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Insuring Against Instability: United States and the Future of the International Monetary Fund

Kati Suominen*

*The German Marshall Fund of the United States, ksuominen@gmfus.org

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Abstract

The International Monetary Fund (IMF), only a few years ago fading into obscurity in the thriving world economy, made a comeback during the 2008-2009 crisis. The G-20 re-tasked the Fund and tripled its lending capacity. Notwithstanding its new windfall and duties, the Fund's legitimacy and effectiveness are in doubt. The main challenges center on disagreements between the Western European nations and emerging markets over the Fund's governance and focus, a specter of disintegration of the global crisis management architecture by way of bilateral and regional financial arrangements (particularly in Asia), and limitations to the Fund's responsiveness to major crises.

Yet the threat of global financial instability persists, and the Fund is uniquely qualified to counter it. The United States, the Fund's founder and main shareholder, has sponsored sound reforms to the Fund in the context of the G-20. However, farther-reaching paradigmatic changes are required for the Fund to effectively manage global economic instability in the 21st century: focusing the Fund's analytical powers squarely on systemic risks and largest economies rather than on small, developing nations; turning the Fund from a crisis firefighter into a global preventive care unit that rewards members for sound policies; and making the Fund a bridge between public and private insurance markets.

KEYWORDS: International Monetary Fund, financial policy, regional financial integration, moral hazard

*Kati Suominen, Resident Fellow, The German Marshall Fund of the United States; email: ksuominen@gmfus.org.

INTRODUCTION

As the Great Crisis of 2008-09 battered economies around the world, the International Monetary Fund (IMF), only a few years ago fading into obscurity in the thriving world economy, sprung back to business. Some of the first rescues went to Ukraine, Iceland, Pakistan, Belarus, Georgia, and Latvia, followed by Serbia, Romania, Poland, and a number of Latin American nations, among others. By the fall of 2009, the Fund had committed over $160 billion in new loans and credit lines. At US initiative, the G-20 pledged to triple the Fund's lending capacity to $750 billion, and minted it as the manager of the G-20 efforts to curb global imbalances. Paradoxically perhaps, the crisis rescued the venerable global rescuer.

The Fund has played a critical role in post-war global economic governance and in advancing US interests. It has issued authoritative commentary on the challenges in the world economy, assiduously surveyed the state of its 186 member economies, and time and again steadied pivotal nations engulfed in economic turbulence. The IMF's counsel, even if at times criticized as draconian, has tempered economic policymaking around the world. Many an emerging market would be a declining market were it not for the IMF's emergency lending and policy advice. Recognizing the Fund's levers, the Obama administration placed it at the center of US foreign economic policy.

The Great Crisis was a case study of opaque hazards in the 21st century global economy and of their severe implications – credit crunch, unemployment, public debt, toxic politics. As an instance with global membership and reach, the Fund is uniquely qualified to help prevent and manage global, systemic crises. Its new windfall notwithstanding, the Fund's future is uncertain.

The global financial architecture risks disintegrating right when globalization of financial markets and crises alike calls for system-wide management. Asian economies, scarred by the Fund's tough policy conditionalities in exchange for loans during the 1997-98 regional financial crisis, are back at building national reserves and regional financial arrangements so as to wean themselves off the Fund's influence. Also Europeans and Latin Americans are discussing deeper regional financial integration.

Such impulses will continue intensifying particularly in Asia absent reforms to the Fund's governance, which remains contested between the Fund's founding fathers, the United States and Europe, on the one hand, and emerging markets hungry for greater say in the Fund's decisions, on the other. The US-sponsored G-20 pledge to expand emerging markets' voting powers in the Fund got a reluctant reception in Europe, and is unlikely to fully address the grudges of China, India, and other under-represented nations.

A further challenge to the Fund is limits to its responsiveness. The Fund's armory is dwarfed by global financial markets and is unlikely to be expanded further, particularly now that the United States and Europe struggle with their own fiscal woes. While helping to keep moral hazard at bay, a lean Fund with staunch loan conditions encourages ailing nations to resort to alternative lenders, such as China, that do not demand sound macroeconomic policies in exchange for loans. Will the Fund hold – and how to make it effective for containing 21st century crises?

GOOD OFFICES

The crowning achievement of the Bretton Woods conference of 1944, the IMF has served US foreign and economic policy interests.[1] It has helped rescue pivotal US allies and strategic linchpin nations, such as Mexico, Pakistan, Turkey, Korea, and Ukraine, build sound economic governance practices and institutions from Asia to Latin America, and spread the tenets of capitalism to Eastern Europe and Russia emerging from communism. The Fund has helped steady US export destinations: American trade flows with emerging nations that have borrowed from the IMF amount to more than $400 billion annually, or almost half of US trade with emerging markets (Henning, 2009a). One administration after the next has justified Fund rescues as critical to US economic and foreign policy objectives.[2]

Washington has played a central role in global crisis firefighting since the 1982 Mexican crisis, initially as the first responder and later as the Fund's second line of defense. By distributing its funding burdens across its membership, the Fund has economized insurance and prevented smaller nations from free-riding on US lending: America's contributions to the Fund are matched more than four-fold by other members (Henning, 2009b).

