From intervention to cooperation: reforming the IMF and World Bank

Ngaire Woods

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NGAIRE WOODS is professor of international political economy at Oxford University, and founder and director of the university's Global Economic Governance Programme. She is a board member of the Overseas Development Institute and a member of the advisory group of the Center for Global Development in Washington. Previously she served on the external evaluation panel appointed by the IMF board to report on the performance of the Independent Evaluation Office.

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Introduction

Cooperation among governments is urgently required to deal with the financial crisis catalysed by the collapse of the US sub-prime mortgage market, immediate threats posed by fragile and collapsing states, climate change and a more inclusive globalisation. In principle, the IMF and World Bank are ideally placed to play a key role. They sit at the heart of intergovernmental cooperation: conducting consultations on exchange rate policy; lending to countries in financial crisis; providing assistance after conflict and natural disasters; and setting standards, offering advice and providing development assistance.

In practice, neither institution is adequately equipped to ensure cooperation to deal with current crises. Two reasons stand out. First, neither institution has globalised its governance. The IMF and World Bank are ostensibly global institutions but each is run by a small directorate of industrialised countries, who cling to their influence over each organisation. Seriously under-represented are emerging economies. But they are not desperately calling for reform. They have alternatives: they are stockpiling their own reserves (and hence have little need of the IMF); in some cases they are setting up their own multilateralised swaps arrangements (the CMI); they have access to multiple sources of development financing (and hence little need for World Bank loans); they are planning new multilateral development initiatives (the Bank of the South); and several now have their own aid programmes. They are not formally disengaging from the IMF or World Bank but in practice the institutions have slipped to the margins of their policy-making since they have little confidence that the agencies will act as multilaterals rather than as agents of the OECD, G7 or G1 economies.

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Put simply, neither institution has a governance structure which today commands the confidence of emerging economic powers whose cooperation is vital if global collective action is to resolve the crises mentioned above.

A second serious problem is that both institutions have a habit of intervention rather than cooperation. Both the IMF and World Bank have been used to bring about change in developing countries over the past few decades. Neither has developed as a forum for serious multilateral cooperation. In the words of former IMF chief economist Raghuram Rajan: "some of the largest industrialised countries see themselves as more sovereign than others, and their politicians brook no interference in their own domestic policies, while being fully prepared to use multilateral agencies to intervene in the domestic politics of others".[1]

The habit of intervention rather than cooperation has left unaddressed the economic storms which besiege small economies—the brunt of globalisation. These include sudden

1. Rajan, R.G. 2008, *The future of the IMF and World Bank.*

destabilising shifts in capital flows, energy and commodity prices and exchange rates. In effect, the IMF and World Bank have been used to exhort governments of small, poor economies to paddle faster in the face of external forces including volatility in capital and investment flows (caused by contagion and crises in other countries); in commodity prices (historically the most volatile of all prices),[2] in energy prices; in exchange rates; and in aid disbursements.

The failure of the IMF and World Bank to deal with the brunt of globalisation cannot be separated from their governance structures, which have made it easy for industrialised countries to urge other countries to reform without committing themselves to any self-restraining or regulatory actions that would result in a more inclusive globalisation.

In sum, the IMF and World Bank should be uniquely placed to promote cooperation among governments to address global collective action problems. In practice, serious reform is required to equip them to do this.

Globalising the institutions: the role for progressive governments

What can be done? Reinvigorating the IMF and World Bank to make globalisation more inclusive will first require rebuilding the multilateral character of each institution. Emerging (and other) economies need to be fully engaged. For this, they will need assurance that the institutions are as much theirs as others'. At present, they see the institutions as instruments of US or G7 economic interests and values.

Capturing confidence is possible. When the institutions were created this was achieved through their governance. The original 1944 structure of the IMF and the World Bank ensured the engagement of the United States (and Wall Street). Since the US was the world's largest creditor at the time, and Wall Street the world's largest potential purchaser of World Bank bonds, this confidence was crucial. It was delivered through a system of formal and informal controls over the organisation.

The assurance-building governance features of the institutions included:

- Control over the headships (and thereby chair of the board) of each organisation and an informal say over the appointments of senior management;
- Weighted voting;
- A small technocratic board on which the US had veto-power over key decisions;
- Location in Washington DC.

