THE EVOLUTION OF THE IMF:
A Case for IMF 1.5 Before Bretton Woods 2.0

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Atlantic Council
GEOECONOMICS CENTER

BRETTON WOODS 2.0

BRETTON WOODS 2.0 PROJECT

This paper is one of four publications launched as part of the Bretton Woods 2.0 Project on October 17, 2022. Launched right after the 2022 IMF-World Bank Annual Meetings, the Bretton Woods 2.0 Project examines the deep challenges facing the Bretton Woods Institutions and leverages interactive data visualizations to reimagine the governance of international finance for the modern global economy. The goal of the Project is to deliver a blueprint for reforms in four key areas: governance and parallel institutions, macro-critical global trends, future of money, and fintech, and non-state and quasi-state actors.

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INTRODUCTION

The Bretton Woods (BW) institutions—in particular, the International Monetary Fund (IMF), the focus of this paper—were launched just before the conclusion of World War II and have contributed significantly to sustaining long periods of peace and prosperity ever since. However, in light of the IMF's mandate to promote the stability of the international monetary system, successive rounds of economic, financial, and sovereign debt crises have shaken public trust in the institution. Moreover, growing inequalities in wealth and income distribution in many countries, especially developed ones, have accompanied overall economic growth—driven mainly by stagnant wages triggering disillusionment and backlash against the policies of free trade and capital flows advocated by the IMF. Many developing and low-income countries (LICs) have even ended up falling further behind developed countries, despite the progress made by a select few—most notably China—in closing the gap. In addition, threats stemming from climate change and pandemics have become acute. All these factors pose significant risks to the stability and growth of the global economy, increasing hardships on low-income countries and poor people, in particular. It is clear that the BW institutions need to be significantly reformed and redesigned to better address these challenges.

However, the required reforms must be underpinned by strong international cooperation to stand a chance of moving forward. The reality is that the world has been riven by contentious geopolitical and strategic rivalry between China/Russia and the US/Europe. This rivalry intensified following Russia's February 2022 invasion of Ukraine, increasing mistrust and enmity between major countries to the point of undermining the functioning of international organizations such as the World Trade Organization (WTO), or forums such as the Group of Twenty (G20), which played a crucial role in stabilizing the 2008 financial crisis.

In a nutshell, without strong international cooperation and consensus (which are sorely lacking at the moment), radical reforms will be next to impossible. But given the urgent need for change and improvement, it is still important to think through various reform proposals and prioritize them accordingly. It is useful, as a start, to divide the reform agenda into two buckets. The first comprises ambitious and structural changes that may be currently unfeasible due to geopolitical realities, but should still be discussed, as those proposals can be seriously considered when global geopolitical dynamics improve—e.g., BW 2.0. The other bucket comprises concrete improvements aiming to improve current practices, which are more modest in scope and technocratic in nature, but can be implemented right away within current institutional structures and using existing resources—e.g., IMF 1.5.

The IMF headquarters building is seen ahead of the IMF/World Bank spring meetings in Washington in 2019. REUTERS/Yuri Gripas.

RADICAL REFORMS NEEDED, BUT NOT FEASIBLE NOW

Many ideas to reform the IMF have been floated. Three important proposals have significant merit, but are unlikely to advance amid today's geopolitical tension and division.

The most important issue on the reform agenda is governance—in IMF language, "voice and representation"—with the aim of improving the IMF's legitimacy. The shareholder structure of the IMF, as reflected in the quotas of its members, remains seriously out of sync with changes in the relative economic weights of the United States/Europe and China/emerging-market countries, despite some reform measures implemented in 2010.[1] Governance reforms essentially mean increasing the relative quota shares of China and emerging-market countries at the expense of the United States and Europe. The United States has strongly opposed any change that threatens its veto power in major IMF decisions requiring an 85-percent majority—safeguarding its 16.73-percent share through the 2010 reform. The European Union (EU) and United Kingdom (UK) lost some shares (and are resistant to any further dilution) to the benefit of the BRIC countries (Brazil, Russia, India, and China), with China gaining the most—its share increased from 3.81 percent to 6.16 percent, although this is still not commensurate with its weight in the world economy. Other emerging-market countries lost their relative shares in the same time period, which is a move in the wrong direction. Given the heightened tension resulting from the strategic competition and ensuing mistrust between China and Russia and the United States and the West, it is clear that the West will not agree to give China more power and influence at the IMF. In particular, any reform proposals that eventually put China at voting-power parity with the United States in the IMF, as proposed by Fred Bergsten, for example, may be welcome by China, but will definitely be unacceptable to the United States.[2] It should also be kept in mind that, according to the IMF, the size of an economy is not the only parameter used to calculate members' quotas. However, deciding on the necessity of changing the current criteria and calculation methodology is also part of the reform agenda.

