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Beyond the IMF

Devesh Kapur and Richard Webb

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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Division on Globalization and Development Strategies, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums.

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BEYOND THE IMF

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Abstract

A consensus has developed that the International Monetary Fund (IMF) is not fulfilling its role, prompting multiple proposals for reform. However, this paper argues that the focus on reform should be complemented with an exploration of alternatives outside the IMF which hold the potential to not only give developing countries greater bargaining leverage with the Fund but also, by increasing competition, spurring the institution to better performance. The paper argues that most of the IMF's functions are being carried out in part through alternative institutional arrangements. It focuses in particular on the insurance role of the Fund and argues that developing countries are developing alternative insurance mechanisms, from a higher level of reserves, to regional co-insurance facilities to remittances as a counter-cyclical source of foreign exchange. The de facto exit of its clientele has been driven by the high political costs associated with Fund borrowing and now poses unprecedented challenges for the Fund, in particular pressures on its income. The paper argues for a rapid restructuring and significant cuts of the Fund's administrative budget with the budget savings instead directed to lower the interest rates charged to borrowers.

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BEYOND THE IMF*

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A. Introduction

The drift away from the Bretton Woods paradigm, of a world where financial markets are coordinated and disciplined by a central multilateral institution, continues. Industrialized countries long since removed themselves from IMF tutoring. When it lost its essential purpose, the Fund survived as a developmental institution, dedicated to the financial stability of developing countries, more concerned with domestic than with international policies, and even joining the poverty alleviation crusade. During the last decade, however, emerging market countries are also drifting away from the Fund, prepaying debts to the institution, rejecting the Fund's role as a debt arbiter, building up international reserves, and above all, reforming domestic policies to lessen the risk of financial crisis and dependence on the IMF. At the same time, the Fund has been losing its financial capacity to provide emergency funding, and its human capital comparative advantage as an adviser. The principal reaction to this erosion of the Fund's role has been to call for IMF reform. A succession of ingenious proposals have been put forward, designed to seduce the Fund's main shareholders into an acceptance of the key steps required for reform – a surrender of voting power and the creation of new funding for the institution.

We argue that the focus on reform – which may or may not happen – should be complemented by greater attention to the reasons for the exodus from the Fund. Starting with a checklist of core IMF functions, one would find examples of both market mechanisms and government interventions that in some measure are acting as substitutes for the IMF, including functions such as crisis resolution, exchange rate management, financial policy coordination and surveillance. At the same time, exit from the Fund is also being driven by high borrowing costs for Fund resources, as market rates decline relative to Fund charges. Behind that trend is a cost crunch in the institution. A shrinking customer base means falling revenues, yet the institution has refused to adjust by cutting its administrative expenses. One reason for a closer look at the factors that are reducing demand

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for IMF services is to assess the significance of a diminished IMF. How effective are those alternative mechanisms? To what extent does the absence of an IMF mean a more dangerous world? Another reason for the examination proposed here is to identify opportunities for intervention that would reduce financial vulnerability, not through the Fund, but by strengthening the market and governmental substitutes for the IMF. The paper focuses in particular on the insurance role of the Fund and argues that developing countries are adopting alternative insurance mechanisms, from a higher level of reserves to regional co-insurance facilities to remittances as a counter-cyclical source of foreign exchange.

B. The Fund's declining relevance

Over the last two years, respected international finance experts have stated that the IMF is rudderless and ineffective (Eichengreen and El-Erian, 2005), that it is suffering from an identity crisis (Truman, 2005b), waning influence (Truman, 2005b) and a reduced role, that it is on the brink of irrelevance (Wolf, 2006), that, as a result, the world economy basically is not managed at all (Williamson, 2005), that the IMF has long since lost its role as the world's central banker (Abdelal, 2005), has lost sight of where it wants to go (Truman, 2005b), and suffers from a mismatch between aspirations and authority and instruments, and that no single step will restore the Fund to its prior respected position (Truman, 2005a).

In most cases the statement was followed by a call for IMF reform, and often by specific reform proposals. For several years, the reform debate has concentrated the attention of the international finance community. Meanwhile, however, markets and governments and civil associations have been building alternative solutions to the various functional deficits that result from the lack of an effective IMF.

In the late 1990s, the Fund appeared to be at the zenith of its influence. Its attempt in 1997 to change the Articles of Agreement to make capital account liberalization a formal goal, and its subsequent role in the financial crisis that began in Asia in 1997–98 and spread to the Russian Federation and Brazil in 1998–99 gave the Fund an unprecedented global role. New forays such as the Poverty Reduction and Growth Facility (PRGF) drew the institution into core development issues hitherto the preserve of the multilateral development banks. These initiatives, however, did not reverse the underlying trend to irrelevance of the institution, and the PRGF may have turned out to be a Pyrrhic victory.

Today, the Fund's future appears much bleaker. Not only is demand for its resources at a historic low, but major borrowers are prepaying the institution. In 2003, Thailand finished paying off its obligations two years ahead of schedule while in 2004 the Russian Federation prepaid its $3.3 billion debt to the IMF. In December 2005 and January 2006, Argentina and Brazil announced their decision to repay their entire debt to the Fund ($15.5 billion in the case of Brazil and $9.8 billion in the case of Argentina). Pakistan, which owes $1.5 billion and is currently the third-largest debtor, has said that it is seeking to cut its dependence on the Fund; Ukraine, the fourth largest debtor, has declined any further assistance; and Serbia has announced that it would not increase its borrowings. In fiscal year 2005, just six countries had Stand-by Arrangements – the lowest number since 1975. The volume of lending rebounded in the current fiscal year, but almost entirely due to one country – a $10 billion loan package to Turkey.

One possible interpretation is that the current decline in the demand for Fund resources is part of a cyclical process. Barry Eichengreen has pointed out that the Fund is "a rudderless ship in a sea of liquidity", suggesting that the Fund's *raison d'être* has not changed. However, it is worth contrasting the global payment systems in the aftermath of the oil price shocks of 1973–74 and 1979–80 with 2005–06. In stark contrast to the earlier two shocks, which created major global disequilibria and led many developing countries to avail of the Fund's facilities, there is little demand this time around. To be sure, this reflects structural and epistemic changes in developing countries, in which the Fund has played an important role. Greater liquidity in capital markets has given many middle-income developing countries alternatives, while low interest rates have made new financial emergencies less likely.