Using the governance of each organisation to ensure "buy-in" and engagement, the institutions were equipped in 1944 to capture the confidence of key members. That experience has important lessons for how each agency could be adapted to today's circumstances. Let us examine each institution in turn.

2. Commodity prices at times exhibit 50% standard deviations in price changes. See Kroner, K.F., Kneafsey, D.P. & Claessens, S. 1993, 'Forecasting volatility in commodity markets', *World Bank Policy Research Working Paper Series*, no. 1226.

Reforming the governance of the IMF

Much has been written about possible IMF reform but what is now required supersedes most existing proposals for reform. The basic structure of voting power and shares in the organisation is based on an anachronism. The US is no longer the world's largest creditor—it is now the world's largest debtor. Global financial stability no longer depends exclusively upon US decisions or the US ability to work in concert with allies such as in the G7—it now depends equally on decisions made by other major holders of reserves. The limitations of the current structure as a forum for multilateral negotiations were obvious a decade ago when, during the east Asian financial crisis, it became clear that discussions about the financial architecture could not sensibly be undertaken just in the G7. However, the creation of the G20 seems to have staved off deeper reform rather than spurred it.

The IMF needs to be reconfigured to gain the confidence of members who have long felt that it is not their institution. Small changes in the right direction are already underway, including small quota increases for China, Mexico, Korea and Turkey; together with discussions about how to enhance the voice and capacity of smaller members. However, these small voting and capacity increments do not answer the central question: what would an institution which could command the confidence of all of its members look like? The elements of governance used to "bring in" the US in 1944 are an instructive starting point.

Control over headship

The managing director of the IMF chairs the board and holds all the senior management and staff to account. Until now the managing director has been appointed from among a small group of European countries in consultation with the US—a crucial element of the 1940s "deal" for the IMF and World Bank.[3] These same countries not only appoint but also decide whether to reappoint the managing director after a five-year term. The result is to skew the accountability of the organisation as a whole towards the small group of countries involved in leadership selection.

In every recent appointment of the managing director this process has come under scrutiny and criticism. This led the boards of both the IMF and World Bank to convene a committee to consider the leadership selection process in each organisation, and to recommend some rudimentary improvements. Neither board adopted them. More recently in the IMF, prior to the election of the current managing director, the board adopted a resolution to treat all candidates equally, regardless of nationality, in all future selections.

In the 21st century the appointment of the managing director—and the consequences for who de facto holds the reins of the IMF—will have to change if the institution is to capture the confidence of emerging economies. An obvious way to take the process forwards is to build on progress made, bolstering a transparent process with more than one candidate, and applying a decision-making rule which encourages consultation and participation in the decision (see section on the board and decision-making, below).

3. An implicit part of the same deal has been influence over appointments to senior management positions.

Weighted voting

A second element of the initial IMF design for assuring a nervous US in 1944 was to create formal stakes in the organisation which reflected the economic preponderance of the US, giving it special rights in respect of financial contributions as well as voting power. The multilateralism of the IMF was underscored by giving all countries an equal allocation of "basic votes". At the same time, special assurance was given to the US by creating a formula that allocated it (and the UK) especially large chunks of voting power, which mirrored responsibilities to lodge reserves with the organisation.

These basic principles are useful. The combination of basic votes and a formula to calculate differential stakes in the global monetary system is a good starting point for thinking about how to engage the current membership of the IMF. Many current proposals for reform note that basic votes have been left to wither on the vine (now accounting for a much smaller proportion of overall votes), and quotas in no way reflect actual economic power.

Missing to date has been a process for reapportioning basic votes and rewriting the formula for voting which includes emerging economies as equal partners. Quota reviews have been undertaken—such as that done at the behest of a managing director (with the consequent accountability problems specified above). The IMF now needs to engage properly with the issue and agree to constitute a representative group authoritatively to rewrite the formula.