Granted, the Fund has not escaped criticism. In the Asian crisis, it was unfairly faulted for its tough conditions – tight money and deep budget cuts to

[1] See Stone (2004), Broz and Hawes (2006), and Dreher et al. (2009) for rigorous analyses on ways in which the United States has employed the Fund to pursue its interests.

[2] In Asian financial crisis of 1997-98, the motivation was economic: the rapidly spreading crisis undermined markets increasingly critical for US trade and financial interests, and offered an opportunity to influence longer-term economic policies across the region. In the Americas and Russia, foreign policy rationales led the way. Mexican crises of 1982 and 1994 needed to be tamed to avert mass migration across the Rio Grande; the Russian meltdown post-Asian crisis had to be arrested lest it aggravated the nuclear power and undermined its nascent democracy. Turkey ailing at the same time needed to be buttressed as a NATO ally in the Muslim world. Even the package to Argentina in 2002, while in part a means to shore up exasperated US creditors, could be defended on the grounds that a fall of the star pupil of the Washington Consensus would make other reforming nations lose heart.

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tame inflation and external deficits. A few years later, its support of the Argentine currency board was blamed for leading to the country's 2002 economic collapse. The Fund also proved powerless to affect its larger members: its warnings in the run-up to the crisis about the US housing bubble went unheeded, and it steered clear from berating China for its undervalued exchange rate.[3]

While the Fund is no magic wand for misgoverned economies, let alone the many nations that fail to complete its programs, it has made a veritable difference. Most studies show that when implemented, Fund programs improve countries' current accounts and international reserves (Dreher and Walter, 2010, Dreher, 2006, Joyce, 2003, Mussa and Savastano, 1999, Ul Haque, 1998).[4] Contrary to the Fund's critics, its impact on preventing currency crises and reducing macroeconomic imbalances is also positive (Dreher and Walter, 2010). For instance, a Fund program decreases the risk of a currency crisis and increases the likelihood that the exchange rate will be adjusted once a crisis is underway. The Fund's indirect benefits, even if hard to measure, may be particularly important. For instance, its involvement sets the stage for unpopular policy reforms by allowing the affected country's government to deflect some of the political fallout. And even if only partially, it shields also US policymakers from discontent: the Fund, not Washington, takes the primary hit from anguished populations wrestling with a crisis and austerity measures to subdue it.

SAVED BY THE CRISIS

The Fund was fading into obscurity before the crisis. Macroeconomic conditions during the first few years of the new millennium were stellar in the Fund's erstwhile clientele. Asian nations were growing at near double-digit rates and increasingly buffered by national reserves resulting from export-led development strategies; Latin American commodity producers thrived on the insatiable Asian demand for commodities. Emerging markets received progressively higher credit ratings, becoming eligible for low-interest private loans. A hammer in a world devoid of nails, the Fund's future was narrowed to two options – to shrink it or to sink it.

The crisis resurrected the Fund.[5] As countries around the world crumbled, Bush and the Obama administrations supported IMF loans as means to forestall a depression. National security arguments were revived, as well: Obama's first Director of National Intelligence Dennis Blair maintained that the financial turmoil posed the foremost near-term security threat to the United States (Pincus and Warrick, 2009).

[3] For Fund commentary on the US housing market, see, for example, IMF (2006).
[4] For a review, see Suominen (2010).
[5] See also, Hufbauer and Suominen (2010).

Policy consensus on the Fund's future shifted practically overnight. At US initiative, in April 2009 the G-20 pledged to restock the Fund with $500 billion in fresh lending capacity. United States committed $100 billion, as did Japan and the European Union. China promised $40 billion, and Korea $18 billion. Norway, Canada, and Switzerland provided a total of $25 billion.

The G-20 also allocated $250 billion in Special Drawing Rights (SDRs), the Fund's quasi-currency unit worth about $1.56, to boost liquidity among the Fund's members. At $283 billion by September 2009, the measure increased the outstanding SDR stock by nearly ten-fold. In another historic effort to raise money, the Fund sold some of its gold and set out to issue bonds nominated in SDRs. The BRICs – Brazil, Russia, India, and China –were keenest on the measure, both because the SDR makes for an ultra-safe investment vehicle, and because buying it allowed central banks to reduce their high dollar exposure. China, proposing the SDR be employed more widely in global economy, was the first customer with a $50 billion purchase.

The Fund's mission was also refurbished. Before the crisis, the Fund lacked a clear, compelling task; now, it would be charged with assessing countries' progress toward the high-profile G-20 balanced growth agenda aimed at taming global imbalances. The G-20 also looked to the Fund for more extensive global surveillance on such systemic issues as asset buildups and exchange rates, and asked it to partner with the Financial Stability Board (FSB) in early warning exercises.

