
The IMF View on IMF Reform

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After browsing some of the papers for the conference, and especially Ted Truman’s masterly overview of the issues on IMF reform, I will begin by paraphrasing Mark Twain and assuring you that reports of the IMF’s death have been greatly exaggerated. In fact, I think that the level of interest in the Fund’s activities, including this conference, suggests that the Fund is still recognized for what it is—the central institution of global monetary cooperation. To continue fulfilling this responsibility as effectively as possible, we do need to make some changes in the way we work. I have some ideas on this, and I would like to share them with you today.

I want to thank the participants for their work in preparation for this conference. I very much appreciate the breadth and depth of the papers. It’s useful for me, for our Executive Board, and for the Fund staff to have critical thought from outside, especially from people who know the Fund well. I can assure you that we will reflect carefully on the suggestions made here.

I want to talk mostly about the agenda for reform of the IMF that I am presenting to our governors for their discussion tomorrow. But first I want to share something about my perspective from inside the Fund and explain why I find some of the suggestions made today unrealistic, especially the suggestion that the Fund “enforce the rules” of the international monetary system.

Let me lead into this with a story from a great scholar of the American presidency, the late Richard Neustadt. In his book, *Presidential Power*, Neustadt quotes President Harry Truman as speculating about how un-

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happy Eisenhower will be when he becomes president. “He’ll sit here,” Truman would remark (tapping his desk for emphasis), “and he’ll say, ‘Do this! Do that!’ And nothing will happen. Poor Ike—it won’t be a bit like the army. He’ll find it very frustrating.” Truman’s broader point was that even the president of the United States needs to persuade others if he is to exercise power effectively. In the same way, the influence of the Fund in the world comes almost entirely from its ability to persuade its members that they should follow its advice—advice that is based on the consensus of the membership. If we want the US Congress to enact budgets to reduce the deficit, then we have to make recommendations that are convincing and communicate them in a way that will resonate with US authorities, Congress, and the broader public. If we want China to adopt more exchange rate flexibility, then we need to be sensitive to the Chinese authorities’ concerns, too. I am a strong advocate of transparency, but if you’re in a room with a friend, you don’t need to talk through a megaphone. I think quiet diplomacy, as some have characterized it, has produced good results, and not just in the area of exchange rates. For example, I am very pleased that China has announced, during the most recent Article IV consultation discussion, its intention to participate in the Financial Sector Assessment Program.

We also need to persuade—rather than dictate to—members on the issue of IMF reform. I view the next two days as an important opportunity to make progress on some of the ideas that I have proposed in my report on the IMF’s objectives and its medium-term strategy. Let me tell you more about these.

First, I believe that the Fund must intensify its focus on helping countries come to grips with globalization. This is the most important force at work in the world economy today. We have seen huge changes in real sector conditions—the global transfer of goods, services, technology, and jobs—and in recent decades we have been experiencing financial globalization, the creation of a global savings pool. This has allowed world savings to be allocated into more productive and diversified investments, but it has also allowed countries to build up much larger current account imbalances, with correspondingly greater risks. A couple of the papers for this seminar mention the case of Long-Term Capital Management (LTCM). The problems of LTCM, and the damage that could have been done to the US financial system by its fall, stemmed from both increasing interlinkages in global capital markets and a discontinuity in the markets: the Russian default of 1998. I hope that defaults will not become a regular feature of 21st century crises, but we can bet that discontinuities of one kind or another will recur. Given the integration of capital as well as goods markets, these will affect advanced economies as well as emerging-market economies. The challenges that advanced economies will face—in macroeconomic policy, in financial-sector policy, and of international eco-

conomic integration—are too little recognized and too often misjudged by decision makers.

This has important implications for the Fund. We need to be able to give all of our members—in our country, regional, and global surveillance—concrete advice on the consequences of increasing integration. Here are some of the things we need to do.

We need to understand the issues more deeply ourselves, and especially the benefits, imbalances, and fragilities caused by cross-border flows of goods, capital, and people. One possibility is that staff from all the departments in the Fund that currently work on these issues separately will work together intensively on selected topics and distill their work into an annual report on the macroeconomics of globalization.

We need to improve multilateral dialogue. I note with interest but respectfully dissent from Fred Bergsten's proposals for a new steering committee for the world economy. I don't think we need a new committee. We have vigorous discussion of issues in the IMF Executive Board, and where we need to raise issues at the level of ministers, I would prefer that this take place through an equally vigorous discussion in the International Monetary and Financial Committee. Indeed, I hope we have such a discussion tomorrow.

We need better surveillance of financial markets. Understanding capital flows has become much more difficult in an increasingly globalized capital market, but it has also become much more important. I don't want to get into the organizational mechanics of this at the moment, especially as the Fund's work on the financial sector is still being reviewed by the McDonough Group. But one thing that is already clear is that we need to have better integration of financial expertise into area department country work.

Our country surveillance work needs to be more focused and more pointed to anticipate upcoming problems and give candid advice on them. Specifically, area department teams should be given greater flexibility to streamline the coverage of reports and to focus on the most pressing macroeconomic issues from the point of view of stability and the challenges of globalization. I would hope that there is also scope for streamlining some of our other country work, including in the area of standards and codes. In this area, great progress has been made, and in most cases the need is for follow-up.

Emerging-market economies are the countries most at risk from volatile capital flows. The Fund has made significant improvements in its work on crisis prevention over the past few years. I am thinking in particular of our internal work on vulnerability assessments and the development of the balance sheet approach to financial crises. We have also, of course, stepped up and provided support for our members when they have needed it, from Thailand, Korea, and Indonesia through Turkey, Brazil,

and Argentina. But this is not an area on which one can ever declare victory and withdraw. Much remains to be done.

