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An Analysis of Competing IMF Reform Proposals

In the wake of several major crises, in which it played a highly controversial role, the IMF has recently come under heavy fire from various quarters. A number of proposals for reform have been put forward, of which the report of the Meltzer Commission has attracted particularly widespread attention. The authors analyze this and some competing reform proposals using the "trilemma of economic integration", which the US Treasury Secretary, Lawrence Summers, suggested as a common framework for investigation.

The International Monetary Fund (IMF) is probably the most often criticized international organization. Surprisingly, this fact has not harmed the IMF much but has rather demonstrated its importance in the international arena. The criticism has been ineffective mainly because the arguments and the demands for reform have represented opposite views and therefore also suggested changes in opposite directions. This fact could be interpreted by the IMF and its supporters as a sign that the Fund's policy followed a middle-of-the-road path, indicating a balanced approach and characterizing the Fund's critics as being radical.[1]

This quite comfortable situation has become more critical as a result of the recently published report of the "International Financial Institutions Advisory Commission" (IFIAC). This commission, headed by Allan Meltzer, was charged by the US congress with analyzing the effectiveness of the international financial institutions, such as the IMF, the World Bank, etc., and to provide a proposal for reform.[2] The result has been a shock for the IMF. The analysis comes to the conclusion: "While the IMF can point to some successes, it has presided over, and fostered, a crisis-prone system". The consequence of this analysis must be a drastic change in the international financial system and in the role of the IMF. The recommendations come close to making the IMF an ineffective institution, still existing, still compiling data and giving advice, but unable to force anything on anybody and largely unable to extend any credit. The IMF would no longer be what it has been since the late 1940s.

Although even more radical proposals have been made in the past, the recommendation of the IFIAC is very influential as it is supported by the parliament of the largest IMF-shareholder. Before we examine this proposal and other competing approaches in more detail, it is useful to establish a common framework for investigation. Lawrence Summers, the present US Treasury Secretary, has made a suggestion in this respect, the "trilemma of economic integration".[3] In the next section, we first explain this framework. We then characterize the IMF using the criteria of this framework. Finally, we analyze three competing reform proposals with a special focus on their contribution towards the international integration trilemma. We conclude with remarks about the IMF's present path of reform.

The Trilemma of Economic Integration

One of the by now traditional analytical tools of the theory of international economic policy is the "impossible trinity". This concept states that the international monetary order is influenced by the pursuit of three goals, of which only two can be reached simultaneously in a satisfactory manner. Thus, policy makers have to decide which two goals they prefer. This largely determines the resulting international monetary system:[4]

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[1] See for this line of argument e.g. Anne O. Krueger: Whither the World Bank and the IMF?, in: Journal of Economic Literature, Vol. 36, No. 4, 1998, pp. 1983-2020.

[2] The report can be downloaded from http://phantom-y.gsia.cmu.edu/IFIAC; for a short summary of the report and critical review of the underlying analytical foundations see Michael Frenkel, Lukas Menkhoff: Welchem Rezept folgt Meltzers IWF-Diät?, in: Wirtschaftsdienst, Vol. 80, No. 4, 2000, pp. 218-224.

[3] See Lawrence H. Summers: Reflections on Managing Global Integration, in: Journal of Economic Perspectives, Vol. 13, No. 2, 1999, pp. 3-18.

[4] For a longer exposition and application to the present discussion see Michael Frenkel, Lukas Menkhoff: Stabile Weltfinanzen? Die Debatte um eine neue internationale Finanzarchitektur, Berlin 2000.

□ If countries prefer stable exchange rates and national monetary autonomy, they will restrict international capital flows and thus create an order like the Bretton Woods system.

□ If countries prefer free capital flows and national monetary autonomy, they cannot fully realize the goal of stable exchange rates, which describes the present system.

□ If countries prefer stable exchange rates and free capital flows they have to give up national monetary autonomy, an order which was by and large realized under the classical Gold standard.

The concept of the impossible trinity is designed to analyze competing goals for the international monetary order but does not cover the broader aspects of international integration. For this latter purpose, Summers proposed a kind of enlarged and thus more abstract impossible trinity which he calls the "economic integration trilemma". It obviously also consists of three competing goals and deals with international economic policy (see Figure 1).