But there is more to the story. The Fund no longer has the mystique, and its imprimatur no longer carries the weight previously associated with the institution, despite the continuing appearance of an all-powerful and non-accountable institution.

For some time there has been a broad consensus on the need to reform the IMF. Ideas for reform cover virtually every aspect of the Fund, from its surveillance role to its role in debt management and emergency lending, to the nature of its advice and the functions it needs to add or discard to its governance (for a recent elaboration see Akyüz (2005), Bryant (2004), Woods (1998; 2005) and Buira (2005). However, there is little agreement when it comes to the details of the reforms. In the past quarter century, developing countries have been periodically afflicted by financial crisis. Each flurry of activity has resulted in an expansion in the scale and scope of Fund itself. Mervyn King has pointed out that, instead of significant reform, the Fund's principal shareholders have merely ensured that the institution be allowed to "evolve through a series of ever more bland communiqués and meaningless statements" (King, 2006).

But today the Fund faces perhaps its gravest crisis, the result not of opprobrium but of irrelevance. The realization that if the Fund is not "kept up-to-date ... [it] risk[s] suffering a lengthy senescence" (Wolf, 2006), may well prompt real reforms. However, as this paper argues, while developing countries should continue to press for reforms, they should take heed of just how little change has resulted from past calls for reform. Consequently, they must complement the focus on reform with exploring alternatives outside the IMF which could eventually increase the bargaining power of developing countries with the Fund, while at the same time spurring the institution to better performance by empowering competitive alternatives.

C. Alternatives to the Fund

Several factors have contributed to the development of alternative and supplementary mechanisms to carry out particular IMF functions. Perhaps the most important has been the rapid growth of financial markets, and especially bond markets, which in turn has driven the expansion of institutions that monitor and carry out continuous market surveillance, notably rating agencies and other private and governmental institutions that track financial conditions. A second factor has been an equally impressive expansion in networking and local or regional cooperation and integration. Bryant (2004) has pointed to the "Multiplicity of institutional venues – consultative groups and international organizations – [that are] involved in surveillance of financial standards and prudential oversight. Similarly heterogeneous and complex institutions are involved in the nascent supranational surveillance of all other types of economic policies" (Bryant, 2004: 10–11). Cerny (2002) makes a similar point, speaking of the "privatization of transnational regulation" through the expansion of "webs of governance", of "epistemic communities", and "multi-level governance" involving government and private sectors and civil associations. The conception of a more flexible networked world order that uses both the traditional vertical international organizations and new, horizontal "institutions of globalization" has also been explored by Anne Marie Slaughter (2004). The third development, closely related to the above, has been modern communications technology which has brought about a multiplication in the volume, access and speed of information, enormously facilitating surveillance by non-official actors. These contextual trends help to explain the specific mechanisms, discussed below, that are being used to complement or substitute for particular IMF functions.

1. *Global financial stability*

a. *Crisis resolution*

Although the Fund has been a pivotal player in many debt and financial crises during the 1980s and the 1990s, it began to be seen by developing countries less as an impartial referee than as a debt collector for private creditors. In the late 1990s, the Fund proposed sovereign debt restructuring mechanisms (SDRM). Even if the Fund had been successful, the SDRM would have had limited utility since debt flows were becoming a much smaller part of total financial flows. In any event the SDRM did not go anywhere as the international community chose to pursue a more market-driven approach through the use of collective active clauses (CAC) in bond contracts. Neither debtors nor creditors appear enthusiastic about the Fund's role in restructuring under CACs. In the end, with the advice and market soundings of a private investment bank, Argentina made a unilateral offer which was substantially accepted by the market (Simpson, 2006). As the Argentinean and Russian defaults have shown, countries have realized that rather than perennial rounds of debt restructuring with the IMF playing a central role, countries may be better off simply ignoring the Fund. The results (at least till now) don't seem to indicate that these countries are any worse off than if they had elected to use the offices of the IMF.

b. Managing the international monetary system

The primary role of the Fund on exchange rate management had vanished with the collapse of the Bretton Woods system. Consequently, its original mandate notwithstanding, the Fund has been much more voluble on its member countries' fiscal policies than their exchange rate policies. Although recent G-7 communiqués have emphasized the importance of flexibility in exchange rate systems, countries continue to peg their exchange rates and there is not much that the Fund has been able to do about it.

Williamson (2005) has emphasized the need for the Fund to act as a referee on disputes over exchange rates and called for the institution to develop a system of reference exchange rates to prevent unsustainable global imbalances. He argues that such a system would help secure global policy consistency. The main problem with these arguments is that the risks to global financial stability are from the systemically important countries and regions, such as global imbalances caused by the huge United States current account deficit, China's system of exchange rate management, or Europe's rigid labour and product markets. But these are the very actors on whom the Fund has little influence and who are least likely to allow the Fund to constrain their autonomy. It is unclear why moving from the current ambiguous guidelines to more well-defined rules (through a system of reference exchange rates) would resolve the enforcement problem. That depends critically on the confidence of players in the institution itself, which in turn is singularly dependent on a perception of presumed neutrality and a referee role of the institution that few emerging markets are willing to accept given the current governance structure of the IMF.

