rather than direct exercise of voting rights by each and every member, since many developing countries are represented by Executive Directors from industrial countries.

The procedures followed for the preparation and approval of country programmes also diminish the impact of developing countries. Typically agreement is reached between the country concerned and the Fund staff before a programme is presented to the Board, and it is not always clear to what extent the agreement reached reflects what the country really wants to do as opposed to what it has been compelled to accept. This tends to discourage developing country Executive Directors to oppose potentially damaging stabilisation and adjustment programmes even though in theory they have collectively the required number of votes to block them.

The current distribution of voting rights and the manner in which they are exercised effectively enable the major industrial countries to use the Fund as a multilateral seal of approval to legitimise decisions already taken elsewhere by this small number of countries. Lack of broad participation in the decision-making process is also a main reason why the Fund does not meet the minimum standards of transparency or accountability. There is an increased agreement that despite certain measures recently taken, lack of transparency goes well beyond that justified by the confidential nature of the issues dealt with by the Fund. The record on accountability is even less encouraging: the Fund is protected against bearing the consequences of the decisions taken, and the burden of inappropriate policy choices invariably falls on countries following its advice.

Proposals for reform for reducing the democratic deficit fall into two categories. First, changes could be made to special majority requirements in order to remove the veto power of the IMF's major shareholders over key decisions. Second and more importantly, voting rights could be reallocated to increase the voice of developing countries by raising the share of the basic votes in total voting rights and by reallocating quotas on the basis of Gross Domestic Product (GDP) in purchasing power parity. Recent changes in the distribution of voting rights have removed some anomalies such as Canada holding more votes

than China, but there are still imbalances that cannot be justified in terms of relative weights of countries in the world economy − smaller European countries such as Belgium and the Netherlands still hold more votes than India or Brazil. The proposals put forward by the Fund staff in the context of the '*Quota and Voice Reform*' do not appear to bring any fundamental change in the voting structure in favour of developing countries. These countries would need to establish a common position on quota allocations rather than leaving it to industrial countries to pick in an *ad hoc* fashion who should get more voting rights.

While a more fundamental reform to special majority requirement or distribution of voting rights could constitute an important step in improving the Fund's governance, on its own it may not make a significant impact on the political leverage of its major shareholders or reduce the imbalance between its creditors and debtors. The problems of governance and lack of uniformity of treatment across members cannot be resolved as long as Fund resources depend on the discretion of a small number of its shareholders. A reform that would translate the Fund into a truly multilateral institution with equal rights and obligations of all its members, *de facto* as well as *de jure*, would call for, *inter alia*, an international agreement on independent sources of finance, and a clear separation of multilateral financial arrangements from bilateral creditor-debtor relations and of policy surveillance from lending decisions. In the absence of such a step, the developing countries may have to decide whether they would need to maintain the IMF in its present form.

Dr Yilmaz Akyüz was the Director of the Division on Globalisation and Development Strategies and Chief Economist at UNCTAD until his retirement in August 2003. He was the principal author and head of the team preparing the UNCTAD *Trade and Development Report*, and UNCTAD coordinator of research support to developing countries (the Group of 24) in the IMF and the World Bank on international monetary and financial issues. Before joining UNCTAD in 1984 he taught at various universities in Turkey, England and elsewhere in Europe. He has published extensively in macroeconomics, finance, growth and development. Since retiring from UNCTAD, he has held the Tun Ismail Ali Chair in Monetary and Financial Economics, University of Malaya. His current activities include policy research for international organisations, and advising governments on development policy issues, and TWN on research in trade, finance and development.

Endnotes:

1 See *Economic Development in Africa: Rethinking the Role of Foreign Direct Investment*, UNCTAD 2005.

2 See World Bank, *Global Development Finance* 2005: pp. 89-90.

3 *Report on the Evaluation of the IMF's Approach to Capital Account Liberalization.* Washington. 2005, p. 11.

4 The importance of coherence among different components of the international economic system was put in broader terms in paragraph 4 of the Marrakech Declaration: 'Ministers recognise, however, that difficulties the origins of which lie outside the trade field cannot be redressed through measures taken in the trade field alone. This underscores the importance of efforts to improve other elements of global economic policymaking to complement the effective implementation of the results achieved in the Uruguay Round'– 'On the Contribution of the World Trade Organisation to Achieving Greater Coherence in Global Economic Policymaking', Declaration of the World Trade Organisation, 15 April 1994, Marrakech.

5 'IMF to Begin Multilateral Consultations with Focus on Global Imbalances'. Press Release, 5 June 2006. Washington, D.C.

6 'Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund'. 17 September 2006. Singapore.