Figure 1
Goals of the "Economic Integration Trilemma"

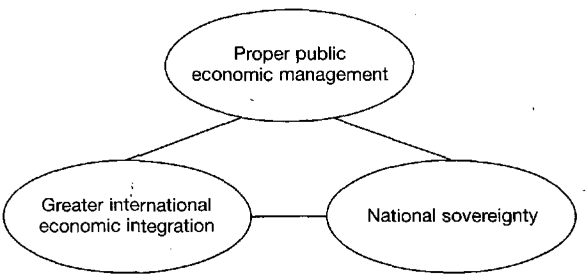
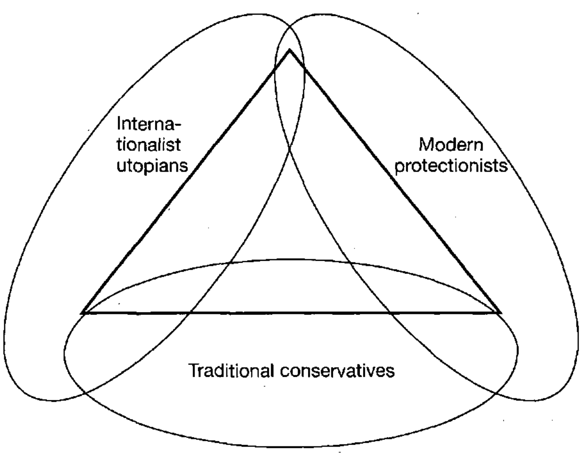


Figure 2
Positions towards "Solutions" of the Integration Trilemma



The "translation" of the three goals of an international monetary order into international economic integration is as follows: the specialized goal of monetary autonomy is advanced into "national sovereignty". The goal of stable exchange rates is transformed into the broader idea of "proper public economic management" (in short "public management"). Summers associates with this objective the creation of institutions and the implementation of regulations that aim at reducing or eliminating market failure and market imperfections. In this sense, arguments in favor of foreign exchange market interventions are based on the expectation that a positive externality results for the real sector of the economy. Finally, the corresponding goal of free capital flows is "greater international economic integration" (in short "international integration"). It stresses the aspect that economic integration generally encompasses more than just the integration of capital markets.

Summers suggests that the three goals of the integration trilemma involve similar trade-offs to the goals of the impossible trinity. For example, if a country pursues greater international integration and appropriate public policies, which also focus on a more global environment, independent national goals cannot be reached.

Policies of International Integration

The logic of the integration trilemma leads – in analogy to the analysis of the impossible trinity – to three "policy solutions" which reflect clear preferences regarding the three competing goals. These solutions largely show the approach of their protagonists towards international economic integration and are thus labelled according to their respective characteristics, i.e. "traditional conservatives", "modern protectionists" and "internationalist utopians".[5] We will briefly elaborate on these positions and later examine their impact on the possible role of the IMF (see also Figure 2):

□ Traditional conservatives typically stress the importance of free markets and sovereign governments. As this position is often accompanied by strong beliefs in the efficiency of markets and by deep mistrust of the motives and capabilities of state agencies, the necessary negligence of the third goal of the integration trilemma, i.e. public management, is not seen as a major loss.

□ Modern protectionists prefer a different solution to the trilemma, which is indicated by the name given to

[5] See Lawrence H. Summers, op. cit., pp. 10 f.

their position. Protectionism against international financial integration is the consequence of perceived inefficiencies of financial markets. Therefore, greater international economic integration is not regarded as a goal of high priority. By contrast, the benefits of public management are regarded as fairly high and national sovereignty is shared as an important goal by protectionists as well as by conservatives.

☐ Internationalist utopians typically differentiate themselves from the other two positions in their less pronounced stance on national sovereignty. If there are forces seen that lead to increasing world integration – and nobody can neglect them – and if public management is rather beneficial, then national sovereignty is less important relative to the two other goals.

The IMF and International Integration

The IMF was designed during the 1940s when the end of World War II was in sight. The war taught the expensive lesson that gaining advantages at the expense of other countries is unlikely to lead to favorable long-term outcomes. In fact, the opposite is needed, an order which provides for a win-win situation for participating countries. Thus, the IMF was intended as an instrument to reduce tensions in the international monetary system and to promote international economic cooperation and integration.

The creation of the IMF highlights that the institution is intended to serve as an instrument of public management. Proponents of the IMF argue that its activities help improve the functioning and the results of the international monetary system. This would, for example, be the case if IMF activities could reduce the meltdown risk of the international financial system which might be induced by a crisis in a member country. However, due to differences in the evaluation of such risks and of the effectiveness of a multinational institution like the IMF, there are often contradictory reform proposals.

