

Back to the Drawing Board

*In retrospect, implementing the
G-20's IMF reform package
would have been a mistake.*

BY DESMOND LACHMAN

Over the past five years, the U.S. Congress has been continuously browbeaten by the U.S. Administration, as well as by a chorus of international leaders, for its failure to approve the G-20 International Monetary Fund reform agreement. Over the same period, however, there have been a number of major developments affecting the IMF that must raise serious questions as to the continued appropriateness of those reform proposals. Those changes would suggest the need for crafting a new IMF reform agenda that would not only be more palatable to the U.S. Congress but would also enhance the IMF's effectiveness.

In 2010, in the aftermath of the global fallout from the Lehman bankruptcy, the G-20 agreed to basic IMF reform. It did so in part to bolster the global financial system, whose weaknesses had been exposed by that bankruptcy. It also did so with a view to improving emerging market buy-in to the IMF by making the IMF's governance structure more reflective of the relative economic importance of those countries.

By now, the G-20's IMF reform package has long since received legislative approval in practically all of the IMF's member countries. The notable exception has been the United States, where Congress has steadfastly been opposed to any increase in the IMF's permanent resources. This has stalled the coming into effect of the IMF reforms, which requires 85 percent approval in terms of the IMF's weighted voting system. Since the

Desmond Lachman is a Resident Fellow at the American Enterprise Institute. He was formerly Deputy Director in the International Monetary Fund's Policy Development and Review Department and the chief emerging market economic strategist at Salomon Smith Barney.

THE INTERNATIONAL
ECONOMY

THE MAGAZINE OF INTERNATIONAL
ECONOMIC POLICY

220 I Street, N.E., Suite 200

Washington, D.C. 20002

Phone: 202-861-0791

Fax: 202-861-0790

www.international-economy.com

editor@international-economy.com

United States still has almost 17 percent of those votes, Congress enjoys an effective veto on IMF reform, which it has chosen to exercise.

THE NEED FOR IMF REFORM

Following the September 2008 Lehman bankruptcy, financial instability quickly spread from the United States to the rest of the global economy. That gave rise to large capital movements towards the United States as market participants sought the relative safe haven of U.S. Treasury bonds. In the process, many countries' balance-of-payments positions came under acute pressure, which required massive IMF financial assistance. The situation revealed that the IMF's own permanent resources were not adequate to effectively deal with a crisis of that magnitude.

The Lehman crisis also shone a bright spotlight on a glaring weakness in the IMF's governance structure. At a time when the major emerging market economies, most notably China, were being called upon to help resolve the crisis, either through lending to the IMF or through refraining from allowing their currencies to depreciate, those countries were grossly underrepresented in the IMF's governance structure. How then could those countries reasonably be asked to play an important part in stabilizing the global financial system when they were so grossly underrepresented in it?

Despite the fact that the relative importance of the emerging market economies had substantially increased over the previous two decades and that those economies now accounted for close to half of the world's output, there had been little adjustment to their IMF quotas. Considering that those quotas determined a country's voting strength in the IMF, this meant that the relative voice of these countries at the IMF nowhere nearly matched their relative importance in the global economy. This was especially the case at a time when the Europeans and the United States maintained their lock on the two top IMF management positions and at a time when the European countries held on to no fewer than eight of the IMF Board's twenty-four chairs.

*The case for increasing the voice at the
IMF of the emerging market economies
has become even more compelling.*



International Monetary Fund headquarters in Washington, D.C.

THE G-20 REFORM AGREEMENT

The essence of the 2010 G-20 IMF reform agreement was twofold. First, it was to increase the IMF's permanent resources to better equip it to deal with future crises. Second, it was to increase the relative representation of the emerging market economies in the IMF's governance.

These two objectives were to be achieved by trebling the IMF's permanent overall lending capacity to US\$750 billion and by having the emerging market economies make a disproportionately large share of the quota contributions. It was also proposed that the emerging market countries would be assigned an additional two seats at the IMF Board, while the European countries would cede two of their eight seats.

