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INTERNATIONAL MONETARY FUND AS THE FOUNDATION OF A NEW GLOBAL INSTITUTION: PERSPECTIVES AND CHALLENGES

Resume *The perspective of International Monetary Fund's reform is considered in the article. The main purpose of the article is to analyze the problems of today's global financial co-operation between developed and emerging countries and how it is being regulated by the IMF and other world financial organizations. The relevance of the material stated in the article, is caused by global financial instability and by processes caused by it. Since it is still a challenge for the world economy, the concerned information is of a great importance and can provide practical outputs in the area of international economic relations.*

Keywords: IMF, G20, reform, emerging economies, quota

Аннотация *Перспективы Международного Валютного Фонда рассмотрены в статье. Главной целью является анализ проблем финансового взаимодействия между развитыми и развивающимися странами, а также, как эти процессы регулируются МВФ и другими мировыми финансовыми организациями. Актуальность материала, рассмотренного в статье, вызвана мировой финансовой нестабильностью и процессами, которые она вызывает. Рассмотренная информация имеет большую важность и может быть использована для практических рекомендаций в международных экономических отношениях.*

Ключевые слова: МВФ, G20, реформа, развивающиеся экономики, квота

Анотація *Перспективи Міжнародного Валютного Фонду розглянуті в статті. Головною метою статті є аналіз проблем фінансової взаємодії між розвинутими країнами так країнами, що розвиваются, на сьогоднішній день, а також, як ці процеси регулюються МВФ та іншими світовими фінансовими організаціями. Актуальність матеріалу, розглянутого в статті, визвано світовою фінансовою нестабільністю та процесами, що вона викликає. Розглянута інформація має велику важливість та може бути використана для практичиних рекомендацій в міжнародних економічних відносинах.*

Ключові слова: МВФ, G20, реформа, економіки, що розвиваються, квота

Global challenges that affected world economy during the severe financial crisis, forced countries to revise the international financial architecture and it is vital to reform global organizations such as International Monetary Fund, World Bank, or to create a new one that will be in charge of global financial system. These are the chief tasks of the research.

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Since the conference's objective is to report on perspectives of setting up a new global financial institution of G-20, this article correlates greatly with the task given.

The official information of IMF and related books were used in this article. What's more, the possibility of the most important reforms has been analysed in this work.

In the wake of crisis, politicians around the world are looking for tools to fix the international financial architecture: how to strengthen economic cooperation and how to effectively regulate financial structures. There are many players involved in this effort: international financial organizations, national governments and groups of countries, such as G-20 and the European Union.

The ineffective management should have been improved by a list of reforms. The IMF Executive Board sanctioned a first reform to the representation of four fast-growing under-represented countries such as China, South Korea, Mexico and Turkey in 2006. The purpose of the exercise is to ensure that both middle and low income countries are better represented on the Board, in the hope that developing countries will not choose to walk away from the Fund.

But this reform suffered significant resistance from subset of middle income countries in Asia, the Middle East and Latin America opposed the 'two-stage' reform process, and European Union members are still vehemently opposed to any change of the quota formula, which benefits the representation of small, open European economies [1].

Developing countries seeking to gain from the reforms three distinct advantages: first, the fact that the IMF's Article of Agreement stipulates that a country's representation cannot be reduced without their explicit consent gives every country an effective veto over the reform process. It implies that developing countries will not be able to lose representation without having the option to veto the deal.

Second, the impetus for this reform is developing countries own economic success - their pre-crisis economic growth and stability has made IMF relatively less important, and therefore the reform process is motivated by willingness to keep them as Fund's active participants.

The third advantage is that, rather unusually in the field of global governance reform, the United States is in favour of reform. The US is the IMF's most important shareholder and the only state with individual veto power over all reforms to the Fund, and its support for a substantial reform process could have moderated the anti-reform position of some countries, and in particular the EU members. This support is hardly can be named altruistic - the US stands to lose nothing from a new quota formula more weighted towards GDP.