Regarding the three above-mentioned positions, the role of the IMF is a consequence of the preferred goals in the integration trilemma: traditional conservatives assign a low priority to the goal of public management and thus the IMF does not seem to be a really important institution but rather one that is to be downsized in the future. Modern protectionists think that international institutions should help control international financial markets. Internationalist utopians finally tend to recognize international institutions, such as the IMF, as the nucleus of coherent worldwide policy making. Although different reform proposals exist about the future role of the IMF, there are some common elements. These are discussed below.

Points of Agreement as to IMF Reform

There are three areas of agreement between the often discussed and otherwise fairly different reform proposals about the future role of the IMF. The first area is the objective of refocusing the IMF on its traditional functions. This means restricting the IMF to balance of payments assistance and lessening the involvement in other matters such as development programs and the fight against poverty. This involves a clearer division of labor between the IMF and the World Bank. This also aims at making the cooperation between the two multilateral organizations more efficient and at increasing the transparency of IMF operations. These proposals would lead to publishing as much about the IMF's work as possible, to a streamlining of the fairly diverse loan facilities and to a redesigning of the loan facilities in order to focus them more on the short-term.

A second area where reform proposals do not differ is the IMF's task of compiling data in its field of operation to improve the basis of decision-making for economic policy as well as for private agents. This task is performed under the leadership of the IMF's Special Data Dissemination Standard (SDDS) and is part of worldwide efforts to improve market transparency, involving the Bank for International Settlements and other regulatory agencies.

The third area of agreement between the reform proposals is the IMF's policy advice in its field of responsibility. Whenever needed, the IMF should support national authorities in their decision making by giving advice and by offering (or by mediating) technical assistance.

Notwithstanding this recognizable and wide area of agreement on IMF reform proposals which aim at improving the efficiency of the international monetary system, the extent of disagreement is still substantial. This will be highlighted below by discussing three different reform proposals which result from the three solutions of the international economic integration trilemma.

Downsizing the IMF

The first position we examine is "traditional conservatism" in Summers' terminology, i.e., a low preference for public management. This position has been established, elaborated and well documented by the work of the IFIAC, the Meltzer Commission.

The analysis documented in the commission's final report is based on the view that the extent and severity of recent financial crises, such as those in Mexico, Asia and Russia, were basically caused by distorted incentives. According to this view, an implicit promise by the IMF and its leading shareholders to bail out developing countries in the case of a severe crisis made international markets risk-loving (before consideration of bailout measures). As a result, international investors invested too much capital in emerging economies, thereby causing an investment boom and an asset inflation. The crises that occurred later are thus seen as necessary corrections of earlier bubbles. Therefore, an expectation of lower loans from the IMF in crises would have had a different effect and would have produced the correct incentives, in particular a much higher risk premium and much smaller capital inflows into these countries.

The Meltzer Commission Report includes more elements of analysis, but for our purpose it is more interesting to focus on the recommendations (see also Table 1). In short, the IMF is seen as an institution that distorts otherwise correct market signals. Therefore, the IMF should be radically downsized. The IMF should help improve transparency, it should offer advice to its members (both tasks roughly in line with the areas of agreement outlined above) but it should offer loans only under the most restrictive conditions. Any loans should be exclusively short-term, at above market rates and only if the countries fulfill some ex ante defined criteria of good behavior.

These criteria of – among others – prudent financial sector policy and public finance are quite restrictive as they apply the standards of industrialized countries to all countries of the world. If these standards were taken seriously in areas such as property rights, prudential regulation or legal framework there would hardly be any developing countries which could reach these norms. The consequence is that the IMF, as proposed by the Meltzer Commission Report, would not be allowed to extend any loans to these countries.

Table 1
The IFIAC Approach towards IMF Reform

Goals of the Integration Trilemma	IFIAC's Preferences	Specification of Preferences	Detailed Recommendations
Public management	Very low	As little public interference as possible	IMF as lender in very few circumstances; IMF advises only on a voluntary basis
National sovereignty	High	Autonomy of parliaments on economic policy	IMF credits with ex ante defined conditionality
International integration	High	Free flows of capital and goods	No restrictions on international markets

The suggested situation would be similar for industrialized countries, although for different reasons. According to the Meltzer Commission's suggestions, such countries should not be eligible to receive loans from the IMF because they are expected to finance their current account deficits in international capital markets. In case of a domestic financial crisis their national central banks are assumed to provide enough liquidity as lender of last resort.