Indeed even the SDR as a notional unit of exchange now faces competition. In spring 2006, the Asian Development Bank (ADB) is planning to launch a notional unit of exchange, called the Asian Currency Unit (ACU), which would help track the relative values of Asian currencies. Modelled on the Ecu (the forerunner of the Euro), the ACU would be calculated using a basket of 13 regional currencies, weighted according to the size of each economy. The ACU would allow monitoring of both the collective movement of Asian currencies against major external currencies, such as the dollar and the Euro, as well as the individual movement of each Asian currency against the regional average. Small borrowers are also expected to issue bonds denominated in ACUs (rather than the SDR).

c. Coordination role

An important role of the Fund has been to function as "a trusted, independent and expert secretariat" for policy makers around the globe. A very evident sign of its failure (on perhaps all three attributes) has been the proliferation of alternatives. A variety of institutional mechanisms are setting, interpreting, diffusing and enforcing rules on affecting global financial stability, ranging from purely governmental to purely private, with complex public-private hybrids added in. Ad hoc non-treaty intergovernmental groupings like the G-7, G-10, and G-20 are agenda setting and rule ratification institutions. Intergovernmental organizations like the IMF, World Bank, International Finance Corporation (IFC), and Bank for International Settlements (BIS) make some rules, but more importantly, serve as transmission and enforcement mechanisms for rules developed elsewhere. Increasingly the rules underpinning global financial governance are being set by private actors: the International Federation of Accountants (IFAC), Inter-Agency Standing Committee (IASC) and groupings of national regulatory institutions such as International Organization of Securities Commissions (IOSCO) and International Association of Insurance Supervisors (IAIS). The annex to this paper lists the goals, representation, decision rules, and agenda setting capacity of the principal institutional underpinnings of global financial governance.

Two features of this institutional mix are worth highlighting. One, there is considerable variation in forms of representation, goals, and authority. Two, there are overlapping jurisdictions in several areas, which is leading to the formation of "second generation" emanation institutions (the Joint Forum on Supervision of financial conglomerates run jointly with the Basle Committee on Banking Supervision, IOSCO and IASC, is an example). Developing countries should give greater emphasis to participating in these multiple fora, rather than wringing their hands about their marginalization in the Fund.

d. Surveillance function

Besides its insurance function (emergency lending), surveillance has long been seen as the Fund's other critical function. Compared to its early years, the very success of the Fund in ensuring greater transparency in countries' macro accounts has meant that a variety of institutions (both private and public) play a role through their reports and analysis, which are similar to those of the Fund. Moreover, a key weakness of the Fund's surveillance is that issues in Article IV consultations are negotiated ex ante with the systemically important countries, implying that the latter exercise agenda control. The coverage of private rating agencies has grown enormously, extending to both sovereign and private debt, to most middle income countries and even many sub-Saharan nations. In addition to wide coverage and freedom from the political inhibitions that limit the Fund, surveillance carried out by the private sector is a source of frequent and up-to-date information, in contrast to the relative infrequency of Article IV consultations which occur only every 12–18 months and, in some cases, less frequently. The rating agencies have not improved on the Fund's prediction record, and, like the IMF, they can be suspected of conflict of interest, yet private surveillance is a growing industry.

Proposals to rescue Fund surveillance stress the need to separate its surveillance and lending functions so as to avoid any perception of conflict of interest. The separation would apparently enhance the independence and credibility of the Fund's technical judgment. However, enhanced surveillance of the global economy and a legal foundation for the international financial system require a tougher and more independent role for the Fund, a delegation of authority that is not likely to be accepted by the newly systemically important countries unless it is tied to a fairer quota allocation.

Better surveillance could result if the Fund were reorganized to reflect the fact that much of what is called globalization is really regionalization. Trade and exchange-rate policies are taking on an increasingly regional character, reflecting in part the fact that international trade has grown faster within regions than between regions. The Fund could adopt an organizational structure akin to that of the Federal Reserve System, with regional branches acting as the principal regional institutional mechanisms for coordination and surveillance, leaving a smaller central core to focus on global systemic issues.

2. Insurance role

For most developing countries, the Fund's insurance role – short-term balance-of-payments (BOP) support during times of crisis, when countries cannot avail of any other sources of external finance – has been its most important function. That is when the Fund has most power, and where controversy over its use has been most manifest. Thus, finding alternatives to the Fund's monopoly in this area will do more to change the relationship between the IMF and developing countries than any other development.

Developing countries have several external financing options in the event of a balance-of-payments crisis. First, they could draw up credit lines on an ongoing basis to preempt crises of illiquidity. But the volume depends on internal economic fundamentals, confidence in international markets, and the predisposition of the G-7.[1]

A second option is self-insurance. There are two main possibilities here. The most obvious is the buildup of reserves. Indeed the most significant sign of dissatisfaction with the Fund is the very conscious choice of developing countries to sharply increase their foreign exchange reserves in recent years (table 1). What is driving this? The demand for reserves is usually modelled on the lines of a buffer stock model, whereby the macroeconomic adjustment costs without reserves are balanced with the cost of holding reserves. Another way of looking at a reserve buildup is analogous to the precautionary motive for savings traditionally put forward for explaining individual consumption (and savings) behaviour (Aizenman and Lee, 2005). Kapur and Patel (2003), extend this line of thinking by stressing two additional factors: strategic considerations arising from prevailing and likely geo-political realities, and the high prospective political price that the government of the day will have to pay if the country faces an external payments crisis (i.e. if the country runs out of foreign exchange reserves).

Table 1

DEVELOPING COUNTRY FOREIGN EXCHANGE RESERVES, 1991–2004

(SDR billion)

Region	*1991*	*1998*	*2004*
Asia	174.4	408.6	1 033.3
Asia (excluding China)	75.9	240.3	580.3
Africa	13.9	28.9	81.4
South and Central America	44.7	112.5	139.2
Developing Europe	15.4	71.7	211.9
Middle East	38.4	69.5	101.9

IMF LOANS OUTSTANDING, 1991–2005

(SDR billion)

Region	*1991*	*1998*	*2005*
Asia	5.0	24.2	7.6
Asia (excluding China)	4.7	24.2	7.6
Africa	5.9	6.8	4.4
South and Central America	12.1	15.6	9.2
Developing Europe	3.5	19.6	13.2
Middle East	0.2	0.7	0.7

RATIO OF LDC RESERVES/IMF LOANS, 1991–2004

Region	*1991*	*1998*	*2004*
Asia	34.7	16.9	119.9
Asia (excluding China)	16.2	9.9	67.3
Africa	2.4	4.3	16.0
South and Central America	3.7	7.2	5.0
Developing Europe	4.4	3.7	10.7
Middle East	247.3	121.6	134.7

Source: Compiled from issues of the *International Financial Statistics* of the IMF.