The board and decision-making

A third element of the initial US-assurance-giving structure of the IMF was the creation of a small resident board of executive directors based in Washington DC (more on location below), and chaired by the managing director. The US and the other largest stakeholding governments each have their own representative on the board (all other members sit in groups who elect a director, who must then represent first and foremost the interests of the organisation rather than the countries who had voted for them). The board makes decisions on the basis of a consensus underpinned by a majority of voting power. Originally, special categories of important decisions required a special majority (such as a 75% majority) which ensured that the US had a veto over those decisions.[4]

The way the IMF board currently works might best be described as semi-representative, semi-technocratic, and semi-efficient

The IMF is well-served by a small board which can make effective decisions. However, the way the IMF board currently works might best be described as semi-representative, semi-technocratic, and semi-efficient. It neither makes countries feel represented, nor acts independently of them. As mentioned, some countries are individually represented and can hold their directors directly to account. Other countries are bundled into groups (constituencies) and represented by an official whom they cannot hold directly to account and who owes a primary loyalty to the institution (Woods & Lombardi 2006).

4. These special majorities have changed to reflect a gradually decreasing US share of overall votes. A special majority of 75% of votes was required when US voting power was just over 25%; that special majority requirement is now 85%, retaining a US veto power even though US voting power has slipped to 17%.

The key to immediate reforms of the IMF board and decision-making is to strengthen buy-in without jeopardising the small and efficient character of the board. A first reform could be to change the convention that the managing director chairs the board. Instead, as an organ which oversees the managing director, the board should be chaired by one of its members.

A second reform concerns decision-making and creating an incentive for countries to consult across the membership and to act more genuinely by consensus. At present, board decisions are reached ("by consensus") when countries wielding a majority of voting power agree. This gives no incentive to powerful vote-holders to consult others, nor does it give an incentive to directors wielding tiny proportions of voting power to prepare positions for, or to use the voice they have on the board. This could be easily rectified.

Already in the IMF a double majority is required to alter the Articles of Agreement as well as to expel a member or deny it benefits. This means that not just the votes of powerful countries matter (for an amendment 85% of voting power), but that they have to gain wider agreement among member countries so as to achieve the consent of a 60% majority of member countries.

Other international organisations also use double-majority voting (eg the EU Council of Ministers, the Global Environment Facility in the World Bank). The effect of this would be to broaden consultation and responsiveness within the organisations. At present the G7 members of the IMF command just over 40% of voting power and need only find one further executive director's vote in order to claim consensus for a decision. A double-majority voting rule would require them also to forge wider alliances of members so as to gain agreement from 50% of the membership. One obvious issue to which an extension of the decision-making rule is relevant is the institutions' leadership selection.

Location: an independent board and the perils of location

More radically, the governor of the Bank of England recently proposed getting rid of the resident IMF board and replacing it with a non-resident group of policymakers meeting periodically. This could well solve some problems. It would put "heavy-weights" on the board, who could give strategic direction to the organisation and ensure more effective oversight of the management and staff of the organisation. More direct and high-level representation might also make countries feel more directly represented.

What the idea of a non-resident board misses is the elephant in the room. Privately, policymakers across the developing world concede that to them the IMF is a US institution. It is located in Washington DC very close to the US Treasury. As already mentioned above, this location has until now been coupled with US influence over its senior management appointments, and the fact that the US is the only country that can single-handedly veto significant decisions in the organisation. The thin veneer that separates the US from the IMF has in essence been the resident board of the organisation, which sits in Washington DC, a symbol of multilateralism and accountability to the membership. For the board to become a non-resident one—an idea with many merits for promoting high-level international cooperation—other key elements of governance would need to change. This may even include moving the headquarters out of Washington DC, and relocating it to a capital that does not have the power to impose its own imprimatur on the institution, or at least shifting some of the authority of the IMF

For example, Asian countries have already begun to develop regional monetary arrangements that nevertheless rely on the IMF as external disciplinarian. They retain control over their reserves but delegate an agency of restraint function to the IMF. Such arrangements could be supported where they emerge with a high degree of autonomy but also with links to a central hub where information can be pooled and disseminated and standards set. Those who pay will have control over their funds at the regional level, but also reap the benefits of a set of international standards and restraints. This radically different IMF would capture the changes described above, embedding them in a political structure in which members have confidence. Only when it has gained that confidence can the IMF be an effective machine for global monetary cooperation, or a welcome and trusted adviser on how to deal with shocks from the global economy.

Reforming the governance of the World Bank

The IMF's governance structure was replicated for the World Bank back in 1944 and similarly served the purpose of assuring the US government engagement through control over the headship, weighted voting, the board and decision-making structure and location. Unlike the IMF, the headship and quotas at the World Bank have not been altered, even modestly. Do these need to change?