In sum, neither industrialized nor developing countries would receive substantial loans from such a redesigned Fund. This would be no accident, however, but a consciously chosen approach. While the Meltzer Plan would allow the IMF to survive in a drastically downsized manner, there are other proposals arguing in a related way which do not see any meaningful role at all for the Fund in the future. Consequently, several contributions to the current debate of IMF reform have proposed closing in down the institution completely.[6]

An IMF to Reduce Poverty

Surprisingly, there is high agreement between the analysis of the above position and the IMF criticism of the opposite wing of political opinion. Several publications by the non-governmental organization (NGO) Oxfam may serve as an example of the latter position.[7] Oxfam (in close cooperation with the German NGO WEED) agrees with the Meltzer Commission Report as to the catastrophic performance of the IMF, which "has mishandled virtually every crisis ..." Therefore, Oxfam sees "clearly a case for slimming the Fund".[8]

However, there are fundamental differences between the position of Oxfam and that of the Meltzer Commission regarding other functions of the IMF. Oxfam demands that the IMF should be transformed into a "poverty-reduction agency" which is embedded

[6] See e.g. Sebastian Edwards: Abolish the IMF, in: Financial Times, 13. 11. 1998.

[7] The most comprehensive document in this respect is the commissioned study by Kevin Watkins: Der IWF, Falsche Diagnose – falsche Medizin, Oxfam, WEED, March 2000 (english edition published in 1999).

[8] The quotes are taken from Kevin Watkins: Reforming the IMF, Oxfam, March 2000, p. 5.

in national and international plans to reduce poverty over the medium run. This means that macroeconomic stabilization measures proposed by the IMF should be subordinated to national poverty reduction plans. In any case, the goal of public management is most important (see Table 2).

The importance of public management still justifies a role for the IMF in the future but the high priority on national sovereignty would not leave the IMF as powerful as it has been in the past. The ideal implicitly suggested by the Oxfam study is to transform the support by international agencies from a de facto dictate into a more participatory process. Measures to reach this goal are to embed the IMF into a broader group of policy-making agencies and to increase the voting share of poorer countries within the executive board of the IMF. Thus, national sovereignty has a high importance but appears to some degree to be limited by the suggested increasing importance of international policy making bodies. The one goal that is not really discussed in this approach to IMF reform is that of international integration. There are some remarks though, even more pronounced in publications by WEED, which clearly recommend slower liberalization processes and restrictions on international capital flows.

An IMF to Police International Finance

Suggestions for an IMF that primarily deals with issues of appropriate international financial markets are presented – although differently justified – in publications by, for example, Paul Krugman and Joseph Stiglitz. We here focus on a paper by Stiglitz as an example in order to demonstrate major arguments of this position.[9] With regard to the integration trilemma, the preferences are very similar to that of the earlier discussed position (the Oxfam study). Public management and national sovereignty are highly regarded whereas restrictions in international integration are accepted. One could almost go as far as concluding that international capital flows have to be stabilized according to this approach, otherwise growth would be heavily curtailed. The reason is that international financial markets are seen as producing (not exclusively but remarkably) large negative social returns.

Table 2
The Oxfam Approach towards IMF Reform

Goals of the Integration Trilemma	Oxfam's Preferences	Specification of Preferences	Detailed Recommendations
Public management	Very high	Poverty reduction	IMF as "poverty-reduction agency": macroeconomic stabilization as subordinate objective
National sovereignty	High	Multilateralism	IMF recommendations integrated in national strategy; increased voting power for poorer nations
International integration	Not mentioned	–	Restrictions of international capital flows; slower liberalization processes

Some reform elements for IMF policies proposed by Stiglitz are the following:[10] national authorities should eliminate incentives that encourage short-term capital flows; financial systems should be strengthened in a way adapted to the circumstances of individual countries; capital flows should be stabilized by direct interventions. These reform elements are obviously not in line with the recent IMF policy which rather emphasized rapid liberalization, quite uniform macroeconomic management of individual countries, and less concern with the financial sector institutions.

The IMF as Part of an International Order

The third position suggested by the integration trilemma is the "internationalist utopian" position. This position prefers the goals of public management and international integration to the goal of national sovereignty. This approach has not been developed coherently thus far because it obviously cannot be realized in the near future. Nevertheless, there are many proposals in the literature suggesting that a world which becomes more and more integrated in economic terms should develop appropriate institutions of overall market governance.