Additionally, ongoing discussions about increasing IMF lendable resources—either through a boost in members' quotas (capital contributions) or arrangements for the IMF to borrow from creditor members—are unlikely to reach a conclusion amid today's geopolitical tension.[3] At present, the IMF has special drawing rights (SDR) of 477 billion ($651 billion) of capital made up by members' quotas, which resulted from an increase approved in the 14th General Review of Quota (GRQ) in 2010; SDR 361 billion ($521 billion) in the New Arrangements to Borrow (NAB), representing a doubling of the former General Arrangements to Borrow (GAB) agreed upon in January 2021 and expiring in 2025; and SDR 135 billion ($193 billion) in the Bilateral Borrowing Arrangements expiring at the end of 2023, with a one-year extension if all participants agree. Given the worsening geopolitical situation, many developing countries, and the IMF itself, are pushing for an increase of quotas in the current 16th GRQ—to be concluded by December 15, 2023—to augment the IMF's own financial resources, especially in case the two other aforementioned borrowing arrangements expire without being renewed. If they were not renewed, IMF lendable resources would be severely diminished, making the organization less able to support its members. Again, heightened strategic competition among major countries will likely prevent a successful increase of 16th GRQ quotas.

Finally, there have been many proposals to promote the SDR as the main reserve currency in the global monetary system, replacing reliance on national currencies, mainly the US dollar (USD) and, to a lesser extent, the euro. The current practice gives the US Federal Reserve, also known as the Fed, and the European Central Bank (ECB) inordinate powers and privileges in supplying the world with needed liquidity and collateral (mainly in the forms of US Treasury securities), for both normal economic and financial transactions and the urgent stabilization of financial crises. Both of these functions, however, depend on the United States running ever-larger current-account and fiscal deficits—a situation that is inherently unsustainable, and has given rise to systemic instability of the global monetary system. Increasing US use of sanctions—excluding targeted entities in unfriendly countries from US financial and payment systems, in particular—has also made a growing number of countries uncomfortable with the continued crucial role of the USD in the global economy. However, in addition to the technical difficulties of implementing the SDR scheme, promoting the use of SDRs as the international reserve currency would require empowering the IMF to act as the world's central bank—something to which many countries will not agree, especially in the current atmosphere of mutual mistrust.

FEASIBLE REFORMS—IMF 1.5

While it is useful to explore radical reform ideas for the IMF and other BW institutions, it is important to primarily focus on a series of modest and technical, but more feasible, measures. Within current institutional setups and the scope of existing resources, these reform ideas can be realistically promoted to address some of the problems mentioned above and improve the current functioning of the IMF. These changes can be initiated by IMF management—in many cases, with additional board approval

PROPOSAL I

The IMF can, and should, treat its diverse membership more consistently and equitably, as prescribed by its Articles of Agreement, by rectifying the unequal treatment accorded to Latin America and Africa. Overall, Latin American countries tend to get larger financial packages, relative to their quotas, than African countries. Furthermore, conditionality in terms of required structural reforms may be even less stringent for Latin America than they are for Africa. A prime example is Argentina, which has had twenty-one IMF rescue programs, each lasting about twenty-four months.[4] The latest program was recently approved by both Argentina's Congress and the IMF board.[5] This thirty-month program provides Argentina with $44 billion, or

