Beyond the IMF

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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 have long removed themselves from IMF tutoring. During the last decade, however, emerging market countries have been joining the drift 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.

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 its governance.[i] In contrast to the heyday of the late 1990s, the Fund's future appears much bleaker. Over the last two years, respected international finance experts have stated that the IMF is rudderless and ineffective,[ii] that it is suffering from an identity crisis,[iii] and waning influence,[iv] that it is on the brink of irrelevance, [v] and that, as a result, the world economy basically is not managed at all.[vi] Demand for its resources is at a historic low, and major borrowers (including Argentina, Brazil, Pakistan and Ukraine) are prepaying the institution and seeking to cut their dependence on the Fund. 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 (Table 1). The emergence of market mechanisms and government interventions that act as substitutes for the IMF, together with the high costs of borrowing from the IMF, have pushed countries to de facto exit from the Fund.

Table 1. IMF Loans Outstanding (SDR $bn)

Region	1991	1998	2005
Asia	5,031	24,173	7,568
Asia (ex China)	4,701	24,173	7,568
Africa	5896	6,776	4,435
S. & C. America	12,135	15,616	9,233
Developing Europe	3,465	19,645	13,181
Middle East	155	572	667

One possible interpretation is that the current decline in demand for Fund resources is part of a cyclical process. However, it is worth comparing the global payment systems in the aftermath of the oil price shocks of 1973-74 and 1979-80 with that of 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 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. There are now a plethora of market mechanisms and government interventions that act as substitutes for the IMF in its core functions, including crisis resolution, exchange rate management, financial policy coordination and surveillance. Several factors have contributed to the development of these alternative mechanisms. Perhaps the most important has been the rapid growth of financial markets, which in turn has driven the expansion of institutions that monitor and carry out continuous market surveillance. A second factor has been an equally impressive expansion in local or regional cooperation and integration.[vii] The third development has been modern communications technology, bringing a multiplication in the volume, access and speed of information, and 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.

Global Financial Stability

Crisis Resolution

Although the Fund was a pivotal player in many debt and financial crises during the 1980s and the 1990s, developing countries have begun to see it less as an impartial referee than as a debt collector for private creditors. A few years ago, the Fund proposed sovereign debt restructuring mechanisms (SDRM). Even if 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. As the Argentinean and Russian defaults have shown, countries have realized that rather than perennial rounds of debt restructuring with the IMF, countries may be better off simply ignoring the Fund. The results (at least till now) do not seem to indicate that these countries are any worse off than if they had elected to use the offices of the IMF.

Managing the International Monetary System

The primary role of the Fund on exchange rate management 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[viii] 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. The main problem with this argument is that the risks to global financial stability are from the systemically important countries and regions - the very actors over whom the Fund has little influence. It is unclear why moving from the current ambiguous guidelines to more well-defined rules would resolve the enforcement problem.

Indeed, even the SDR as a notional unit of exchange now faces competition. In spring 2006, the ADB planned to launch a notional unit of exchange, called the Asian Currency Unit (ACU), which would help track the relative values of Asian currencies. Modeled 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, 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).

Coordination

An important role of the Fund has been to function as "a trusted, independent and expert secretariat" for policy makers around the globe. An evident sign of its failure has been the proliferation of alternatives, ranging from purely governmental to purely private. Ad hoc non-treaty intergovernmental groupings like the G-7, G-10, and G-20 are agenda setting and rule ratification institutions. Increasingly, the rules underpinning global financial governance are being set by private actors (IFAC, IASC) and groupings of national regulatory institutions (IOSCO, IAIS). Appendix I lays out the goals, representation, and financial issue areas of the principal institutional underpinnings of global financial governance.

Surveillance

Besides its insurance function, surveillance has long been seen as the Fund's other critical function. The very success of the Fund in ensuring greater transparency in countries' macro accounts has meant that a variety of institutions play a similar role to the Fund through their reports and analysis. The coverage of private rating agencies has grown enormously, for sovereign and private debt, to most middle income countries and even to many Sub-Saharan countries. In addition to wide coverage and freedom from political inhibitions, private sector surveillance is a source of frequent and up-to-date information, in contrast to the IMF's Article IV consultations which occur only every 12-18 months. It should be noted that although the rating agencies have not improved on the Fund's prediction record and face conflict of interest pressures, yet private surveillance is a growing industry.