On crisis prevention, I would like to see more work in the Fund both on the underlying vulnerabilities in emerging-market countries and on the risks from supply-side disturbances in advanced-country financial markets. On crisis resolution, we need to continuously review the effectiveness of the Fund's instruments, including the lending into arrears policy. I have said in the past that we need to have a Fund that can say no. I still believe that.

We also need to consider further the possible ways in which the Fund's instruments can provide insurance to its members against crises, such as through high-access precautionary arrangements or a successor to the Contingent Credit Lines. The problem with the latter was trying to balance the member's need for assurances that it can draw on the Fund's resources quickly if needed and the institution's need for assurances that the Fund's support will be part of a package of financing and measures that works—one that enables the member to both get out of trouble and eventually repay the Fund. We need to keep looking for a solution that achieves this balance.

Another issue very relevant to the situation of emerging-market economies is capital account liberalization. The Fund has been heavily criticized on this issue in the past, and I think much of that criticism is unfair. In the face of that criticism, it is tempting to withdraw and let the advocates and enemies of capital account liberalization just fight it out. But I don't think we can do that. Countries are choosing to liberalize their capital accounts because they want to take advantage of the huge and growing pool of global savings. And this liberalization brings macroeconomic challenges that require careful management, including of the sequencing of liberalization with financial-sector reforms. The Fund must have a view on this area. So I think it is important that the Fund deepen its knowledge of the issues surrounding capital market liberalization. And we will do so in the months ahead.

We also need to deepen our work on low-income countries. There is a body of opinion that thinks that the Fund ought to get out of the business of supporting low-income countries and turn over its responsibilities to the World Bank. I completely disagree with this view. The low-income countries need macroeconomic advice from the Fund, and they often need financial support from us, which we provide through the Poverty Reduction and Growth Facility. Moreover, we are at a critical juncture in trying to help countries achieve the Millennium Development Goals, and we have an opportunity arising from the growing consensus in wealthy countries that aid must be increased and debt must be reduced. Now is the time when we have the best opportunity to make a difference in the lives of billions of people.

I do think we need to improve the focus of the Fund's work on low-income countries. This will probably involve doing less in some areas. Over the coming months, we will have a discussion with our colleagues at the World Bank on what the right allocation of work between the two institutions is. I think there may be scope for changes. I'm also concerned that the Fund's work on low-income countries is overloaded with procedures that absorb substantial resources but yield questionable gains. Our work must be streamlined.

But there are also areas where we need to do more. We need to deepen the Fund's involvement in advising countries on how to deal with the macroeconomic effects of higher aid flows. The impact of large aid flows on macroeconomic management takes many forms. Fiscal management can be complicated by large aid flows, and the quality of spending can suffer. So there is a need to improve public expenditure management to ensure that additional aid does not lead to wasteful and inefficient spending. In addition, large aid financing can also weaken longer-run incentives to develop an adequate domestic revenue base and strengthen the tax system. The Fund has an important role to play in improving fiscal management, which is often key to raising aid effectiveness. Higher aid flows can also cause real exchange rate appreciation, leading to weaker external competitiveness and slower growth. The Fund has a crucial role here too, advising on the potential for macroeconomic problems and coming up with solutions to them. For example, real exchange rate appreciation can be countered by enacting structural reforms and using aid resources to improve productivity in the domestic economy. All of these are areas where the Fund has a comparative advantage and where our support will be very important.

One issue on which I agree strongly with views expressed by many of the participants in this conference is the need for a change in IMF voting shares and representation. The Fund's ability to persuade our members to adopt wise policies depends not only on the quality of our analysis but also on the Fund's perceived legitimacy. And our legitimacy suffers if we do not adequately represent countries of growing economic importance. This means, in particular, increases in voting power for some of the emerging-market economies, especially in Asia. We must also ensure that our members in Africa, where so many people are profoundly affected by the Fund's decisions, are adequately represented. It's usually taken as axiomatic that if some countries "win" from a reallocation of quotas, others must "lose." I don't agree. This is not a zero-sum game. If there is broad acceptance of the IMF's legitimacy, the institution and all of its members will benefit.

I referred earlier to both the quality of the Fund's advice and the effectiveness of our communicating that advice as being important in determining the Fund's influence. Let me talk some more about the second part

of this—the importance of communication—because this is another area where we may need to change our practices. As many have noted, there are countries where the Fund gives advice that is not followed. Sometimes this is because of disagreement on the analysis of the issue. These are cases where we obviously need a serious, engaged dialogue with the member on the nature of the problem and how to fix it. But there are also plenty of cases where there is agreement on the analysis but reluctance to act on that analysis for political reasons. In these cases, I would like the Fund to be more forthright in making the case for the policies we support, including to the public. In globalized democracies, public opinion can be changed by persuasive arguments, and changes in public opinion can change the positions of policymakers. We should certainly make sure that the Fund’s position is not misunderstood or misstated—that our views are clear. In the best cases, where we help generate public support for good policies, we can go further and do a service to our member governments by making the case for reform in a clear and forthright way.

Finally, I would like to share with you a point that was made by an executive director when we discussed this issue of communication in the Executive Board. He said it was important that the Fund listen as well as talk. I agree with that completely. We want to engage in dialogue, not adversarial politics. In that spirit, I would once again like to thank the Institute for International Economics and the organizers of this conference, and especially Ted Truman, for their work in promoting dialogue on reform of the IMF.