The G-20, in short, gave the Fund a resounding vote of confidence. However, the Fund faces daunting challenges to its legitimacy and effectiveness. The most immediate challenge for the Fund is managing the new diverse demands – evolving from a single-minded hedgehog to a multitasking fox. The larger one is governance, where the epicenter is Asia.

RUNAWAY REGION?

After the Asian financial crisis, the regional governments set out to build national reserves and pursue regional financial integration as an indigenous means to insure against future crises. The foremost scheme is the Chiang-mai initiative, network of bilateral swap arrangements among the ten Association of South East Asian Nations members and China, Japan and Korea (or ASEAN+3) created in 2000.

Asians saw the Great Crisis as validating their decade-long reserve build-up. The need for liquidity in the US and Europe reverted capital flows from Asia, raising risk premia in the region. And as the region's capital inflows dwindled, equity prices dropped. National reserves were widely seen as proper vaccination, even as a source of national pride, and the regional economies have set out to

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aspire for even sturdier armories.[6] The crisis also solidified Asians' resolve to foster regional financial integration. In the aftermath, Asians expanded Chiang-mai to a total of $120 billion, and multilateralized it into a regional pool in order to realize the very same scale economies the Fund promotes at the global level. The main powers, Japan and China, agreed to equal voting shares.

Chiang-mai is widely discussed as a precursor of a regional IMF, an Asian Monetary Fund (AMF). At a time of its formation, the US Treasury insisted Chiang-mai be linked to the IMF. Under the arrangement, borrowers can draw up to 20 percent of their bilateral or multilateral swaps, but then need to agree on an IMF program, including Fund's policy prescriptions, to access the remaining 80 percent. As such, Chiang-mai is much more tightly referenced to the Fund than the European Union's balance-of-payments facility, Medium-Term Financial Assistance, or the EU and US Treasury's Exchange Stabilization Fund used mostly within the Western Hemisphere (Henning 2009a). However, given their powers in the Fund, the US and EU schemes have a built-in consistency with the IMF. But Asians, with less weight at the Fund, do not necessarily agree on all Fund policies, and may be more eager to go it alone. While guarded in their comments, many emerging Asian governments wish for a substantial increase in the 20 percent link, or delinking Chiang-mai from the Fund altogether.

Discussions on regional schemes are growing elsewhere, as well. Following the crisis, Latin American finance ministers started debating regional financial cooperation, and, in March 2010, the German finance minister, anguished by the debt crisis in Greece, floated the idea of a European Monetary Fund.

While reserve accumulation is economically inefficient, regional insurance pools can be a force of good.[7] They can serve as the first line of defense in regional crises, and their surveillance can supplement the Fund's analysis and alleviate its propensity for group-think. The division of labor is desirable as long as it leads to prompt crisis management and policy recommendations aimed at sound economic policies and good governance. If taming local crises with local funds, they would also reduce US burden to help rescue far-flung nations, something increasingly difficult to justify on Capitol Hill.

However, in a globalized world economy with global crises, unilateral responses or even a multi-region effort would fall short of effectively responding to crises, and so to the detriment of all nations. Crises disrespect borders,

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[6] While for China a by-product of export-led strategy, some emerging Asian nations pursue reserves as an end in and of themselves. An estimated two-thirds of the reserve accumulation is due to insurance motivations. However, in the Chinese case, reserve accumulation primarily reflects the export-led growth strategy. See Obstfeld et al. (2009). For an innovative study on the effects of an Asian "crisis union", see Strobel (2009).

[7] See Schularick (2009) on the downsides of reserve accumulation.

rendering regional responses but imperfect substitutes for the Fund. Relying on regionalism alone would be perilous in a world of global crises. The Fund's reach across regions and its global surveillance are as unique as they are indispensable.

To be sure, Latin American schemes would take years to build, Europe's future financial schemes will at least *de facto* remain linked to the IMF, and Chiang-mai remains small and untested. It was not Asia's liquidity window in the Great Crisis. Hit hard, Korea and Singapore turned directly to Japan and China, and Korea performed its largest, $30 million swap arrangement not in Asia, but with the US Federal Reserve. Indeed, the region was not applauded for its response to the crisis, but faulted for lack of responsiveness.

Intra-regional politics also stand in the way of sturdy regionalism (Suominen 2010). Beijing has grown increasingly enthused about the AMF and made the case for an Asian Currency Unit, but Japan has a large stake in the IMF and wants to continue playing the role of a leading power in Asia. Even if Tokyo and Beijing collaborated seamlessly, political divisions not unlike those at the IMF could erupt between the Sino-Japanese-dominated financial schemes and other nations in the region.

As long as the IMF is a second-best insurer for Asians and the regional insurance pool remains small and/or political, the Asian nations will step up their tested and tried self-insurance (Suominen, 2010). The strategy is for now the first-best for the region's major nations, even if it de-economized the provision of insurance that the IMF is designed to economize, perpetuated global imbalances, and unnecessarily diverted funds away from regional investments in, say, education or infrastructure. None of such outcomes is in US interest.