Country/economy lists

Foreign reserves

Asia: Afghanistan, Bangladesh, Bhutan, Cambodia, China, Fiji, Hong Kong (China), India, Indonesia, the Lao People's Democratic Republic, Macao (China), Malaysia, the Maldives, Micronesia (Federated States of), Mongolia, Myanmar, Nepal, Pakistan, Papua New Guinea, the Philippines, the Republic of Korea, Samoa, Singapore, the Solomon Islands, Sri Lanka, Thailand, Tonga, Vanuatu, Viet Nam.

Africa: Algeria, Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, the Central African Republic, Chad, Comoros, Côte d'Ivoire, the Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Morocco, Mozambique, Namibia, Niger, Nigeria, Rwanda, Sao Tome and Principe, Senegal, the Seychelles, Sierra Leone, Somalia, South Africa, Sudan, Swaziland, Togo, Tunisia, Uganda, the United Republic of Tanzania, Zambia, Zimbabwe.

South and Central America: Anguilla, Antigua and Barbuda, Argentina, Aruba, the Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica, the Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Montserrat, Netherlands Antilles, Nicaragua, Panama, Paraguay, Peru, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago, Uruguay, Venezuela.

Developing Europe: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, the Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Malta, Poland, the Republic of Moldova, Romania, the Russian Federation, Serbia and Montenegro (former Yugoslavia), Slovakia, Slovenia, Tajikistan, The former Yugoslav Republic of Macedonia, Turkey, Ukraine.

Middle East: Bahrain, Egypt, Iran (Islamic Republic of), Iraq, Israel, Jordan, Kuwait, Lebanon, the Libyan Arab Jamahiriya, Oman, Qatar, Saudi Arabia, the Syrian Arab Republic, the United Arab Emirates, Yemen.

Loans outstanding

Asia: Afghanistan, Bangladesh, Cambodia, China, Fiji, Hong Kong (China), India, Indonesia, Kiribati, the Lao People's Democratic Republic, Macao (China), Malaysia, the Maldives, Mongolia, Myanmar, Nepal, Pakistan, Papua New Guinea, the Philippines, the Republic of Korea, Samoa, the Solomon Islands, Sri Lanka, Thailand, Tonga, Viet Nam.

Africa: Algeria, Angola, Benin, Burkina Faso, Burundi, Cameroon, Cape Verde, the Central African Republic, Chad, Côte d'Ivoire, the Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Morocco, Mozambique, Namibia, Niger, Nigeria, Rwanda, Sao Tome and Principe, Senegal, the Seychelles, Sierra Leone, Somalia, South Africa, Sudan, Swaziland, the United Republic of Tanzania, Togo, Tunisia, Uganda, Zambia, Zimbabwe.

South and Central America: Antigua and Barbuda, Argentina, the Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica, the Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago, Uruguay, Venezuela.

Developing Europe: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Poland, the Republic of Moldova, Romania, the Russian Federation, Serbia and Montenegro (former Yugoslavia), Slovakia, Slovenia, Tajikistan, The former Yugoslav Republic of Macedonia, Turkey, Ukraine.

Middle East: Bahrain, Egypt, Iran (Islamic Republic of), Iraq, Israel, Jordan, the Syrian Arab Republic, Yemen.

While in some cases (most notably in East Asia), countries have been building up their reserves to prevent appreciation of their currency, in the vast majority of cases the primary motive has been "self-insurance". To guard themselves against external shocks, developing countries can either seek some sort of joint insurance or attempt to obtain self-insurance. The institutional mechanism for the former has been the IMF, and for the latter foreign exchange reserves. The trade off between the two has been between political and financial costs. While borrowing from the Fund has lower financial costs, the political costs have been high. As conditionalities mounted so did the political costs. In retrospect, the Asian financial crisis was the turning point. Policy makers are well aware of the humiliation heaped on East Asian economies in the course of their Fund programmes during the East Asian crisis from 1997–99. Although the Fund has changed tack since then, its perceived lack of independence means that policy makers would be understandably risk-averse. Developing countries appear to be prepared to pay a high financial cost (estimated to be about one percent of GDP of developing countries taken as a whole) to preempt the prospect of a ruinous political cost (Rodrik, 2006).[2]

Thus, the high costs of holding reserves notwithstanding, they are still a more attractive option relative to availing of any contingent credit line, either from markets or the IMF. For one, the very act of securing contingent credit facilities may trigger a downward spiral of confidence that a government would want to avoid in the first place. Moreover, once a crisis builds up it is exceedingly difficult to either predict or control its momentum. High levels of uncertainty enhance the case for the *status quo* option (i.e. hold high reserves and pay a financial premium). This is even more the case given current geopolitical realities where economic pressure, whether through international financial institutions or on trade policies or even something as seemingly mundane as travel advisories, means a high level of reserves is essential for a country to maintain policy autonomy. Large reserves also help to reassure foreign investors that the likelihood of default on foreign currency denominated liabilities is extremely small.