Some countries are over-weighted with the current formula (e.g. Belgium, Spain), while some developing countries are under-weighted (e.g. Brazil, Turkey, Saudi Arabia).

The urgency of reforms in post-crisis time is great and developed countries are slightly more willing to revise the current governance of the IMF [2].

It is reckoned the region interested in the IMF's reform the most is the Asia in general and China particularly. There is general agreement that the IMF is the body best placed to help the growing number of debt-ridden emerging economies hit by the global recession; that if it is to offer this help, it will need more money; and that China, with its huge reserves, is best placed to provide those extra funds. But China is unwilling to finance an organisation over which it has little or no influence, while the EU and the US appear unwilling to cede control. Negotiations are already heated and protracted: China is driving a hard bargain, demanding immediate quota reform, IMF bond issuances to give it an alternative to US treasuries, and a reserve currency, managed by the IMF, to replace the dollar.

The US and Europe agree that the IMF needs to be bigger. It has about $250 billion; Japan and the EU have recently agreed to lend $100 billion each, but this will almost certainly not be enough. The Institute of International Finance has shown credit flows to emerging economies have fallen from $929 billion in 2007 to $165 billion this year, driving businesses under, and wiping out government finances as tax revenues fall. $500 billion won't fill the gap, if the crisis drags on into 2011. Simon Johnson, former IMF chief economist, thinks it could need $1 trillion or even more to bail out emerging economies as the global recession takes its course. A recent IMF paper, 'Global prospects and policies', is pessimistic about developing country prospects. It will take a long time to restart international finance: the outflows of capital in the Latin American and East Asian financial crises of the 1980s and 1990s amounted to 5 per cent of GDP and capital inflows took years to reach pre-crash levels. While Asian and to a lesser extent Latin American governments responded to these crises by building up foreign exchange reserves, many eastern European countries have large current account deficits and high levels of external debt, both of which make fleeing capital much harder for governments to replace. The IMF is already bailing out Romania, Hungary, Latvia, Ukraine, Belarus and Iceland, and many other European countries are on the brink. The G20 must act swiftly if disaster is to be averted.

At present, the developed world is stalling for time. The US and Europe have agreed to bring forward a review of IMF voting weights to 2011, but the last one, after two years of negotiations, only managed to raise China's quota to 3.6 per cent – slightly larger than Italy's. The old G7 economies are also disbursing the new Japanese and European cash through the 'New Arrangements to Borrow', which circumvent the main IMF voting system. This means China won't have demanded rights. BRIC countries – China, India, Brazil and Russia – are drawing a red line under this issue: they are demanding governance reform now. And China is staking out a position at the edge of what is possible, to try to manoeuvre the US and EU towards the deal it wants. In exchange for giving more money to the IMF, it demands an end to the US veto. It suggests that the IMF should create a new reserve currency to replace the dollar, and issue bonds, which China would be happy to buy. Perhaps the most surprising development in China's position is its apparent conversion to the benefits of international multilateralism. Zhou Xiaochuan, president of the People's Bank of China, proposed in his recent speech that the IMF might become the trusted custodian of national reserves [3].

In 2009, exports of emerging Asia to countries outside the Asian region still amounted to almost 25 percent of regional GDP compared with less that 15 percent for the EU-15 and about 5 percent for NAFTA. As of September 2009, the Asian region held about $3.75 trillion in international reserves, 60 percent of the global total, and almost $2 trillion in sovereign wealth funds, 40 percent of the world total. For individual countries, those reserves and other financial assets may be invested within the region, but the region as a whole is in current account surplus of more than 5 percent of GDP. This means that on balance the region's excess of saving over investment must be invested outside the region.

It follows that the Asian region has an overriding self interest in the continued economic prosperity and financial stability of the entire world and, therefore, in strengthening the principal institution of global governance that is dedicated to sustaining and maintaining that prosperity and stability - the IMF.