GOVERNANCE CONTESTS

Members' buy-in into the Fund is predicated on their power in it. National representation in the Fund is supposed to be allocated according to a member's respective importance in the world economy, as determined by the Fund's quota formula.[8] Representation in the Fund has long been a source of bitter contention particularly between Asian emerging markets and Western European nations. Currently, European Union members, along with Norway and Switzerland, claim 34 percent of the Fund's voting power. Europeans also occupy, depending on timing, 7-10 of the 24 chairs on the Fund's executive board, and by tradition hold the power to name the Fund's Managing Director.[9] The United States holds 17

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[8] Fund member's voting share can be expressed as 100 * [1/186 * S + the member's quota share * (1 – S)], where S = the share of basic votes in total votes. Votes do not count as much in practice, as they are seldom taken.

[9] For quota shares, see IMF (2010). The four biggest EU donors - Germany, France, UK and Italy – constitute a bulk of the European share, together holding almost 20 percent of IMF voting

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percent of the voting power, enough to give Washington a veto over the rare but important decisions that require an 85 percent majority, such as on Fund's quota reforms and gold sales.[10]

After weathering the Asian financial crisis, emerging markets argued for a larger quota. In 2006, Fund members approved a modest quota increase to select nations – China, Mexico, South Korea, and Turkey. Others, such as India, Brazil, Egypt, South Africa, and Argentina, opposed the measure as improvised and inadequate. Some of them, like most Europeans, also argued against the Bush Treasury's proposed new quota formula that gave pride of place to GDP in determining a member's voting powers, as opposed to such factors as economic openness advocated particularly by small (and very open) European nations.[11] The new quota formula was approved in April 2008.[12]

If voting powers were strictly based on the Fund's quota formula and revised per the IMF's latest calculations based on pre-crisis economic factors, the UK, France, Netherlands, Belgium, Switzerland, Sweden, and Italy would incur cuts in their respective voting shares.[13] Germany's share (5.9 percent) would remain unchanged, and Spain, Poland, and some other Eastern European nations would score gains. US share would rise to 18 percent, and Japan too would gain a percentage point (to 7 percent of total). China's share would double to 7.4 percent and India's rise from 1.8 to 2.2 percent. Many emerging Asian nations, including Korea, Malaysia, and Singapore, would see an increase in their voting power,

power. On the Fund's board are eight Executive Directors representing their own countries – the United States, Japan, France, Britain, Germany, China, Russia and Saudi Arabia – and 16 others, including 4-7 European countries that represent groups of countries and rotate in their groups. For an authoritative account on the leadership selection issues, see Kahler (2010).

[10] The 17 percent does not confer veto powers in the Fund's day-to-day management that require either simple majorities or 70 percent majorities.

[11] Some European nations called for a reform of the quota formula favorable to them. The Dutch, for instance, argued votes should factor in an economy's openness rather than GDP. There have been numerous proposals to reform the quota. For prior quote reform ideas, see Cooper and Truman (2007) and Kelkar et al. (2005).

[12] The April 2008 quota formula is a weighted average of GDP (weight of 50 percent), openness (30 percent), economic variability (15 percent), and international reserves (5 percent). For this purpose, GDP is measured as a blend of GDP based on a market exchange rates (weight of 60 percent) and on PPP exchange rates (40 percent). The formula also includes a "compression factor" that reduces the dispersion in calculated quota shares across members. See IMF (2008). In a letter to the IMF's executive directors, eight prominent Washington analysts argued the new formula inadequately reflected especially emerging markets' share in the world economy. See letter at http://www.brookings.edu/~/media/Files/rc/opinions/2008/0409_imf_linn/letter_imf_quota_refom.pdf

[13] See IMF (2009a).

while the markedly over-represented Saudi Arabia would lose. Robust growth in emerging markets would entail further gains in the coming years.[14]

Following the crisis, emerging markets stepped up their demands for greater powers in the Fund's decision-making. Beijing is not only seeking to match its economic prowess with political power, but also to increase the representation of developing countries, whose cause it claims to champion, in the Fund and the World Bank.[15] Along with Brazil and Russia, in 2009 China and India called for a quota increase of seven percentage points for emerging markets, sufficient to bring them to a par with the advanced countries. The BRICs also reissued demands for changes in the Fund's board and for a "merit-based" selection of the Fund's director (Varadarajan, 2010).

At their September 2009 Pittsburgh Summit, the G-20 compromised to expand emerging markets' quota by five percentage points to 48 percent of the total by 2011. While a politically feasible way to start addressing some of the complaints about Fund's governance, the US-sponsored idea got a hesitant reception in Western Europe, the likely loser of any quota reshuffling (Reuters, 2009a).