In order to classify the different proposals of this position it seems to be worthwhile to make a distinction between issues of microeconomic and macroeconomic governance.[11] Institutions of governance are put in place to control or design markets. Some directly aim at improving the efficiency of market behavior and decision making, such as regulatory measures, while others influence the macroeconomic conditions in an effort to improve the market impact on social welfare. Table 3 provides an overview of some proposals and shows their relation to the issues

[9] Joseph E. Stiglitz: Reforming the Global Economic Architecture: Lessons from Recent Crises, in: Journal of Finance, Vol. 54, No. 4, 1999, pp. 1508-1521.

[10] See Joseph E. Stiglitz, op. cit., p. 1513.

[11] See for this approach Michael Frenkel, Lukas Menkhoff: Stabile Weltfinanzen? Die Debatte um eine neue internationale Finanzarchitektur, Berlin 2000, pp. 10 ff.

of either micro- or macroeconomic governance. These proposals cannot be discussed here but their short characterization by catchwords reveals the intended direction of reform.[12] Instead, we pick one proposal that appears to cover a broader range of issues. This is the proposal by Eatwell and Taylor.[13]

The major impetus of the proposal is the notion that international markets need an international order to be functional, just as is the case on a national level. Eatwell and Taylor suggest creating a new international organization, the World Financial Authority (WFA), which would not replace the IMF but which would oversee and complement the IMF's work (see Table 4). They argue that the function of the WFA would have to be the regulation of international capital markets in way similar to the present regulation of national financial markets. Their proposal involves a centralized solution to the issue of the international harmonization of minimum standards. By contrast, the working groups established by the Financial Stability Forum presently try to accomplish a better structure of international financial markets by reaching a consensus among countries about appropriate financial regulation.

Table 3
Proposals for Upgrading the International Financial System

Author	Main Proposal	Addressing Governance	
		Micro	Macro
Eatwell and Taylor (1999)	World Financial Authority (WFA)	X	X
Fischer (1999)	International lender of last resort		X
Kaufman (1998)	Global financial regulator	X	
Soros (1998)	International Deposit Insurance Corporation	X	
Cooper (1984)	World Monetary Authority		X
Raffer (1990)	International Bankruptcy Court	X	

Table 4
The WFA Approach towards IMF Reform

Goals of the Integration Trilemma	IFIAC's Preferences	Specification of Preferences	Detailed Recommendations
Public management	High	"Taming" of international financial markets	Foundation of a World Financial Authority: strictly regulates inter. fin. markets and oversees the IMF
National sovereignty	Low	Not functional	–
International integration	High	Managed international integration	Allows only regulated international transactions

It is certainly no coincidence that Eatwell and Taylor envisage the proposed WFA as a sister organization of the World Trade Organization (WTO). Moreover, the WFA is intended to be linked to the Bank for International Settlements, which currently coordinates banking regulation and hosts – among other committees – the Financial Stability Forum. Finally, the WFA is regarded as an institution superior to both the IMF and the World Bank. The reason behind this institutional setting is a deep mistrust of the real motivation behind IMF decisions. Although the IMF is a worldwide body it is – due to the capital-based voting rights – effectively dominated by a few industrialized countries and, in particular, by its largest shareholder with the only veto power, the USA. The reorganization would transfer the decision making to the WFA, which might delegate some macroeconomic counseling and possibly an international lender of last resort function to the IMF. It seems to be important that the policy design is decided by the WFA, which applies the – political rather than economic – voting rule "one country – one vote".

IMF Reform Proposals: Right or Wrong?

So far, we have presented three approaches towards IMF reform, which make competing proposals. This raises the question whether one or the other position should be preferred from an economic point of view. We argue in this respect that the framework of the integration trilemma nicely reveals the underlying preferences behind the arguments. Thus, the competing proposals cannot be regarded as either right or wrong but simply as trying to achieve different goals:

- If one does not recognize much economic improvement from public management, then the Meltzerreport shows a reasonable way for IMF reform, i.e. basically to drastically downsize the IMF and to strip it of its decision making power.