The Bank has transformed since its birth. It now sits at the centre of an international development assistance regime that is notoriously fragmented, duplicative and cluttered with a large number of donors tripping over each others' bilateral rather than multilateral efforts. In theory, the World Bank, by pooling information and resources, should vastly reduce transaction costs on both sides of the aid relationship.

In practice, powerful World Bank donors have sustained and expanded their own separate aid agencies and processes, creating a cacophony of donors making different demands on over-stretched governments. The governments of these countries speak daily to developing countries through dozens of megaphones, including their own national agencies and special initiatives alongside several multilateral agencies (the UNDP, World Bank, IMF, WHO, WTO and so forth). The result is that already over-stretched government officials in very poor countries are forced to spend most of their time and staff strengthening and maintaining external relations with donors, and doing their bidding.

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More perversely still, even when donors have used the World Bank, they have encumbered it with special demands, special funds and additional procedures. This practice can be seen in the increasing use of "trust funds" in the World Bank. These are funds given to the Bank for a particular use—often supplementary to the institution's core work. As described by a former UK government aid official, "we construct an elaborate mechanism for setting priorities and discipline in the Bank, and then as donors we bypass this mechanism by setting up separate financial incentives to try to get the Bank to do what we want" (Ahmed 2006, p. 90).

At the highest level, donors have engaged in a discussion about how they might better coordinate, harmonise and align their aid efforts (OECD 1996, 2005). That said, the rate of progress on the ground has been glacial; crowded out is the thought that for any new modalities to work, recipient countries will need to take a lead in formulating solutions to the non-coordination problem.

The Bank has the potential to be a good multilateral forum on development assistance, as well as harnessing the benefits of pooling the delivery of aid. However, this will require the Bank first to command the confidence of donors who will otherwise cling to their own programmes. It will also require the confidence of aid-recipients, who will otherwise prefer to deal with multiple donors.

The new donors need assurance that the Bank is not simply an instrument of the US or other donor preferences. Precisely to guard against this, the Bank was born with constitutional guarantees against political interference both in its funding and in its governance structure. Those guarantees were rapidly pushed aside when the Bank was headquartered in Washington DC and it became clear that the US executive director's approval would be a sine qua non for any loan (Woods 2006, ch. 1). The question now is how to resurrect the sense of a bank which is genuinely multilateral. Intriguingly, the Bank has moved far less than the IMF on this.

Control of the headship

Although the IMF has progressed some way on opening up the headship selection process, the World Bank has not. Indeed, the last two selections of presidents led to the appointment of US administration insiders to the headship, cementing the sense that the Bank is tightly bound into the US political administration. The original rationale for an American presidency of the Bank was impeccable. The Bank needed to command the confidence of both the American political system (for confirmation of the Bank's Articles of Agreement) and of Wall Street (where the Bank would raise funds). Subsequently, however, Bank funding and activities have come to rely far less on US and other guarantors and far more on the Bank's own net income (from fee-paying borrowers), its investment income and the investment grade it has built up from its loan portfolio.

There is no longer a reason to make the World Bank more accountable to the US than to any other government. Indeed, the assurance problem has shifted to emerging economies who need luring to the Bank both as fee-paying clients and as donors in their own right. The Bank recently hired a Chinese national as its chief economist, Joseph Lifu Yin. However, this does not overcome the accountability bias inherent in a US-appointed and reappointed president. Clearly a first step towards preparing the Bank for a more active role in global cooperation is to revise its headship selection process.

Weighted voting

In the World Bank there has as yet been no discussion of shifts in weighted voting or the Bank's formula for calculating quotas and votes. Although the IMF has proceeded with modest reforms, the World Bank has not. The weighting of votes in the World Bank is a historical curiosity. The Bank simply inherited a slightly modified version of the IMF's quota structure. Yet, its mission (or missions) is different. Stakes in the World Bank should reflect the agency's purposes. Where the Bank acts as a coordinator of development assistance, the relevant stakes are related to donorship. The World Bank needs a properly constituted, representative group to assess and propose a weighted voting structure which makes sense of the stakes which are relevant to the Bank's own activities.

The success of the replenishment negotiations for the Bank's concessional lending fund (the International Development Association) bears noting. The negotiations had stalled during President Wolfowitz's tenure at the Bank, and have been carefully pieced back together under the new president. The addition of China and Egypt (among others) as new donors highlights a degree of confidence in the IDA, as does the record pledges to increase its funding.