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. Borrowing from the Fund has lower financial costs, but higher political costs. Recently, developing countries have appeared 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.[ix]

Table 2. Developing Country Foreign Exchange Reserves (SDR $ bn)

Region	1991	1998	2004
Asia	174,444	408,569	1,033,250
Asia (ex China)	75,920	240,229	580,282
Africa	13,937	28,932	81,356
S. & C. America	44,748	112,471	139,154
Developing Europe	15,391	71,736	211,883
Middle East	38,385	69,515	101,931

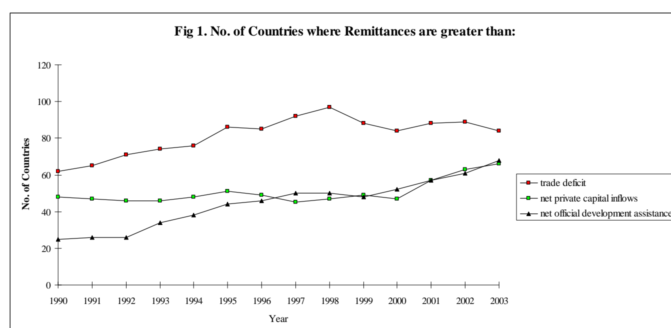
Recent years have seen a surge in foreign exchange reserves (Table 2). While in some cases (most notably in East Asia), countries have been building up their reserves to prevent appreciation of their currency, in the vast majority of cases, the primary motive has been "self-insurance". The demand for reserves is usually modeled 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) behavior.[x] Kapur and Patel 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).[xi] 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 (Table 3).

Table 3. Ratio of LDC Reserves/IMF Loans

Region	1991	1998	2004
Asia	34.67	16.902	119.87
Asia (ex China)	16.15	9.93	67.32
Africa	2.36	4.27	15.989
South and Central America	3.69	7.202	4.99
Developing Europe	4.44	3.65	10.706
Middle East	247.26	121.57	134.68

Another source of self-insurance is from citizens abroad. Remittances are an important source of financial flows for many developing countries. These flows come without a plethora of conditionalities, do not require repayment, and increase in times of shocks. They allow developing countries to cover their trade deficits and avoid the cycle of unsustainable external borrowings to cover high current account deficits, thereby necessitating an IMF program.



A country's diaspora can be a source of self-insurance, 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 US$4.2 billion through India Resurgent Bonds (IRBs). Again, in 2000, apprehensive about its balance of payments prospects, India raised another US$5.5 billion through the India Millennium Deposit (IMD) scheme. The experience underscored a new possibility: a country with a large overseas diaspora can raise significant resources in relatively short time, without having to go to the Fund.

Political motivations have also led to emergency financing between countries, as illustrated by Venezuela's recent offer to buy $3.4 billion of Argentine 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.

Developed countries already have developed self- and joint-insurance systems. It was the establishment of the General Agreements to Borrow (GAB) among the G-10 in 1964 that undermined the Fund's *raison d'etre* for the industrialized countries. 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 GAB, the Fund's importance to the region will diminish for the same reason that it has all but disappeared in the industrialized countries.

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 with liquidity provided by the ECB, rather than the IMF. China's demand for raw materials has fuelled a new commodity boom and led China to stake strategic partnerships – and much needed investment – in Asia, Africa, and Latin America. China's volume of trade with Africa has quadrupled in the past five years (to about $37 billion).[xii] And China's policies are much less constrained than those pressed on the Fund by its major shareholders. Even as Zimbabwe defaulted on its obligations to the Fund, Beijing rolled out the red carpet for President Mugabe.