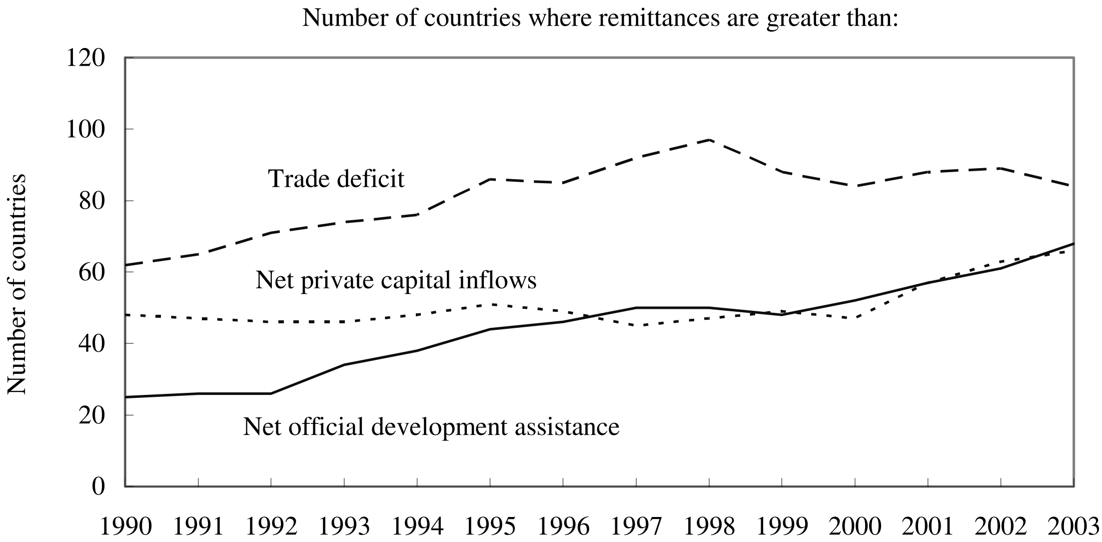
For many poorer developing countries whose exports are insufficient to build reserves, the need for insurance has been reduced by growing cash flows from their citizens abroad. Remittances have emerged as an important (in some cases, critical) source of financial flows for many developing countries (figure 1). These flows come without a plethora of conditionalities, are unrequited transfers (and therefore do not require repayment), and increase in times of shocks. They are allowing many developing countries to cover their trade deficits and therefore avoid the cycle of unsustainable external borrowings to cover high current account deficits, thereby necessitating an IMF programme.

But a country's diaspora can be a financial resource not just through accretion in the current account (in the form of remittances) but in the capital account as well. For instance in 1998, when India faced sanctions and global financial markets were in turmoil, the country raised $4.2 billion through India Resurgent Bonds (IRBs) and again in 2000, apprehensive about its balance-of-payments prospects, India raised another $5.5 billion through the India Millennium Deposit (IMD) scheme. While both issues (especially the latter) were expensive, they were much less costly than any other alternative. And the experience underscored a new possibility: a country with a large overseas diaspora could raise significant resources at relatively short notice, without having to go to the Fund. Nonetheless there are clear limits as to the amount of money that can be raised through this route.

Political motivations have also led to emergency financing between countries, as illustrated by Venezuela's recent offer to Argentina to buy $3.4 billion of Argentinean government bonds, of which $1.1 billion has been disbursed thus far. Similar financing has been a long established practice between oil-rich and needy Muslim nations in the Middle East and Africa.

Figure 1

GROWING IMPORTANCE OF REMITTANCES



Developed countries had already developed self- and joint-insurance systems. It was the establishment of the General Agreements to Borrow (the GAB) among the G-10 in 1964 that undermined the Fund's *raison d'être* for the industrialized countries. Following the onset of the Asian crisis, the United States shot down the idea of an Asian Monetary Authority and severely criticized the Asian Development Bank when it attempted to adopt a position different from the prescriptions of the IMF. In the last few years Asian countries have renewed efforts at establishing swap facilities between the region's central banks to pool resources against a speculative attack (under the so-called Chiang Mai Initiative), and efforts to develop a region-wide market for local currency bonds. In the medium-term, the swap arrangements (now around $70 billion) pose a singular challenge to the Fund. If growing cooperation among central banks in the region (exemplified by central bank swap facilities) leads to an Asian equivalent of a GAB, the Fund's importance to the region will diminish for the same reason that it has all but disappeared in the industrialized countries.

The strong development of regional monetary and financial arrangements has been pointed out by Henning (2005) and Cohen (2003). "Cohen counts four full-fledged monetary unions, involving 37 countries, thirteen fully dollarized countries, five near-dollarized countries, and ten bimonetary countries" (Henning, 2005: 1). Henning also notes that the Exchange Stabilization Fund of the United States has entered into nearly 120 agreements since its introduction in 1934.

Some developing countries are seeking insurance by coming under the umbrella of a major power. The EU will effectively provide insurance for new Central and East European members through the ERM2. The liquidity provided to these countries will come from the European Central Bank rather than from the IMF.

The Cold War powerfully shaped the lending of the Bretton Woods Institutions in two distinct ways. First, the prospect of a country turning to the Soviet Bloc made the market for lending contestable. Second, allies of major shareholders could always expect their economic transgressions to face less opprobrium. For a while the collapse of the Soviet Union seemed to remove any political competition, but the war on terrorism and the rise of China has changed that. In Asia, Africa, and Latin America, China has mounted a charm offensive, with economic deals that eschew advice and hectoring. Its demand for raw materials from the latter two regions in particular has fuelled a new commodity boom and led China to stake strategic partnerships. China's volume of trade with Africa has quadrupled in the past five years (to reach about $37 billion).[3] And the pragmatic Chinese policies are a much less constraining philosophy than that of the Fund's major shareholders. Thus, even as Zimbabwe defaulted on its obligations to the Fund, Beijing rolled out the red carpet for President Mugabe.

Table 2 summarizes the variety of mechanisms reviewed above that supplement the IMF or reduce the demand for insurance, and points out the principal mechanisms used in each region.

Table 2

ALTERNATE RISK MANAGEMENT MECHANISMS FOR LDCs

Region	*Insurance mechanism*
Central America (incl. Mexico)	Remittances
East Asia	Reserves, swap facilities
East Europe	ECB (through EU membership)
Latin America	Reserves
Middle East and North Africa	Remittances
Russian Federation	Reserves
South Asia	Remittances, reserves
Sub-Saharan Africa	Assistance from Asia

D. Organizational changes

The drift away from the Fund is also a consequence of the growing access by emerging markets to private finance and the rising relative cost of Fund loans. At the same time, the Fund is not responding to the loss of competitive advantage by reducing its administrative expenses. The resulting *de facto* exit of its clientele, driven by the combination of high political costs associated with Fund borrowing and growing availability of alternatives, now poses an unprecedented challenge for the Fund, in particular pressures on its income. This paper examines the options available to the Fund if it is to reverse its loss of clientele.

