DOI: 10.1007/s10272-006-0193-4

Inadequate IMF Reform

Slightly more than 90 per cent of the necessary votes at the biannual meeting in Singapore were in favour of the mini-reform the First Managing Director, Rodrigo de Rato, of the International Monetary Fund (IMF) had proposed to its members. There will a modest increase of the relative weights ("quotas" in IMF jargon) for China, Mexico, South Korea and Turkey, implying that countries like Germany and the United States will experience a small drop in their relative weights. The reform is meant to be only a first step, followed by a more far-reaching reform in 2008 to give more weight to the main clients of the IMF, the developing and emerging economies in Asia, Eastern Europe, Latin America and Africa. This is a welcome idea but problems are showing up already.

Twenty-three countries voted against the proposal, most of them from Latin America and Asia. They presumably felt that they, too, should have been considered for an increase in weight this time around. And their fear is justified that a major reshuffle of voting rights, in contrast to declared intentions, is not on the cards anytime soon. It will be close to impossible to forge a consensus beyond this mini-reform because important countries fear a loss of influence. This is manifest in the controversy about how quotas should be determined in the future.

So far, quotas are based on the economic weight of a country, its trading share, and its stock of currency reserves. Clearly, all these have changed tremendously since the time when quotas were first calculated. China, for instance, has 15 per cent of global income but had an IMF voting share of only 2.9 per cent before Singapore. However, proposals differ as to what the new formula should be. Emerging markets, like China and other Asian countries, favour a large weight for currency reserves because theirs are so large. The United States prefers GDP since this would increase its relative weight even more, while the G-24 group of developing and emerging countries advocates the use of purchasing power GDP, which would increase the weight of countries like China and India. And the European countries, in particular the smaller ones, stress the importance of international trade. That in turn leads others to argue that intra-European trade, especially within the euro area, should be ignored. This makes sense because for the IMF only extra-European figures matter. Since exchange rates and currency crises are the main fields of activity for the IMF, there is little reason to have several nations with one currency being represented individually. Even European Central Bank board member Lorenzo Bini-Smaghi has called for the joint representation of Europeans (probably through the ECB), arguing that Europe risks undermining its international standing. Not for the first time does the European Union aspire to be a world player in its own right but is shamefully unable to get its act together.

The strong US government support for the reform is part of its strategy of pushing China into doing more to correct global imbalances. The foremost aim, as confirmed by the newly institutionalised high-level meetings between China and the USA, is to have China revalue its currency. The US government asserts its belief that a sharp appreciation of the renminbi (RMB) would help to reduce its huge current account deficit. The United States is borrowing two-thirds of global savings this year (800 million dollars) to finance its trade deficits and puts the blame for this on China's reluctance to revalue its currency. This is either naïve or willingly misleading the public. There may be many reasons why it would be in China's self-interest to allow a gradual appreciation of the RMB, but without a fundamental correction of US policy global imbalances will not disappear and the country will become increasingly vulnerable to financial crisis itself.

The catch-22 is that in its attempt to keep the RMB down China is buying foreign currency, chiefly US dollars, in huge amounts. This not only helps to finance President Bush's

budget but makes China increasingly reluctant to revalue. Sitting on an estimated 50 billion US dollars in currency reserves, a 10 per cent appreciation of the RMB would wipe out some 5 billion of China's wealth. Why should it be willing to do this? Just because some Western economies have decided it is time for China to assume more responsibility for the world economy?

In fact, expecting the IMF to put more pressure on China and others to help reduce imbalances reveals the fundamental problem of the IMF – it is running the serious risk of becoming irrelevant. Former creditors like Argentina, Brazil and Russia have paid back credits in advance, and others like Bolivia have refrained from renewing theirs. Thus, the institution is losing business and influence fast, and since its main source of finance is interest on outstanding credits it will lose around 30 per cent of its income in the next two years. Accordingly, the IMF itself is undergoing an effort at belt-tightening. But not only are customers taking their business elsewhere (China and Venezuela are very happy to help out countries in need, it is rumoured), there is even talk about creating rival institutions. Asian nations are considering extending the Chiang-Mai Initiative, an arrangement of reserve pooling that should help countries under pressure. More recently, there is even talk about creating a regional bank for Mercosur countries to be bankrolled by the ambitious Mr. Chavez. With emerging markets flush with money, there is a growing feeling that the IMF is not delivering what emerging markets and developing countries want and that better and less stringent alternatives may exist.

Yet, the minuscule reform agreed upon in Singapore conveys the impression of rearranging deck-chairs on the Titanic in front of the iceberg. It is in no way adequate to deal with the future problems the IMF is facing. Granted, financial crises will not disappear and regional alternatives to the IMF are not very likely to become significant anytime soon. Countries like Hungary are vulnerable, interest rates are increasing and flows to emerging markets are drying up. With the turn in the global cycle, the next crisis will certainly come, and the IMF will be back in business very quickly. But the more disconcerting question is whether the IMF has enough fire-power to fend off the next round of balance of payments crises. Its resources are hardly enough, given the tremendous amount of money that is circulating in liquid markets. It might therefore be worthwhile seriously thinking about proposals that the IMF act more like a credit cooperative. Member states would deposit currency reserves with the IMF and these funds would then be used to support countries under pressure. Certainly, even with pre-qualification this would not solve moral hazard problems completely but it would at least ensure that financial resources are large enough to make a real impact. Thus, one needed reform is to put IMF finances on more solid ground.

A second, and by no means less important, thing is that the IMF's recommendations need to have more teeth. It is presently not very convincing that some accuse China and other emerging markets but refuse to correct their own economic policy like the USA is currently doing. An IMF reform is needed that makes the Fund's advice more powerful and less restrained in its recommendations. The Fund must be more open, independent and assertive not only against China but against the United States and Europe as well. For this, political influence must be reduced sharply and advice must become more independent, frank and less politically guarded. That is a reform long overdue. If restructuring helps to achieve this by creating a more balanced representation of major global players, fine. But mere changes to the voting rights are not enough.

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