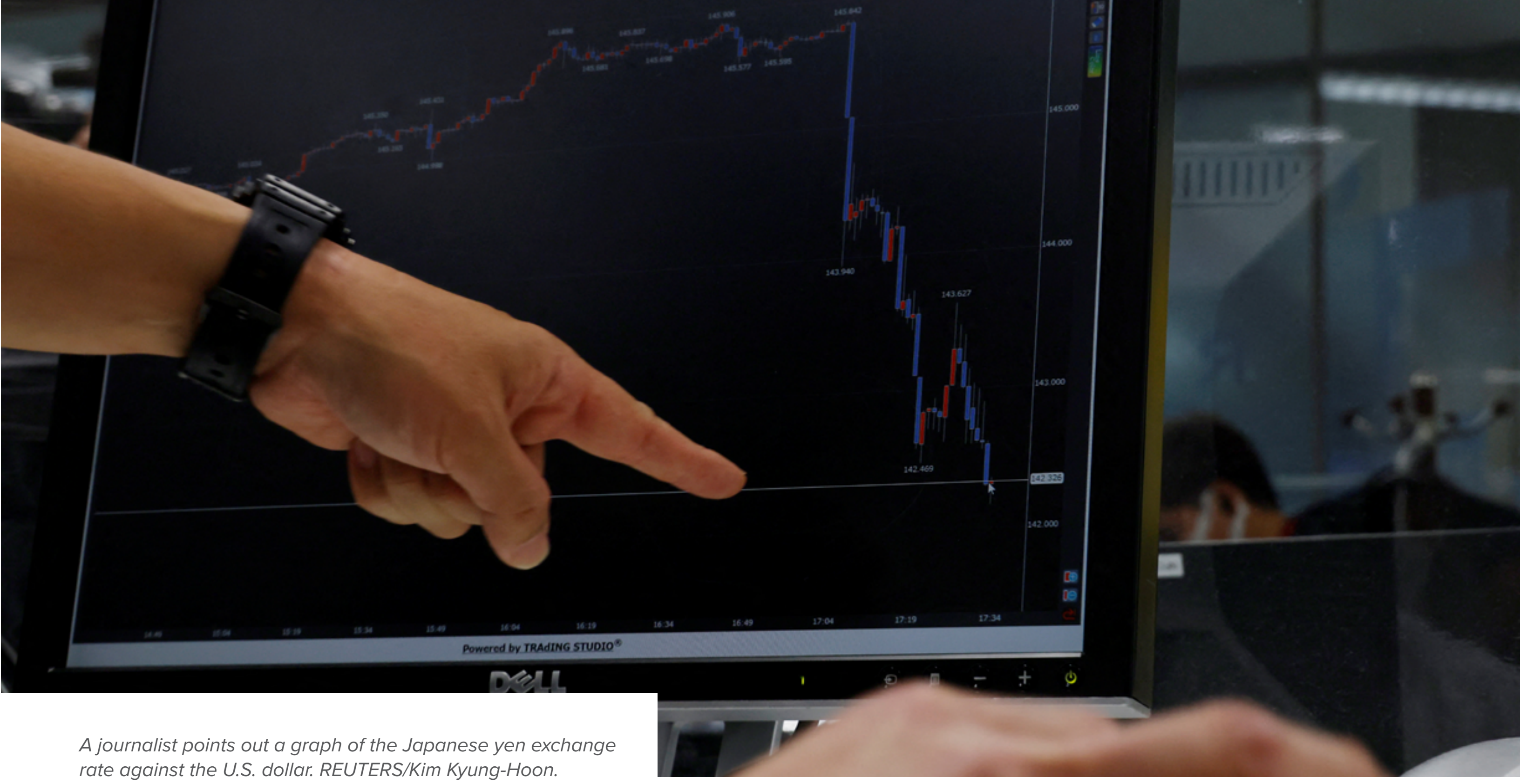
1,000 percent of its quota (which breaks down to about $956 million per capita), mainly to help the country repay an outstanding amount owed to the IMF from a failed $57-billion program in 2018. The program's conditionality, especially on structural-reform requirements, is light given the hostility of both Argentina's political class and voters toward the IMF, which was anxious to avoid a large default to itself. More generally, except for a few countries like Chile, which enjoys the highest per capita income in the region, Latin America has had a poor track record in implementing structural reforms required for these programs—a reality the IMF must recognize. These countries remain vulnerable to domestic economic rigidities and distortions, exposure to commodity-market fluctuations, and insufficient domestic savings leading to overreliance on volatile international capital flows.