In particular, in addition to governance reform, the Fund's future seems to require significant cuts in its administrative budget, using budget savings to lower borrower interest rates. The recent decision of Argentina and Brazil to prepay their IMF debts has meant that the Fund income will decline by $116 million in 2006. Apart from a short period in 1990, the IMF's loan book is at its lowest in the past quarter century. One option that the Fund is considering to augment its shrinking income is a proposal to invest some of its reserves in higher yielding longer-term securities, while another option would find a way to generate income from its gold holdings.

One alternative that does not seem to be on the cards is to cut the Fund's administrative expenses. The Fund like the IBRD is cost-plus lender and therefore has had little incentive to make the sorts of hard choices that are forced on its clients. In recent years, the cost of borrowing has increased and along with high administrative expenditures, the financial costs of IMF loans are high. When added to the political costs, it is hardly surprising, therefore, that countries are prepaying loans.

Unlike the Bank, which has undergone several major and wrenching organizational changes, the Fund has enjoyed a charmed existence. The only fundamental reform occurred in the aftermath of the collapse of the Bretton Woods system in the early 1970s, but even that had very modest organizational effects. However, as discussion above has sought to demonstrate, the Fund's current financial situation is not the result of temporary circumstances, but is being driven instead by longer-term structural factors. The income pressures facing the Fund will not be resolved by tinkering with the budget. The underlying cause of this predicament is that the Fund is losing rents that it enjoyed as a monopolist, but which are dissipating as alternative sources of insurance and counter-cyclical flows become available to developing countries. Consequently, the revenue shortfalls facing the Fund are of a more permanent nature than the management appears willing to acknowledge. We believe that the Fund has little alternative but to swallow some if its own medicine, tightening its belt and reducing administrative expenditures. We believe there is considerable scope for doing that, though the Fund's recent strategic review avoided any serious consideration of the matter. The standard cost-cutting steps required are to overhaul compensation policies, develop more flexible (internal) labour markets, greater decentralization and outsourcing to lower cost locations.

The biggest anomaly in the Fund's compensation is its pensions. The anomaly is both in terms of level and structure. On level, a comparison of the pension of the median Fund staffer with other comparable places (e.g. universities) is revealing of the extent to which the Fund has gone overboard. It is simply over the top. The present value of the pension due to a Fund staffer who retires at B3–B4 level after about 25 years at the Fund is about $5–6 million.

Even as the Fund's advice recommends that countries move from defined benefit-regime to defined contribution-system, its own compensation policy remains wedded to a defined benefit pension system, one of the last bastions in the world. Even worse, the defined benefits are linked to a staffer's last three years salary, a perverse incentive from the point of view of another favourite Fund recommendation, labour market flexibility. Its pension system actually encourages immobility because pensions increase disproportionately with years of service: in fact there are two major career kinks, when the pension jumps discontinuously, so a staffer within sight of these kinks simply drops anchor. The Fund's justifies this policy with references to the importance of factors such as experience and institutional memory. The Fund, however, stands out from other organizations that require similar skills.

A second problem with the Fund's compensation policies is wage compression. The Fund's standard prescription is to argue for wage decompression to allow more flexibility to hire staff with special skills, especially at senior levels. Sadly, here too the Fund has failed to follow its own advice. Unlike most of its member states, senior Fund staff is well compensated. The wage compression arises from the fact that junior staff is compensated much too handsomely, especially when one adds in munificent expatriate benefits: home leave, education, the G-5; (ability to "import" domestic help and pensions). These high salaries do not compensate for greater risk, since it is virtually impossible to be downsized from the Fund.

A third issue is the need for greater transparency in salary structure. IMF staff receives a range of benefits in non-monetized form from education for children to home leave travel allowances. The Fund's message to its civil service clients around the world has been a consistent one – monetize all benefits so that they are clear and transparent. A comparison of lower level total emoluments (including the present value of pension liabilities), with his/her counterpart in comparable private/public institutions would be telling.

Developing countries have a strong interest in pushing for organizational changes in the Fund, and in particular a major overhaul of the Fund's personnel and compensation policies, in line with what the institution advocates everyone else. Since personnel expenses amount to about 70 per cent of the Fund's budget (which is approaching nearly $900 million), there is simply no alternative but to address the size of staff and the structure of compensation. Recent attempts to reform the Fund's pension plan were scuttled when Executive Directors from some industrialized countries bowed to pressure from staff.[4] These countries feel that few nationals from their countries would be willing to join the Fund if the compensation package were less attractive. Current policy, however, means that developing countries are subsidizing the ability of rich countries to have nationals on the staff.

E. Implications

The lack of voice in the IMF has been a perennial complaint of developing countries. Currently Europe (including the Russian Federation) accounts for 40 per cent of the IMF's voting share and up to 10 of the 24 seats on the Executive Board. Japan, China and India and other East Asian countries account for only 16 per cent of the vote share and 5 chairs. Current discussions indicate that Europe might be willing to give up 2 per cent of its vote share (and perhaps one seat), which will do little to address the structural imbalance.

However, as Hirschman has pointed out, "voice" is not the sole source of legitimacy for an organization. If membership is voluntary, and "exit" does not impose onerous costs, then governance by voice is not necessary for legitimacy. Private firms are not democratic but nonetheless enjoy societal legitimacy when factor and product markets are competitive, since competition gives both input suppliers and output buyers exit options. Even where factor and product markets are not competitive, legitimacy can exist if markets are "contestable" (that is, entry costs are low), or where viable anti-trust and regulatory institutions exist.

Consequently the possibility of exit even in the absence of voice could give the Fund greater legitimacy. Unfortunately, for virtually all developing countries exit was not a viable option. The "market" for international organizations is, for the most part, not contestable except in the few areas where both regional and global institutions exist. Thus in development projects borrowers had some choice between a regional development bank, the World Bank, and (to varying degrees) the private sector. In some cases countries can engage in forum-shopping – for instance Canada, Mexico and the United Nations can chose between the North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO) dispute settlement mechanisms in cases of trade dispute resolution. But in many important areas this has not been true, especially in the case of functions and services supplies by the IMF – until now.