Organizational Changes

The Fund has a few options if it is to reverse its loss of clientele to these alternative mechanisms. Suggestions for reform to augment the Fund's falling revenues abound, from investments of its reserves in higher yielding longer-term securities to generating income from its gold holdings. A relatively unexplored alternative is to cut the Fund's administrative expenses, using budget savings to lower borrower interest rates. To do this, the Fund needs to implement standard cost-cutting measures including an overhaul of compensation policies, development of more

flexible (internal) labor markets, greater decentralization and outsourcing to lower cost locations.

Since personnel expenses amount for about 70 percent of the Fund's budget (nearly $900 million), there is simply no alternative but to address the size of staff and the structure of compensation. The biggest anomaly in the Fund's compensation is its pensions. 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 benefits to defined contributions, its own compensation policy remains wedded to a defined benefit pension system, one of its 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 favorite Fund recommendation, labor market flexibility.

A second problem with the Fund's compensation policies is wage compression. Here too, the Fund has failed to follow its own advice. Support staff is compensated much too handsomely, especially when one adds in munificent expatriate benefits. 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. The Fund's message to its clients around the world has been a consistent one – monetize all benefits so that they are clear and transparent. Yet, IMF staff receives a range of benefits in non-monetized form, from education to travel allowances. In order to maintain relevance, the Fund should launch a rapid restructuring and significant cuts of the Fund's administrative budget, with the savings directed to lower interest rates charged to borrowers.

Conclusion

We find a variety of initiatives and developments outside the Fund that complement or substitute for the IMF's financial coordination, insurance and surveillance functions. The resort to non-Fund alternatives is driven, in part, by the increasing cost of Fund resources, largely explained by its very high administrative budget. These alternatives outside the IMF 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.

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.

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[i] For a recent elaboration, see: Akyüz, Y. (2005). Reforming the IMF: Back to the Drawing Board. G-24 Discussion Paper No.38, UNCTAD/GDS/MDPB/G24/2005/5), United Nations, Geneva.
Buira, A. (2005).The Bretton Woods Institutions: Governance without Legitimacy? In *Reforming the Governance of the IMF and the World Bank,* ed. A. Buira. London: Anthem Press: 7-44.
Woods, N. (2005). Making the IMF More Accountable. In *Reforming the Governance of the IMF and the World Bank*, edited by A. Buira. London: Anthem Press: 149-170.

[ii] Comments by Barry Eichengreen and Mohammed El-Erian, Conference on IMF Reform, Institute for International Economics, September 2005, cited in *IMF Survey*, October 2005, p. 305.

[iii] Ted Truman, interview in *Finance and Development*, October 31, 2005, p. 321.

[iv] Ibid, 321.

[v] Martin Wolf, *Financial Times*, February 22, 2006.

[vi] John Williamson, "Reforms to the International Monetary System to prevent Unsustainable Global Imbalances," in World Economic Forum, *The International Monetary Fund in the 21st Century: Interim report of the International Monetary Convention Project*, p. 22.

[vii] See, for example: Bryant, R C. (2004). *Crisis Prevention and Prosperity Management for the World Economy*. The Brookings Institution, Washington, DC.

[viii] Williamson, J. (2005). Reforms to the International Monetary System to Prevent Unsustainable Global Imbalances. In *The International Monetary Fund in the 21st Century: Interim Report of the International Monetary Convention Project*, World Economic Forum, Davos, Switzerland.

[ix] Generally, these costs are calculated as the difference between short term borrowing abroad and yield of liquid foreign assets (e.g. US 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 reserves, but also increase liquidity to respond to external shocks. See: Rodrik, D. (2006). The Social Cost of Foreign Exchange Reserves, National Bureau of Economic Research, Working Paper 11952, Cambridge, MA.

[x] Aizenman, J., and Lee, J. (2005). International Reserves: Precautionary versus Mercantilist Views, Theory and Evidence. Research Working Paper no. 11366, National Bureau of Economic Research, Cambridge, MA.

[xi] Kapur, D., and Patel, U. (2003). Large foreign currency reserves: Insurance for domestic weaknesses and external uncertainties? *Economic and Political Weekly*, XXXVIII (March 15-21): 1047-1053.

[xii] 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.