Besides governance, there are substantive disagreements over the Fund's mission. China wants the Fund focus on surveillance of the largest economies, while Western Europeans are interested in retaining the Fund's surveillance and technical assistance work on developing nations. The United States is wary of IMF judgments on American domestic economic policy, but keen on surveillance of systemic, global economic issues such as imbalances and exchange rates. To be sure, Beijing would be unenthused about scrutiny of Chinese currency policies.

Washington has been pressing Europeans to concede power for the better of the institution. Besides calling for quota reforms, both the Bush and Obama administrations have proposed reducing the number of Fund executive directors from 24 to 20, with Europeans incurring the cut. The Obama administration has explicitly called to cap European seats to four. In August 2010, the United States forced the reluctant Europe's hand by blocking plans that would maintain the current size of the board at 24 and effectively curb it to 20. This is the strongest US measure yet to essentially halve Europe's heavy presence on the board, and

[14] Board representation is also more complex than often argued. Three European nations, France, Germany, and UK, hold a single, non-rotating seat, along with the United States, Japan, Russia, Saudi Arabia, and China. The other European Board members represent groups of directors whose members circulate to the Board. For instance, Spain belongs to a group that includes such Latin American countries as Venezuela, Mexico and Colombia; Belgium in a group with several Eastern Europeans, former Soviet Republics, and Turkey. As such, the votes of most European directors reflect the preferences of their respective groups. Further, in light of the rotations, there can plausibly come a moment where such emerging markets as Mexico and Turkey take a seat on the Board, representing their groups in lieu of Spain and Belgium.

[15] See, for example, Chinese Foreign Ministry (2009).

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reflects US frustrations with European resistance to change. It stops short of implying a single seat for Europe, an aspiration of the European Commission. As such, it decreases the number of European chairs while precluding the rise of a second veto-wielding bloc.

At the time of writing, the outcome of the trans-Atlantic confrontation remains uncertain. Europeans are opposed. One reason is that each European nation drives somewhat distinct interest at the Fund (Ahearne and Eichengreen, 2007, Bini Smaghi, 2008); another, that they are unwilling to concede their powers without *quid pro quos* by emerging markets – such as greater contributions by emerging markets to the Fund and their willingness to consider exchange rate matters.[16] Intra-European politics are also at play: no European leader wants to ask his or her counterpart to concede powers due to concerns that such a request could ricochet as non-cooperation in European affairs. The situation implicitly sets Europeans up to play game of chicken with China, with neither wanting to swerve first. Sufficiently disgruntled with the *status quo*, especially the Asian nations have exit options.

LIMITS TO RESPONSIVENESS

The Fund's resources will unlikely go far enough to meet the magnitude of potential financial turmoil and trillions in financial assets – no less than $178 *trillion* even in 2008, a dreadful year in the global economy. Even with its new $750 billion in lending power, the Fund's armory would be but a fifth of the $4 trillion that the United States had committed domestically by the spring of 2009 to stem the crisis.[17] The Fund's Director Dominique Strauss-Kahn has set his sights to another $1.25 trillion to bring the total lending capacity to $2 trillion (Strauss-Kahn, 2009), a sum in line with some other proposals. But although the crisis concentrated minds on the importance of emergency insurance, expanding the Fund much further would be unfeasible and unadvisable.

First, neither of the debt-laden United States and Europe is likely to muster further political capital to contribute greater resources to the Fund. Subject to repeated funding requests by administrations seeking to keep ailing foreign nations afloat, US Congress has grown progressively more loath to fund the Fund, with many a Congressman seeing its rescues as free bailouts to distant nations. In

[16] A paper by the French EU Presidency that circulated among European capitals in the fall of 2009 proposed another *quid pro quo*: that Europe give up the Fund directorship if China agrees to increase its contributions to the Fund. See EurActiv (2008).

[17] This sum includes direct spending, loans and guarantees to arrest the financial crisis by the London G-20 Summit. The funds provided by the FDIC as well as the Treasury and the Federal Reserve. See Congressional Oversight Panel (2009). For an overview on financial globalization, see Das (2006).

a familiar scene, the Obama administration's call for the $100 billion in US commitments to the IMF were approved only after weeks of wrangling.[18]

Constraints on Capitol Hill span politics. The Fund is hostage to similar collective action problems as frequently trouble US trade policy: the benefits it imparts are dispersed, implying that no particular constituency is likely to rise in its support. This by default gives greater voice to groups opposed to the Fund. Lawmakers with blue-collar constituencies may be particularly wary about committing taxpayer dollars to buttress nations that might be America's economic competitors: Lawrence Broz (2005) finds that the greater the proportion of low–skilled workers in a district, the likelier a House member is to oppose the executive's pro–bailout agenda. The collective action problem is compounded by institutional set-up. The responsibility for legislation and oversight in Congress is fragmented, with the banking, international relations, and appropriations committees of both chambers involved. The Fund in such a setting is more easily neglected than championed by any one instance (Henning 2009a).