On the basis of the IMF's routine quota exercises, based on an agreed set of economic indicators, Europe with a current voting weight of over 30 percent was generally considered to be grossly over-represented in the IMF. By contrast, the United States' relative IMF voting position of almost 17 percent was generally considered to be broadly appropriate.

The proposed six percentage point increase in the emerging market countries' relative IMF shareholding was to be achieved primarily at the expense of the European countries. By contrast, the relative voting position of the United States was to be reduced only to around 16 percent. That quota would still leave the United States with more than the 15 percent of the votes that it needed to continue enjoying an effective veto on key IMF policy decisions.

Continued on page 53

Continued from page 29

A CHANGED WORLD SINCE 2010

Since 2010, the case for increasing the voice at the IMF of the emerging market economies has become even more compelling. While in the aftermath of the Great Recession there was a pronounced slowing in industrial countries' economic growth, the emerging market economies retained their vigor and became the principal drivers of the global economic recovery. If the trend toward the formation of regional financial institutions mimicking the functions of the IMF was to be arrested, the emerging market economies needed to be better represented at the IMF.

While the case for greater emerging market representation might have strengthened, the case for a bigger IMF has considerably weakened. In 2010, on the eve of the European sovereign debt crisis, it could be argued that one needed a very much larger IMF to support Europe's beleaguered economic periphery. At that time Europe did not have the financial instruments in place to provide that support.

However, much has changed since then. In June 2012, Europe established a €500 billion European Stability Mechanism to support troubled eurozone member countries as needed. More important yet, in September 2012, the European Central Bank introduced an Outright

The case for a bigger IMF has considerably weakened.

Monetary Transaction mechanism that would enable the ECB to do "whatever it took" to save the euro. With Europe now more than in the position to take care of its own problems, could one still really argue that the IMF needed an additional \$500 billion in permanent lending capacity?

Viewed from a different angle, one might ask from where will the demand for future IMF large-scale lending come? As just mentioned, Europe now has in place the means to take care of its own. Meanwhile, following their painful experience with IMF involvement in the Latin American and Asian financial crises of the late 1990s, the major Latin American and Asian countries maintain their determination never again to subject themselves to the humiliation of IMF conditionality. And they have been in the process of building up their international reserves and of setting up regional financial institutions to ensure that this indeed does not happen again.

ABUSE OF EXCEPTIONAL ACCESS LENDING

Further substantially weakening the case for a larger IMF has been the way in which the IMF has abused its "exceptional access" lending policy over the past five years. This policy, which effectively removes any reasonable limit on the amount that the IMF can lend to an individual country, has allowed the IMF to lend large amounts without precedent to countries such as Greece, Ireland, Portugal, and Ukraine. Whereas in the past IMF lending had been

The IMF has abused its "exceptional access" lending policy.

limited to a cumulative maximum 600 percent of a country's IMF quota, in the cases of Greece and Portugal the IMF committed itself to loans more in the region of 2,500 percent of those countries' respective quotas.

As current events in Greece are now underlining, such large IMF lending was all too likely counterproductive in that it unduly delayed debt restructuring that might have given IMF programs for those countries a better chance of success. In addition, such large lending has also now exposed the IMF to very large loan losses, which, despite the U.S. Treasury's repeated assurances to Congress, could put U.S. taxpayers' money at risk. In this context, it is striking that of the total US\$85 billion in IMF loans currently outstanding, a full two-thirds of those loans are to three countries with highly dubious capacities to repay—Greece, Portugal, and Ukraine.

BACK TO THE DRAWING BOARD?

Recognition of post-2010 developments would suggest that the IMF should go back to the drawing board on its proposed reforms. A new IMF reform package might still seek to increase the relative voice of the key emerging market economies in the IMF's governance structure. However, this should not be achieved through an increase in the IMF's permanent lending capacity. Indeed, there is the strongest of cases that the IMF's "exceptional access" lending policy should be terminated and that the IMF should return to its original role of a catalytic lender. Such a reform package would offer the IMF a very much better chance of getting the U.S. Congress on board than the package currently on the table. More important yet, it would also make for a better functioning IMF. ♦