Among the public goods that the Fund provides, including information, analysis, advice to individual governments, advice on co-ordination of policies, management of defaults and emergency lending, viable alternatives now exist for many more developing countries than ever before.

F. Conclusion

We find a variety of initiatives and developments outside the Fund that complement or supplement the IMF's financial coordination, insurance and surveillance functions. It seems highly likely that the cumulative effect of those initiatives has been, in some degree, to reduce the risk and potential costs of financial instability, in short, to make the world safer, though it is difficult to arrive at a more precise assessment due to the lack of systematic data, to the heterogeneous nature of the initiatives, and to the fact that many have an informal character. However, the evidence suggests a growing trend that is driven both by the growth and diversification of financial markets, and by the increasing complexity of global and national governance. A September 2004 report to the IMF Board, *The Fund's Strategic Direction*, opens with a reference to the "tectonic shifts in the ground the IMF is directed to tend", and acknowledging that "in some important measures, the Fund has lagged rather than led" (IMF, 2004). Those lags are part of the explanation for the surge in non-Fund initiatives aimed at reducing financial vulnerability, whether as a direct intent, as in the case of regional insurance arrangements, higher reserve holdings, and increased market-based surveillance, or as an indirect effect of other governance objectives, especially the rapid growth of bilateral and regional trade agreements. However, this paper has argued that the resort to non-Fund alternatives is also driven in part by the increasing cost of Fund resources, largely explained by its very high administrative budget.

Further analysis is needed to explore the extent to which these developments can be integrated into a new model for the management of financial instability in the world, a model that will complement the centralized decision and rule-making capacities of an IMF with the more flexible, and more participatory, decentralized governance that is being generated through the combined action of national governments, regional arrangements, market institutions, and civil associations.

Notes

1 In 1995, in the aftermath of Mexico's crash Argentina faced a liquidity crisis and entered into $6.7 billion worth of "reverse repo" arrangements with 14 international banks that gave it access to liquidity in the event of a sudden large capital flight. The banks charged Argentina a fee together with Argentine bonds as collateral.

2 Generally these costs are calculated as the difference between short term borrowing abroad and yield of liquid foreign assets (e.g. the United States Treasuries) in which reserves are usually invested. One puzzle (highlighted by Rodrik) is why countries in their quest to insulate themselves from financial crises choose to increase their foreign reserves rather than reduce their short term liabilities. Rodrik notes that developing countries have resorted to the former but the optimal solution is in fact a combination of the two measures. This would not only decrease this social cost of holding excess foreign re-

serves, but also increase liquidity to respond to external shocks. The issue is also examined by Aizenman and Marion (2004).

3 Details of official Chinese policy can be found in “China’s African Policy”. The so-called “Five Principles of Peaceful Co-existence” enshrine mutual territorial respect, non-aggression and non-interference in each other’s internal affairs The white paper promises that the Chinese Government will now “vigorously encourage” Chinese enterprises to take part in building African infrastructure and help Africa to build its own capacity.

4 The IMF can learn a little from its sister institution, the World Bank, which moved toward defined contribution pension schemes and more transparent, monetized benefits since 1997.

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ANNEX

INSTITUTIONS OF GLOBAL FINANCIAL GOVERNANCE

Organization	*Institutional goals*	*Interests represented*	*Decision rules*	*Agenda setting capacity*	*Financial issue areas*
International Monetary Fund (IMF) **[1944]**	• Promotes monetary cooperation and orderly exchange arrangements • Financial assistance to members undergoing balance-of-payment problems, with conditions attached • Technical assistance • Surveillance of member country economies	• Shareholders: 182 countries • 24 executive board members – 8 single country representatives and 16 multi-country constituencies • Managing director is traditionally European	• Weighted majority voting based on shares • G-7 shareholders control 46 per cent of votes • Executive board appears to practice consensus, yet formal voting occurs on key policy decisions	• Sets informal norms through technical assistance and dissemination • Sets rules for members relying on financial assistance through conditionality • Influence on members not seeking financial assistance through “surveillance” is quite limited	• Capital and current account convertibility • Exchange rates • Corporate governance • Banking regulation • Capital markets
World Bank **[1944]**	• Sustainable development and poverty alleviation	• Shareholders: 182 countries • 5 largest shareholders appoint executive directors, 19 others elected by groups of countries • President is traditionally American	• Executive board makes most decisions; weighted majority rule based on shareholding • G-7 shareholders control 44 per cent of votes	• Sets rules for members relying on financial assistance through conditionality • No influence on non-borrowing members • Didactic role through technical assistance and research • Technical assistance	• Development programmes that have far reaching economic influence • Corporate governance • Banking regulation • Capital markets

INSTITUTIONS OF GLOBAL FINANCIAL GOVERNANCE (*continued*)

Organization	*Institutional goals*	*Interests represented*	*Decision rules*	*Agenda setting capacity*	*Financial issue areas*
International Monetary and Financial Committee (formerly Interim Committee) [1999]	• Supervise management and adaptation of international monetary and financial system	• Same as Executive Board of the IMF	• Consensus but weighted in favour of G-7	• Adjustment process • Global liquidity • IMF policies	• Internal monetary system • Systemic crisis
International Finance Corporation (IFC) (Affiliate of World Bank) **[1956]**	• Loan and equity financing for private sector projects in developing countries • Advisory and technical assistance for business and government	• Shareholders: 174 countries	• Board of Directors composed of World Bank Executive Directors • Weighted majority rule; G-7 shareholders control 52 per cent of vote (the United States controls 24 per cent)		• Capital Market Development • Investment policies, especially FDI • Corporate governance
Bank of International Settlements (BIS) **[1930]**	• Forum of central bankers for international monetary and financial cooperation, financial services for central banks • Implementation of international financial agreements	• Until early 1990s 11 countries from G-10 (industrialized states) • Major expansion in 1999 to include 45 central banks from OECD and larger LDCs • General manager, traditionally European	• Board of Directors: 21 members. 2 each from Belgium, Italy, France, Germany, the United Kingdom and the United States); 9 others elected (currently no developing country on the board)	• Sets standards for industrialized states • These standards become the yardstick for all other countries	• Banking standards and regulation (Basel standards) • Corporate governance • Financial Conglomerates through Joint Forum with IOSCO and IAIS