Second, a much larger Fund would also be unadvisable. It could exacerbate moral hazard, an issue that has long appeared on Congressional list of complaints and one that for months kept the Bush administration from agreeing to loans to Argentina. The position is very sound and the foremost argument against expanding the Fund further. In practices indicative of moral hazard, since the 1970s, several countries have used the Fund's lending for prolonged periods of time (some 7-10 years), and been repeat borrowers, accessing the Fund's facilities time and again (Haldane and Taylor 2003). For countries in arrears, the availability of insurance appears to encourage expansive policies that only increase the likelihood that a Fund loan will be needed (Lee and Shin, 2008, Dreher, 2009, Taylor, 2009). There is also considerable evidence that Fund insurance leads to moral hazard among investors. For example, a country with access to the IMF window has lower bond spreads than might otherwise be expected.[19]

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[18] The $106-billion emergency bill included commitments to the wars in Afghanistan and Iraq, funding for battling swine flu, and a $5 billion to approve of the US $108 billion loan to the IMF. The Senate approved the legislation June 18 on a vote of 91-5; it passed the House, 226-202, on June 16. All but five of the 175 House Republicans who voted opposed the legislation, largely because of the IMF provision. Some Senate Republicans opposed the idea, as well, but they were overpowered by John Kerry, multilateralist Massachusetts Democrat, and Judd Gregg of New Hampshire, a ranking Republican on the Budget Committee and Obama's initial candidate for Commerce Secretary. However, strings were attached. At the initiative of Kay Granger, Republican from Texas, Congress conditioned the funds on the executive's commitment to vote in favor of health and education issues affecting poor countries. House approved an amendment 429-2.

[19] Dell'Ariccia et al. (2002) examine the non-bailout in Russia in 1997 as a natural experiment. The episode should have frightened risk-taking investors and profligate nations into believing that no longer would the IMF dash to their rescue. They found this to have happened: the non-event in

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While the growth of the world economy suggests a large IMF, limits to and certain ambiguity about the Fund's lending could help keep economies on an even keel. Moral hazard can certainly be curbed by tough conditions on Fund lending. However, tighter strings create a tension with the Fund's responsiveness. More flexible lending policies would likely be attractive to potential clients and, since ensuring compliance with loan conditionality requires gradual disbursements, accelerate the lending process (Kenen, 1986). Yet, substantially looser strings would risk moral hazard and surely be objectionable to Congress, which is bound to, and has a right to, insist that bailouts have a price.

The Meltzer Commission, sponsored by Congress in the wake of the Asian crisis to make recommendations for reforming international financial institutions, argued that IMF loans should carry a penalty in order for potential borrowers to explore other options before resorting to the Fund (Meltzer 2000). The Commission proposed the Fund be a "quasi-lender of last resort" and provide short-term funds only to such crisis-torn countries that have met certain pre-conditions, such as sound macroeconomic governance practices. The idea of rewarding for good behavior was not novel: the Clinton administration had opened a facility based on a similar philosophy during the Asian crisis. Also a concurrent Council on Foreign Relations Task Force (1999) argued the Fund should reward emerging markets for "good housekeeping," and recommended Fund rescues be limited to 300 percent of the member's quota.

Today's catch-22 is that the Fund is not the only game in town. Tough conditions can accentuate the relative appeal of alternative lenders that do not demand sound economic policies in exchange for loans. China, whose $2.5 trillion reserve pool is thrice the Fund's armory, could emerge as just such a substitute window. This is problematic: in what might be called "mercenary finance", Beijing has provided bilateral loans and emergency swap lines to Latin American, Asian, and African nations without requiring any of the policy changes required by the Fund in return. Instead, China has expressed disdain for the reforms-for-loans *quid pro quo* that is the essence of the Fund (Reuters, 2009b).

Russia had momentous implications, raising the level of spreads and the sensitivity with which spreads reflect country fundamentals.

MANAGING SYSTEM MANAGEMENT

Instead of being re-endowed further, the Fund needs to be re-geared. Three immediate reforms are required for the Fund to retain its effectiveness in the 21st century.

The first is governance. Granted, only a Fund that is effective in providing global financial stability will garner the support of its members. But also the reverse holds: the Fund can be effective in the world economy only if the main economies buy into it. This realization is required for tackling one of the most consequential challenges of the 21st century: engaging China and other main emerging markets to play a responsible and constructive role in global governance. Advancing on substance at the Fund now requires changes to its structure. Giving Asia and especially China more power in the Fund would unlikely – and ought not – undo plans for a regional fund. But it should give Asians greater incentives to hone the multilateral financial system and build complementarities between the Fund and their regional arrangements.

As the first step, Europeans need to concede to the five percent share increase for emerging markets, not because it is the best or right solution, but because it has already been agreed upon. Step two is for Europe to commit to a staged consolidation of the number of their seats on the Fund board. Of course, Europeans have a chance to turn the battle over chairs to advantage by counter-proposing that they hold a single chair. While highly unlikely, such a move would force Europe to act in a united fashion and lend the continent tremendous powers to steer the emerging nations in the right directions, an aim shared on both sides of the Atlantic.