Today, the Fund is under stress, threatening its capacity to play its assigned role. It faces an existential crisis, an identity crisis, a sharply reduced demand for its lending, and a lack of consensus about what its role in the global economic and financial system should be. The Fund's past and present contributions are badly misunderstood in the United States as well as here in Asia. Over the past 60-plus years, the Fund has evolved constructively to deal with problems that, in effect, have been assigned to the IMF because it was there. I would submit that this approach is more efficient than creating an additional institution and bureaucracy every time a so-called "new problem" arises either globally or regionally.

Despite becoming the repository of worthy new initiatives, today the Fund's major problem is that it has been phenomenally successful in discharging its fundamental mission. However, the Fund has not continued to evolve with the global economy and financial system over the past decade. Many other countries with growing stakes in the continued successful globalization of the world economy have turned their backs on the Fund.

Consequently, the achievements in the IMF reform process, which has been underway for about three years, have been limited. One significant, but partial and minor, milestone was passed in September 2006 with agreement on a first stage of adjustments in IMF quotas. If the emerging countries are disappointed, the damage to the Fund and the international economic and financial system will be lasting. It is difficult to exaggerate the collateral negative effects on the Asian economies that are highly dependent on the prosperity of the world economy.

The IMF faces twin crises of relevance and legitimacy. What needs to be done? The relevance agenda should include four elements: enhancing the IMF's role in surveillance, modernizing its lending facilities, leaving broad issues of economic development to other better-qualified institutions, and revamping the IMF's financial and business model. The legitimacy agenda should encompass five elements: management selection, internal governance, external accountability, realignment of representation on the executive board (what I call chairs), and redistribution of voting power within the Fund, so-called shares [6].

The IMF is not the only institution that can help diagnose and deal with these problems, but at a minimum there are lessons to be learned; they will be lessons for countries and financial institutions around the world, and the IMF is the unique global institution positioned to assist in this educational process. It is inevitable that there will be consequent, adverse external financial repercussions for some countries and the Fund will be back in the lending business on some scale.

IMF lending itself is also a public good. Its purpose is to mitigate the costs of crises and policy mistakes for the residents of the particular member country that is borrowing and for other members who would receive the adverse spillover effects if that particular member country had to adjust without the availability of external financial assistance. More than half the IMF's 185 members do not have meaningful access to international capital markets. For about half of the remaining countries, access is intermittent, in particular for countercyclical borrowing. Although healthy on balance, the increased scope and scale of private financial markets means that the potential adverse economic and financial effects of inherently volatile private capital flows have increased not declined.

The Fund is widely perceived to lack the kind of legitimacy that is necessary if it is to carry out its mission. This perception may not be well grounded - and it is probably exaggerated - but it is widespread and persistent. Something has to be done about that perception if the IMF is to overcome its existential crisis.

The issues with respect to the IMF's internal governance are more complicated. The Fund is an international organization, its members are countries. Its structure was established more than 60 years ago with only modest modifications in the meantime despite a quadrupling of its membership and a wholesale transformation of best practices in public sector governance. The respective roles and responsibilities of the IMF governors, the International Monetary and Financial Committee (IMFC), the management, and staff are ambiguous. Consequently, responsibilities are blurred. Radical change in this area is not a realistic possibility. However, constructive evolution is necessary. One can hope that the forthcoming IEO report on IMF Corporate Governance will contribute to this process. The activities of the executive directors should be more focused, and management and staff should be given more responsibility along with an increase in their accountability [4]. External accountability is a crucial complement to the IMF's internal governance. Transparency is a key tool of accountability. Although the transparency of the Fund has increased substantially over the past decade, it is far from ideal. Furthermore - representation on the executive board - there are two issues. Is the board too large to be effective? It may well be, but its size cannot be reduced without dramatic changes in representation, where at least half the seats are occupied by representatives from the 27 traditional advanced countries, not counting Russia, and at least 7 seats are occupied by representatives from members of the European Union. Everyone knows what needs to be done to break this logjam: dramatic consolidation of European representation. The Europeans as a group have taken this issue off the table. Although the topic has been raised from time to time by officials from individual European and from other industrial countries including my own, my impression is that no pressure in this area has been exerted by the Asian countries. There are two tests for success on the issue of shares: First, will the new quota formula points toward a substantial redistribution of voting power away from the traditional industrial, or "advanced," countries as a group? Second, once adopted, will the formula be used transparently to implement a significant, immediate realignment of voting power away from those countries on the order of 10 percentage points including, but not highly dependent, on a permanent boost in basic votes? Every member of the Fund should receive some increase it its quota at this time [5].