In contrast to the program in Argentina, the IMF has approved an agreement with Zambia for a thirty-eight-month program totaling only $1.3 billion, or 100 percent of its quota (which breaks down to about $73 million per capita), which includes fairly stringent conditionality involving specified structural reforms.[6] This contrast generally hold true when comparing Latin America and Africa. Another example is IMF lending during 2020–2021, mainly for COVID-19 pandemic measures—the $118.3 billion (or $118 per capita) allotted to Latin America far exceeded the $25.9 billion (or $23 per capita) allotted to Sub-Saharan Africa.[7] Reducing the size of IMF programs in Latin America and increasing those in Africa can reallocate critical financing to Africa, which is in dire straits due to chronic underfunding, coupled with the COVID-19 pandemic and fallout from the war in Ukraine, while remaining within the current IMF resource envelope. In designing programs for Sub-Saharan Africa, the IMF can, and should, take the opportunity to learn from both the relative successes and recurring challenges experienced by countries like Ghana.[8] Doing so will help the IMF both find success in Africa and avoid being dragged deeper into widespread bad practices like ever-greening its loans—i.e., giving a member country an outsized IMF loan with a conditionality-lite program designed to enable it to repay the outstanding loan and escape default, eventually causing losses to the IMF and its broader membership, as exemplified in the case of Argentina.

PROPOSAL II

Members' economic problems have become increasingly complicated, going beyond current account imbalances that could be rectified by changing inappropriate policies, such as maintaining uncompetitive exchange rates. In the current spectrum of economic and financial crises, comprehensive structural reforms are usually needed to adequately address a country's economic distortions and improve its economic performance. However, those conditions are considered politically intrusive and difficult to implement. They historically trigger resentment toward the IMF, contributing to its unpopularity in many developing countries. Lack of political will in recipient countries to implement agreed-upon reforms has also led to repeated failures of IMF programs, with many countries coming back to the IMF for help time and time again.

IMF staff should take stock of countries' frequent failures to implement structural reforms traditionally included in their programs, and to use this knowledge to rethink their approaches. These negative experiences suggest that counterproductive and unsustainable institutions and practices—e.g., widespread tax avoidance and evasion, reliance on promises of public spending of all kinds to buy votes and win elections, systemic cronyism and corruption, etc.—that the IMF rightly wants to tackle and reform can only be accomplished by will in the country itself, not by an externally imposed assistance program. Unfortunately, there are relatively few cases of countries having the rare combination of enlightened and effective leadership coupled with a supportive citizenry to successfully implement these kinds of necessary structural reforms in a crisis. With this reality in mind, the IMF's usual structural-reform requirements—e.g., reducing fiscal deficits by raising revenues and scaling back spending, including for subsidies; floating exchange rates; cutting corporate tax rates; promoting foreign trade and capital inflows, including foreign



A journalist points out a graph of the Japanese yen exchange rate against the U.S. dollar. REUTERS/Kim Kyung-Hoon.

direct investment; etc.—should be scaled back and much less ambitious going forward. Conditions should instead focus on a relatively small number of achievable benchmarks, such as a reduction of external and budget deficits. Otherwise, countries will continue failing to carry out structural reforms, and the IMF will be left with more failed programs and an increasingly negative reputation of being intrusively demanding on recipient countries. Lack of positive progress in these countries means many will eventually run into difficulties again, requiring further IMF assistance, and the cycle will continue. The IMF must accept this reality and take it into consideration—it was designed to provide short-term financing to help members reduce imbalances in their balance of payments, not to structurally change countries and the ways according to which they operate.