The US veto is often argued to be but symbolic and something that should be given up without concessions.[20] Both positions miss the mark. The veto has power even when it is not exercised because it conditions other nations' behaviors: anticipating it, others are unlikely to offer proposals that the United States would oppose. Besides, given America's economic size, US voting share is completely legitimate. The veto could of course be eliminated without hurting US quota if the threshold for important votes was reduced, say, to 80 percent instead of 85 percent. However, some emerging markets resist such moves on the grounds that they would be better able to assemble a vetoing coalition under the current rules.

The reform ball is not on US but on Europe's court, but Washington will need to keep persuading Europeans to play in the interest of the world body. To be sure, political accommodations cannot be carried to extremes. With all nations represented, legitimacy may be maximized, but so is inefficiency and

[20] See, for instance, Bergsten (2009).

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ineffectiveness. Instead, representation needs to be based on objective measures of economic importance rather than on politicking and past power. The Fund members need to consider an even more objective quota formula – to be sure, a political matter in its own right – based on a member's economic size and presence in financial markets. The voting powers should also be adjusted more frequently than every five years, perhaps annually.[21]

Second, with or without governance reforms, the Fund will continue paralleled by substitute regional and bilateral rescue schemes. The task for the Fund is to convert such schemes into complements. Working particularly with Japan, China, Korea, and Europeans, Washington should develop a clear set of principles to define the relationship among the various instances so as to tie their fates, policies, and work together (Suominen, 2010). A range of non-zero-sum mechanisms could be used. For example, members of the Chiang-mai could be given committee status to set the agenda or pre-approve IMF packages related to member states (Lipscy, 2009). Or, Chiang-mai members could gain voting shares in proportion to their Chiang-mai contributions for Fund decisions concerning the region. Money confers influence, but, as President Roosevelt understood in the 1940s, influence can be exercised in a fashion constructive to long-term viability of the global economy (Suominen, 2010). Emerging nations will now need to be tied into this paradigm.

Since Asia is the likeliest main hub of both new financial arrangements and global reserves, the United States needs a coherent strategy vis-à-vis Asia that retains a strong US presence in the region's economic panorama, both in finance and trade. Asia-Pacific Economic Cooperation forum (APEC), an instance that encompasses ASEAN+3, Australia, New Zealand, Russia, the United States and four other Western Hemisphere nations, should form the core of the effort to open and integrate regional financial markets, and enhance financial regulations and governance. APEC would be particularly well-positioned to spearhead an umbrella center for excellence in regional financial surveillance. Politically, a strong US commitment to the ASEAN, lapsing since the early 2000s, is particularly critical for a foothold in a region keenly courted by China.

The debate on the European Monetary Fund, if continuing, will have implications on the dynamics in Asia. It will likely inspire Asians, just as the euro and European integration have done in the region. But the €720 billion joint EU-IMF package issued in May 2010 to stabilize the eurozone presents an opportunity for Europeans and Washington to set a precedent for a constructive, complementary relationship between regional funds and the IMF – one that can be

[21] Truman (2009) proposes that total quotas will be increased in line with the expansion of the global economy, trade, and financial system over. Bryant (2008). has called for a formula based on economic relevance (population or GDP at PPP exchange rates, which favors emerging markets) and capacity to pay (GDP at market exchange rates, which favors the US).

referenced and leveraged with Asia. Europeans need to understand that their actions with the Fund in shepherding the eurozone out of debt will have far-reaching repercussions to the future of the global financial architecture.

Besides formalizing ties with regional schemes, the Fund needs co-opt the various bilateral schemes. Truman (2009) proposes that the Fund help national central banks to swap SDRs for key national currencies in the global financial system – the US dollar as well as the euro, yen, pound, and Swiss franc. The currencies could then fund the IMF's short-term lending facility. Such a centralized system, while requiring changes in the Fund's charter, would replace bilateral lending operations of national central banks, enhance consistency in policy prescriptions, and lower risks to all nations.

Third, the Fund needs further its responsiveness. Going forward, new fixes can be devised that avoid moral hazard yet make the Fund more responsive and less austere.[22] One such measure is providing funding for members with sound policies that become embroiled in a payments crisis not of their own making. One permutation of the idea was applied during the Asian crisis; another, amid the Great Crisis in the form of the Flexible Credit Line.[23] Existing financing mechanism can be used. For example, Cooper (2009) argues that SDRs could be employed as an extra reserve pool employed only in response to major global liquidity demands and retired after the crisis passes.

CHANGING THE PARADIGM

For most of its lifespan, the Fund has served as global economic surveyor and firefighter of balance of payments crises in developing and emerging markets. But the world has changed. On the one hand, the frequency, wrath, and global reach of crises is greater and, if the Great Crisis was of any indication, can go well beyond the Fund's capacities. On the other hand, each crisis has delivered new lessons, and surveillance techniques are more sophisticated and fresh sources of insurance are more readily available than in the past. The Fund requires a paradigmatic change that confronts the threat of instability with the new opportunities: reserve its analytical powers on the range of risks that can converge into global crises, reward members for policies that promote stability, and start bridging public and private sources of insurance.