Although it is true that the Fund's liquidity is at an all-time high, that should not be the only consideration. It is unfair and would be a mistake to limit the amounts that countries inevitably will borrow from the Fund over the next five years to the size of their quotas that were set a decade ago. Thus, it is unfortunate that the executive board has recommended to the IMF's board of governors that the Thirteenth General Quota Review be concluded without taking any action on the overall size of quotas. This action can be overturned as part of an agreement on the overall issue of quotas, but it sends all the wrong signals. The forces favoring the status quo are winning. If they do win, their victory will result in a progressively declining role for the Fund. It is in developing country's interests constructively to confront those forces and to turn them back. Once substantially diminished, it will be very difficult to restore the Fund to the role it should play in promoting economic growth and maintaining financial stability for the world as a whole.And in the view of the above developing, under-weight countries are pleased with another sort of rebalancing: that of global institutions to better reflect today's economic realities. From now on, the G20 will replace the narrower, Western-dominated G8 as the primary global economic talking-shop, giving the likes of China, India and Brazil a permanent seat at the table. In return, it is hoped that they will be more flexible in other areas, such as climate change and trade. The governance structure of the rejuvenated IMF will also change, with under-represented, mostly developing countries getting at least 5% more of the voting rights by 2011. Taken together, the Fund's overhaul and the G20's expanded powers mark an important shift in international macroeconomic policy. The other big institutional change is the ascension of the Financial Stability Board (FSB), a club of central bankers and financial regulators, which has also been broadened to include the big developing countries. From now on it will take a lead role in coordinating and monitoring tougher financial regulations and serve (along with the IMF) as an early-warning system for emerging risks. The FSB could turn into the "fourth pillar" of the modern global economy, along with the IMF, the World Bank and the World Trade Organisation. The FSB will also help to ensure that the rules governing big banks are commensurate with the cost of their failure. The main tool for this will be higher capital requirements. All agree that banks need more capital and that a greater share of it should be pure equity, the strongest buffer against loss. The G20 communiqué also supported forcing banks to hold especially high levels in good times so they are better prepared to ride out the bad. Strengthened positions of developing countries are also supported by better economical results comparing to European countries. Big populous countries - China, India, Indonesia - did not tip into recession; they merely suffered slower growth. Brazil and the Asian tigers saw output fall but bounced back. Even before the crisis, according to the World Bank, nearly three-fifths of the growth in global GDP came from China and India alone. In 2010 pretty much all the growth in the world economy will come from outside the rich world. This has made reform of the international financial institutions, which already looked out of sync with reality before the crisis, even more urgent.The Fund's government admits the IMF needs to regain trust of its poorer members, so that they rely on the fund's resources, rather than their own reserves, to insure against crisis. Gaining this trust will require reforms to the fund's "quotas" to give emerging economies more voting power. One round of changes has already been agreed, though not yet implemented. The G20 countries have asked the IMF to complete its next set of quota reviews by January 2011. But to satisfy developing countries, rich ones would have to give up more power than they may be prepared to. To sum up the IMF's future depends on its flexibility and implementation of vital reforms. If it did not accept the changes then the setting up of a new global financial institute would be possible, with the dominating role of BRIC and other developing countries. Nevertheless until 2012 the International Monetary Fund will remain the number one global financial institute.

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