Of particular interest is the evolving IMF position on the use of capital controls. Leaving behind its advocacy of free capital flow and subsequent reluctant acceptance of capital controls as a last resort—after serious disputes with members like South Korea and Malaysia during the Asian Financial Crisis in the late 1990s, and India and China in the mid-2000s—the IMF has recently begun to give members more freedom in imposing capital controls on a proactive basis under specific circumstances (e.g., if there is a currency mismatch in the country's external assets and liabilities). The IMF should follow this line of change further, to its logical conclusion, and adopt a non-normative approach to capital controls—i.e., neither prohibiting nor advocating for them, but leaving the decision to the members.[9] This would bring the IMF closer to its original charter, which did not put capital-account transactions under its purview. The IMF can instead focus on adding value by analyzing the impacts of existing capital controls and identifying possible distortions or risks caused by these measures, including negative spillover impacts on other countries—especially if the controls are maintained too long.

The IMF could also offer capacity-building programs to help developing countries use recent technological advances in finance (fintech) to improve the mechanics of public finance and more effectively combat corruption and inefficient use of government resources—perennial problems plaguing many developing countries. For example, establishing effective e-government, as Estonia has done, can significantly improve tax collection and disbursement of public funds. Both Kenya's successful promotion of mobile payments via cellphone through the M-Pesa program and India's encouragement of bank-account access with simplified identification requirements and widespread availability of mini-automated teller machines (ATMs) can also be considered financial-inclusion improvements, a key public policy goal for overcoming structural impediments to growth.[10] The IMF is in an ideal position to create programs that share the knowledge foundational to these successes with other countries in similar situations, amplifying the reach of best practices.

PROPOSAL III

The IMF should try to better define its role in coordinating the various layers of the global financial safety net. The top concern here is that emerging-market countries have focused on accumulating foreign reserves as self-insurance against financial crises, even though reserves accumulation is not a very productive way for countries to deploy those resources. Foreign-exchange (FX) reserves at central banks worldwide have reached $12.7 trillion, with $7.3 trillion held by emerging-market countries—most notably China, with $3.2 trillion.[11] This serves as a country's first line of defense for stabilizing an FX payment or funding crisis. However, drawing down reserves to calm such a crisis can, in some cases, send a negative signal to market participants and end up intensifying a crisis until the policies responsible for the initial trigger are changed.

Bilateral currency-swap lines (BSLs) are more effective for dealing with global or regional financial crises. To address a global USD liquidity or funding crisis, for example, the US Fed BSLs with five permanent counterparties (other central banks) with unlimited drawing and nine other ad hoc counterparties with limited drawing are the most important safety net. The Fed BSLs were crucial in calming the dollar-funding crises during both the 2008 global financial crisis and the beginning of the COVID-19 pandemic in March 2020. In more regional setups, a group of Asian countries established the Chiang Mai Initiative Multilateralization (CMIM), with a liquidity pool of $350 billion; China has established BSLs with forty-nine countries, worth $500 billion; and the euro area established the European Stability Mechanism (ESM) with €705 billion in capital, including €80.5 billion paid in capital, making it the highest capitalized international financial institution in the world.[12] The ESM provides financial assistance, with conditionality, to member countries in need (with a maximum lending capacity of €500 billion), effectively making it more like a proto-IMF than a normal set of BSLs.

In this multilayered global financial safety net, the IMF's lendable capacity of about $1 trillion is quite useful for developing countries. Although it would not be suitable to deal with a global USD funding crisis or a domestic sovereign debt crisis of a highly indebted middle- or high-income country, the IMF could leverage its in-house technical expertise and intimate knowledge of members' economies to add value by serving as a coordinator, helping various emergency liquidity providers by sharing information and insight. This would help liquidity providers coordinate announcements of their financial rescue packages, which could have significant stabilizing effects during a financial crisis.

PROPOSAL IV

The IMF should work with the G20 to strengthen the Common Framework for Debt Treatment to help manage the recent cascade of sovereign debt distresses and defaults, which will only become more numerous in the foreseeable future.[13] The proposed measures discussed below are mainly technical in nature, so they are more likely to be seriously considered by the G20 even during periods of deep mistrust among key members.