INSTITUTIONS OF GLOBAL FINANCIAL GOVERNANCE *(continued)*

Organization	*Institutional goals*	*Interests represented*	*Decision rules*	*Agenda setting capacity*	*Financial issue areas*
Organisation for Economic Co-operation and Development (OECD) **[1961]**	• Club of like-minded countries in an advanced stage of economic development; forum for coordination of policy development	• 29 countries; initially from western countries in Europe and north America, recently expanded to include Mexico, the Rep. of Korea, Poland, Hungary and the Czech Republic • Development Assistance Committee consists of Paris based delegates of OECD and permanent observers: IMF, UNDP, World Bank	• Council is overriding committee • Specialized committees for specific policy areas (trade, development assistance etc.)	• Information and analysis • Development assistance committee to coordinate donor programmes	• Corporate governance • Tax havens • Corruption
London Club	• Forum for commercial holders of sovereign debt	• Private financial interests, especially large banks	• Consensus	• Restructuring of privately held sovereign debt • Pressure on governments of country of origin (mainly G-7) on sovereign debt related issues	• Terms of restructuring privately held sovereign debt
Paris Club **[1956]**	• Forum for bringing together debtors and official creditors in a unified negotiating framework; to avoid default on debt	• Mainly OECD governments (secretariat provided by French treasury dept.)	• Consensus	• Restructuring of officially held sovereign debt	• Terms of restructuring officially held sovereign debt
Group of Seven (G-7) **[1974]**	• Forum for discussion of economic and financial issues among the major industrial countries	• Seven industrialized countries (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States)	• Consensus	• Most influential global body but influence overwhelming	• Broad influence in overarching rules of global financial architecture

INSTITUTIONS OF GLOBAL FINANCIAL GOVERNANCE (*continued*)

Organization	*Institutional goals*	*Interests represented*	*Decision rules*	*Agenda setting capacity*	*Financial issue areas*
Group of Ten (G-10) **[1963]**	• Forum for consultation and cooperation on economic, monetary, and financial matters	• 11 industrialized countries (G-7 plus Belgium, Netherlands, Sweden, Switzerland) • Composed of finance ministers and central bank governors	• Forum for exchange of ideas; no explicit powers • Meets twice a year in conjunction with IMF interim committee meetings; in addition meets in smaller groups regularly through the year	• Reports that have an agenda setting capacity for other international institutions (IMF and BIS in particular)	
Group of 20 (successor to G-22) **[1999]**	• Forum for discussing and forming consensus on avoiding and dealing with financial crises	• Finance and Treasury officials of G-7 and systemically important developing economies plus EU, IMF and World Bank • Created by US Treasury to limit European influence	• Unclear – probably consensus	• Reports and deliberations could have agenda setting capacity; too early to tell	• Rules and standards for averting and dealing with financial crises
Financial Stability Forum **[1999]**	• Forum for discussing and forming consensus on avoiding and dealing with financial crises	• Representatives from G-7 countries (treasury, supervisory, and central bank); World Bank, IMF, BIS, OECD, Basel Committee, IOSCO, IAIS • Created in 1999 out of a G-7 initiative	• Forum for exchange of ideas	• Reports and recommendations from working groups and forums have agenda setting capacity	• Compendium of best practice standards for financial institutions
United Nations Commission on International Trade Law (UNCITRAL)	• Common practice on cross-border insolvency	• UN membership	• Consensus	• Together with International Bar Association and World Bank	• Bankruptcy, especially cross border

INSTITUTIONS OF GLOBAL FINANCIAL GOVERNANCE *(continued)*

Organization	*Institutional goals*	*Interests represented*	*Decision rules*	*Agenda setting capacity*	*Financial issue areas*
International Organization of Securities Commissions (IOSCO) **[1974]**	• International cooperation on regulatory standards for stock markets	• Heads of stock markets and regulatory authorities from around the world • Executive committee of 19; elected from regional committees and by general membership	• Two specialized working groups • Technical committee composed of 16 agencies from developed and international emerging markets • Emerging market committee	• Professional codes of conduct and standards • Advisory	• Securities laws • Equity instruments
International Association of Insurance Supervisors (IAIS) **[1994]**	• International insurance regulation	• Executive committee consists of representatives from various regions of the world		• Professional codes of conduct and standards	• Insurance regulation
International Federation of Accountants (IFAC) **[1977]**	• Harmonizing international accounting standards • Accounting lobby	• Private sector • Accounting organizations recognized in home country (143 organizations from 104 countries)	• IFAC council consists of 18 members from G-7 plus other industrialized and emerging market countries	• Professional rules and standards • Lobbying	• Auditing standards
International Accounting Standards Committee (IASC) (Related to IFAC) **[1973]**	• Benchmarks for financial reporting around the world (businesses and other organizations)	• Private sector • Same membership as IFAC (automatic membership for IFAC members)	• Board consists of 16 countries (G-7 plus other industrialized and emerging market countries) • No EU representative yet	• Professional rules and standards	• Accounting standards

INSTITUTIONS OF GLOBAL FINANCIAL GOVERNANCE (*concluded*)

Organization	*Institutional goals*	*Interests represented*	*Decision rules*	*Agenda setting capacity*	*Financial issue areas*
Institute of International Finance (IIF) **[1983]**	• Forum for private financial community to interface with public sector • Advance common views on global financial architecture	• Private sector • Initially created by 38 banks from leading industrialized countries; now 300 strong with increasing representation from leading emerging market financial institutions	• Consensus	• Actively lobbies multi-lateral organizations and governments • Informational and coordination	• Data standards • Common criteria for loan classification and non-performing loans • Risk exposure to emerging markets

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