First, the Fund's resources need to be focused squarely on systemic risks, cross-border issues, and the world's main economies, advanced and emerging,

[22] For such arrangements, see Kenen (2001).

[23] The new FCL replaced first remedy devised to face the crisis, the Short-Term Liquidity Facility (SLF), which provided rapid short-term liquidity without the conditionality of the Fund's stand-by loans. It allowed qualified members to borrow up to five times their quota for a three-month period twice a year. See IMF (2009b).

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rather than on small, poor developing nations. The Fund is the only instance in the world to credibly serve as a system-wide overseer and, to the extent possible for a body that referees its shareholders, an objective analyst of national economic policies.

The Fund's judging its main shareholders is politically sensitive, including in Washington and Beijing. However, reserving the Fund's resources for assessing and attacking the main adversary rather than battling its effects or dealing with peripheral issues is fundamentally in the interest of all Fund members. It is keenly in emerging Asian interest: the region is much more integrated with the US and European financial markets than intra-regionally (Eichengreen and Yung, 2005). It is also in the interest of small developing nations: countries like East Timor or Mozambique do not originate global crises, but are impacted by them. Such countries would also be the foremost beneficiaries of a world free of global financial crises.

Second, rather than conceptualized as a firefighter, the Fund should be a preventive care unit that encourages healthy behaviors. One way to do that is by providing tangible rewards – such as technical assistance and support for countries' international lending operations – for national policies conducive to financial stability.[24] Such policies include not only good rules and sound economic management, but greater financial openness, a gateway to financial development.[25] While a decidedly political initiative, a Fund-based reward system could incentivize good behavior and pre-empt moral hazard around the world. Albeit controversial, the Fund should be also be made into an advocate of open capital accounts, something in US interests particularly in Asia.

Bad behavior could of course entail punishments. A drastic punishment might be expulsion of some kind: for instance, amid the Greek crisis, many analysts argued that nations exceeding a certain fiscal deficit target (and thereby jeopardizing the common currency) should be expelled from the eurozone. However, in a world of multiple potential funding sources, a punishment regime, unless globally applied, would only drive a crisis-torn nation to "funder-shop" and opt for a lender that exacts least punishment. Such considerations accentuate the need for coordination among the various funding instances.

Third, the Fund should start bridging private and public insurance markets. A number of reasons have kept private markets from insuring sovereigns, from moral hazard to adverse selection and difficulties in pricing country risk in light of cross-border contagion. Harnessing private sector lenders would help overcome Fund's limited funds. It can be accomplished by leveraging the Fund's global

[24] Truman makes a rather similar argument. See Edwin M. Truman, "The G20 and International Financial Institution Reform: Unfinished IMF reform," Voxeu.com, 28 January 2009.

[25] For a recent discussion on financial openness and development, see Hufbauer and Suominen (2010). For earlier assessments, see also Summers (2000) and Fischer (1998).

membership: a Fund team suggests that the IMF pool country-specific risks in a diversified portfolio, thereby creating economies of scale that lower pricing and underwriting costs for the private sector (Mateos y Lago et al., 2010). The Fund could particularly readily provide advice to its members on ways to use hedging instruments employed in private markets, something that could even render reserve accumulation less palatable.

CONCLUSION

In 1998, then-Federal Reserve Chairman Alan Greenspan called for strong US engagement in fighting financial crises in emerging markets, arguing that the United States could not remain “an oasis of prosperity” if the rest of the world descended into financial chaos (Newshour, 1998). Even if unable to do away with crises, the IMF has helped safeguard the American oasis. Whether it will do so also in the 21st century is a matter of policy.

Recalibrating the Fund to make it more legitimate and responsive is no guarantee for keeping Asians in, the Fund’s advice relevant, and global crises at bay. Countries will look to the Fund only if it helps them solve their problems and reach their goals better and more cheaply than conceivable alternatives would. Reforming the Fund’s governance and re-gearing the Fund to tackle arising challenges may not be sufficient for containing all crises, but it is the necessary and only means for keeping the Fund relevant and effective in the 21st century world economy.

The Fund will not and should not become an all-powerful insurance agency able to respond to all crises. But in the globalized world economy with a specter of global crises, no single government or even a multi-region effort suffices for delivering the world from instability. The United States also cannot be the fallback insurer. From rescuing Latin Americans bilaterally and complementing the Fund amid the Asian crisis, America has repeatedly summoned the resolve and funds to shore up the world economy, but now runs short on both. And even if global competition compelled countries to manage their economies well and even if regional institutions excelled at surveillance, the world would still need a chief economist to opine on hidden perils in the global economy. Regional arrangements alone will not do, America should not bear the brunt, and mercenary finance is out. The premise of Bretton Woods remains: a global economy requires global institutions.

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