First and foremost, the IMF should persuade the G20 to extend the Common Framework to cover highly indebted middle-income emerging-market countries in addition to the usual low-income countries. After all, while 60 percent of the LICs are at high risk of debt distress or are already in distress, about 35 percent of emerging-market sovereign bond issuers have seen their bonds trading above 10 percent, a distressing level of yield.[14] The IMF can put more public pressure on both debtor and creditor countries, especially China, to actively engage the Common Framework in a timely manner to negotiate debt resolutions and minimize the cost of defaults, including economic disruptions in debtor countries. So far, only three countries—Chad, Zambia, and Ethiopia—have engaged the Common Framework, and their negotiations in official creditor committees have proceeded very slowly.

To alleviate disincentives for debtor countries making use of the Common Framework, the IMF and credit-rating agencies should also discuss how to avoid automatically downgrading countries applying to the Common Framework. The IMF should also propose discussions in the G20 about according private-sector creditors and investors timely opportunities to participate in equitable discussions of debt-restructuring terms, instead of asking them to simply accept the terms negotiated by public creditors and debtors. Lack of participation in the debt-restructuring negotiation process has long kept private creditors and investors away from the Common Framework.

Another major problem plaguing sovereign debt-restructuring processes is the lack of full and transparent disclosure of debt by a number of debtor countries. The IMF can be useful here. As part of its routine operations, the IMF should strengthen its regular Article IV consultations with all members, as well as program negotiations with members asking for assistance, to require full disclosure of relevant economic and financial facts and data—most importantly, both on- and off-balance sheet liabilities—that can affect economic and financial sustainability. Crucially, this information should also be promptly and fully disseminated to the public. In particular, the Debt Sustainability Analysis carried out jointly with the World Bank should be published in full, and in a timely manner. This would significantly improve debt transparency, especially for scores of developing countries with poor track records in this respect. Although a lack of debt transparency has already contributed to many sovereign debt crises, it has not been an area of focus for many international efforts dependent on the voluntary actions of sovereign borrowers, lenders, and investors. Finally, the IMF should change its current policy of publishing country reports after Article IV consultations only if the country in question agrees. The country report should be published automatically after the review, and should not be subject to country's approval. In fact, the reports should go further, and include a country's objections to the staff analysis and recommendations.

PROPOSAL V

The IMF should clarify its involvement in new focus areas, such as dealing with the impacts of climate change or problems caused by social and economic inequality, to avoid accusations of engaging in mission creep. In the context of its economic-surveillance and assistance-program design work, the IMF should focus on analyzing the risks these issues present for economic and financial sustainability and monitor countries' progress in addressing them, using benchmarks developed by competent international bodies—not necessarily the IMF itself. For example, the IMF could monitor members' progress toward achieving the net-zero-emission (of CO_2) goals pledged by participating countries at COP26.[15] It could also strengthen its monitoring of members' progress toward meeting the United Nations' seventeen goals, scheduled to be accomplished by 2030.[16]

G20 Finance Ministers, Central Bank Governors and head of delegates attend the G20 Finance Ministers and Central Bank Governors Meeting. Made Nagi/Pool via REUTERS.

PROPOSAL VI

Finally, and this is perhaps the most feasible, the IMF should learn from the controversy surrounding former World Bank Chief Executive Officer (CEO) (and current IMF Managing Director) Kristalina Georgieva's alleged influence on a "Doing Business" report.[17] Going forward, to better protect the integrity and credibility of IMF analyses and policy recommendations, all comments sent to the authors of documents should be in writing and transmitted electronically—never via verbal comment or instruction—by the managing director, and should be easily accessible for other appropriate staff, officials, and country authorities, so as to preserve a digital paper trail for better auditing.

CONCLUSION

As geopolitical tension and strategic conflicts intensify, common purpose and cooperation in international relations have been replaced by mutual suspicion and mistrust. Bretton Woods institutions have, in parallel, been weakened. In this environment, achieving necessary radical reforms of BW institutions that require international cooperation will be next to impossible. As such, and given the need for broad institutional improvement, narrower but more feasible agendas—such as those suggested in this paper for the IMF—should be considered. The management of the institutions involved are capable of driving these reforms, which would help them better carry out their missions under increasingly difficult circumstances. Implementing even some of these measures would be a positive step forward against a backdrop of geopolitical tension, strategic conflict, and mistrust between major players.

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