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The board, decision-making and decentralisation

Like the IMF, the World Bank has a resident board as well as a board of governors. However, the resident board works rather differently to that of the IMF. Much of its work is devolved to committees through which the Bank has taken a more active role such as in overseeing quality management and development effectiveness. The quality-oversight role is important, since "success" in the World Bank's work is difficult to assess as the organisation's mission is a wide-ranging one. Many of its goals are long-term and difficult to measure. The Bank should not be crowding out private financing, and an overly high success rate might suggest that the Bank was taking too few risks. For all these reasons, the board's oversight role is important, albeit discharged at present with far too much micromanagement of lending.

Missing from the World Bank is a forum for longer-term agenda-setting and genuine multilateral cooperation on development assistance. Neither the resident board nor the board of governors has worked as a strong agenda-setting presence or forum for multilateral cooperation. The evidence of this lies in the fact that most multilateral discussions on development assistance have been undertaken in the OECD Development Assistance Committee, even though many see this group as inadequately representative. More recently, a new forum has been created by the UN—the Development Cooperation Forum.

One area in which the Bank has altered its governance has been in its decentralisation. The Bank has devolved significant authority in some cases to its country offices, bringing the Bank's development lending and advisory work closer to country priorities. In several cases this has proved to be a very successful strategy. Building on this, the Bank's package of governance elements could be configured better to earn the trust of members whose cooperation it requires, as well as to invigorate the Bank as a forum for cooperation on development assistance.

Conclusion

The multilateral institutions are crucial for managing globalisation in the world economy. To do this more effectively the Fund needs to be reorganised so as to command the confidence of emerging economies upon whom global financial stability now depends. Equally, the World Bank is well placed to make a major contribution to cooperation—and the provision of global public goods—in development assistance. To take up this role effectively, the Bank will also need to command the confidence of a wider range of members, gaining their engagement and trust as a hub for development assistance, cooperation and knowledge. The Bank's decentralisation is already a step towards ensuring that the Bank better responds to its members' needs. Progressive governments now need to push its governance in a similar direction.

The argument against reforming the IMF and World Bank is often expressed as a trade-off between effectiveness and legitimacy. Effective institutions get things done. This is the IMF of the 1980s. The debt crisis created a queue of needy countries at the IMF's door and it played jury, judge and jailor on their economic policy, imposing ever-expanding conditionality. This is because it enjoyed "hard power"—the power to lend or not to lend—and could make rules which could be enforced with pressure and even coercion where required. By contrast, participatory, legitimate and inclusive institutions like the UNGA enjoyed legitimacy at the expense of any effectiveness. They spend time and effort ensuring representation and participation, but get little done. On this logic, some commentators have long argued against "opening up" the IMF and the World Bank, for (as they say) it will render them ineffectual.

But this is false reasoning. Neither the IMF nor World Bank can continue to be governed as they have been. Their legitimacy in the eyes of their members is inextricably bound up with their potential to be effective. If key economies politely disengage, they cannot do their business. This is why participation has in fact been opened up a little, not just in the relatively visible organisations such as the IMF and the World Bank, and in the G7 finance ministers' creation of the G20, but also in more technical organisations such as the Financial Stability Forum, and the Bank for International Settlements. In each case, wider participation has been seen as an efficient way to gather information and to improve compliance. In short, it reflects a bid for greater effectiveness.

In the contemporary global economy there is a serious risk that the established powers will cling to their well-crafted but out-of-date institutions. If they do so, they will diminish the possibilities not just for collective action but for a deeper form of global cooperation and the forging of common purposes among governments.

Progressive governments should take steps towards globalising both the agenda and the governance of the IMF and World Bank. In 1944, elements of the governance of each institution were used to build the confidence of the then shy US. Similarly, today they should be used to attract and assure key emerging economies. These elements include control of the headship, weighted voting, and the role of the board and the location of each institution (or its authority). This confidence is a necessary pre-requisite if either institution is to become a genuine part of the machinery for international collaboration and cooperation.

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Policy Network
Third floor
11 Tufton Street
London SW1P 3QB
United Kingdom

t: +44 (0)20 7340 2200
f: +44 (0)20 7340 2211
e: info@policy-network.net
www.policy-network.net