- If one does not expect much from international integration and calls for major corrections of market

[12] A short description of most proposals can be found in Kenneth Rogoff: International Institutions for Reducing Global Financial Instability, in: Journal of Economic Perspectives, Vol. 13, No. 4, 1999, pp. 21-42; see also Stanley Fischer in the same journal and Richard N. Cooper: A Monetary System for the Future, in: Foreign Affairs, Vol. 63, 1984, pp. 166-184.

[13] See John Eatwell, Lance Taylor: Towards an Effective Regulation of International Capital Markets, in: International Politics and Society, No. 3, 1999, pp. 279-286.

outcomes, then the Oxfam approach shows a direction for reform. The IMF would subordinate its macroeconomic policy under the goal of poverty reduction. A variation of this second position is to put less emphasis on the poverty issue but to attend more to the regulation of international financial markets. However, both variations can be combined with each other.

☐ Finally, if one does not regard national sovereignty as functional in economic affairs anymore, the strengthening of international organizations would be the consequent answer. This way of reform would rather upgrade the importance of institutions such as the IMF, although the concrete proposal presented here, i.e. the creation of a World Financial Authority, suggests institutional reforms that weaken the IMF in favor of a new body.

Where is the IMF Heading?

Having considered above the diverse approaches, do any of these fit the present reforms being undertaken in the international financial order? Rather not, as the reform process is restricted by the consensus principle.[14] This means that major reforms can only be realized if the big players agree and can sell them to others. This is exactly the limitation to any reform idea:

☐ The IFIAC suggests a reform path that almost nobody seems to be interested in (except the US congress). With such a reform poor countries would lose a source of financing and rich countries an instrument to prevent negative feedback effects on their own markets and on their political interest. This proposal is based on great optimism regarding the perfect functioning of free financial markets. However, this proposition does not receive much support.

☐ Oxfam suggests an approach that does not serve the (possibly shortsighted) interests of the industrialized countries.

☐ The ideas of Stiglitz on financial reforms are reported to work like a rebellion against US interests.[15]

☐ The approach of founding a WFA is obviously not feasible at a time when international cooperation fails on even much smaller issues.

Thus, very few substantial changes can be expected. The reason is that the political process is not driven by academic plans of grand new designs of the international financial order but by events that produce urgent needs for reform. As long as there are no more drastic crises in the industrialized countries, the reform process follows a piecemeal-approach.

The presentation by Stanley Fischer early this year can be seen as a good example of how the IMF tries to adapt flexibly to criticism of its policy.[16] Three examples of this are the explicit reference to "direct anti-poverty measures"; that "the IMF has begun to undertake assessments of the strength of financial systems in member countries"; and finally the expressed desire of "sharpening the focus of IMF activities". It is difficult to judge from the outside whether the institution is really changing something or whether the powers of persistence are stronger.

Concluding Remarks

Having analyzed different proposals for reform of the IMF, we would like to evaluate some of the arguments brought forward so far. It seems to us to be important that there is indeed not only room but need for an international financial institution addressing issues of international "public management", such as preventing international systemic risks and coping with financial crises. Therefore, we do not share the preferences of the IFIAC. With regard to the other proposals, it appears to be not only beneficial but even necessary that international institutions are powerful. Accordingly, the at present strongest institution, the IMF, should be neither abolished nor weakened – but, apart from the three areas of agreement mentioned at the beginning of this paper, are there any areas in which the IMF should do things differently from the present?

On the policy level the IMF signals in several publications that it is willing to deal more extensively with institutional requirements for successful financial liberalization. This would include, in particular, appropriate banking regulation in emerging economies. Moreover, we could envisage the IMF as a promoter of a unified international order of financial markets. Steps to be taken in this direction would be the inclusion of appropriate elements, such as certain standards, into the Article IV consultations and into IMF conditionality.

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[14] We are aware that there are many more reform proposals which are less extreme than the "corner solutions" being discussed here. Among them are Barry Eichengreen: Toward a New International Financial Architecture, A Practical Post-Asia Agenda, Washington, D.C., 1999, and the Council on Foreign Relations Independent Task Force Report, Safeguarding Prosperity in a Global Financial System, 1999 (download at: www.foreignrelations.org).

[15] From the outside this looks like a confirmation of the opinion expressed by Jagdish Bhagwati: The Capital Myth, The Difference between Trade in Widgets and Dollars, in: Foreign Affairs, Vol. 77, No. 3, 1998, pp. 7-12.

[16] See Stanley Fischer: Presentation to the International Financial Institution Advisory Commission, 2. 2. 2000, on the IFIAC's webpage, see footnote 2.