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## The IMF: Back to Basics

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As I flipped through the newspapers very early this morning in preparation for today's G-7 finance ministers and central bank governors meeting and other meetings throughout the weekend, I was reminded why this issue—IMF reform—is so important and so topical. The challenges we—policymakers—face are extraordinary, and we must have effective, adaptable institutions to assist us as we craft solutions.

So let me start my remarks today by stating that I am a believer in the IMF—that is, an IMF as a facilitator of international monetary cooperation. History has repeatedly demonstrated how much the world needs such an institution—from the maintenance of a fixed exchange rate system centered on the major industrialized countries in the 1950s and 1960s, to the resolution of the Latin American debt crisis of the 1980s, to the economic transformation of Eastern Europe, to the emerging-market crises of the 1990s. There is a role for the Fund.

Yet the IMF now faces fresh, tough questions about its relevance. For example, is there any meaningful role for the IMF in the industrialized countries? With emerging-market economies implementing better domestic economic policies, steadily repaying their IMF debts, and self-insuring through increasingly large reserve accumulation, will the IMF simply cease to matter to this key group? Should the IMF react by shifting more of its policy and financing focus to low-income countries?

In a generalized response to these questions, I think that the best way to strengthen the IMF's relevance is to refocus on the core mission envisaged by the IMF's founders at Bretton Woods—international financial sta-

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bility and balance of payments adjustment. We should measure IMF effectiveness by how well it helps countries and the global system avert or recover from financial crises, not by the volume of Fund lending. Managing Director Rodrigo de Rato's strategic review is a good first step, and I urge you to pay close attention to what he has to say.

For my part, allow me to touch on five key priorities.

## Quota and Representation Reform

First, it is necessary for us to address the governance structure of the IMF. The IMF's governance structure should ensure that every member has a voice, with each country's vote scaled to reflect its weight in the world economy. This shareholder structure provides for both universal representation and weighted influence, while keeping the Fund's financial position strong so that it can meet its systemic responsibilities and come to the aid of members when needed.

At the spring meetings of the IMF and World Bank, Treasury Secretary John W. Snow stated that the governance of the IMF should evolve along with the world economy so that countries have a rightful stake in the institution. The world economy has evolved considerably, as some countries have grown more quickly than others and Europe has achieved monetary union and deepened integration.

The quotas for many fast-growing emerging-market countries are much smaller than the IMF's own calculations would suggest they should be. For example, Korea is 66 percent underweight, Mexico about 35 percent underweight, and Turkey about 32 percent underweight. The IMF's quota formulas also do not reflect many countries' weight in the world economy. This is true for the United States, whose quota is 17 percent of the total, while US GDP was roughly 29 percent of global GDP in 2004.

The IMF's liquidity is at a record high by any measure. There is no need to increase its resources—either through a general or an ad hoc increase. The United States is not seeking to increase its own quota share and will not accept any decline. Rather, we wish to explore ways to improve the balance.

Within that context, what can be done?

- First, a voluntary rebalancing of quotas, within the existing total, from “overweight” countries to the most “underweight” emerging markets would be a major step forward. This will depend on countries whose quotas are out of proportion to their global economic weight stepping forward to help modernize the Fund.
- Second, the poorest countries are among the most overweight relative to calculated quota or share of GDP but should be held harmless so that their quota does not fall.

- Third, in addition to rebalancing quotas, representation on the Executive Board should better reflect the IMF's full membership. Consolidation of European chairs would help to increase the relative voice of emerging-market and developing-country members.

These are complex issues, and the United States will not be able to effect change alone. But together, the IMF's membership can begin a process that will bring a better balance to IMF governance and that of the international financial institutions more broadly.

## Exchange Rate Surveillance

Second, the IMF needs to be far more ambitious in its surveillance of exchange rates.

IMF Article IV requires that the IMF exercise "firm surveillance" over the exchange rate policies of members. After the collapse of the Bretton Woods fixed exchange rate system, the IMF in 1977 developed surveillance guidelines that determine its approach to what is still called the Article IV process. Those guidelines included domestic policies, since domestic policies can impact a country's balance of payments position.

Over time, however, domestic policies have come to dominate Article IV reviews, and it is not uncommon to read an Article IV review with only a brief reference to a member's exchange rate policy and its consistency with both domestic policies and the international system. There is almost never discussion of whether an alternative regime could be more appropriate or how to transition to it.

Many large emerging-market countries would benefit from regimes that allow substantial exchange rate flexibility. Research, including by the IMF, has shown that for developing countries integrating into international capital markets, the requirements for sustaining pegged exchange rate regimes have become very demanding.

The IMF also has standing authority to initiate "special consultations" whenever one member's exchange rate policy is having an important impact on another member. However, in over a quarter century, the IMF has held special consultations exactly twice. This has placed increased pressure on bilateral mechanisms and actions to address instances of protracted currency misalignment.

We understand that tough exchange rate surveillance is politically difficult for the IMF. It is also true that a country has the right to determine its own exchange rate regime. Nevertheless, the perception that the IMF is asleep at the wheel on its most fundamental responsibility—exchange rate surveillance—is very unhealthy for the institution and the international monetary system.

## Public Debt Sustainability

A third issue, also related to crisis prevention, is public debt sustainability in emerging markets. High public debt keeps domestic borrowing costs high (which is a tax on citizens), limits scope for countercyclical fiscal policy, and eventually could lead to explicit default or implicit default through high inflation. The banking sector often holds domestic debt, making any restructuring particularly difficult given the potential impact on bank capital. Domestic debt can be a problem even in countries with large amounts of international reserves, and what starts as a domestic debt crisis can rapidly spill over into external accounts through capital flight.

The IMF has been further ahead of the curve on this issue, most notably in its September 2003 *World Economic Outlook*, which pointed to the risks of high public debt levels in emerging markets. But while emerging markets have made progress over the last two years amid an exceptionally benign external environment, the average public debt ratio is still uncomfortably high at 60 percent.

Accordingly, countries should seize the day before the benign conditions dissipate. This means greater focus on fiscal consolidation, debt structures, and structural fiscal reforms. The IMF should deepen its traditional focus on fiscal policy by increasing efforts to help countries improve their debt structures and by stressing structural fiscal reforms in its surveillance and programs.

## Crisis Resolution

The fourth issue is crisis resolution. Crises cannot always be prevented—they will sometimes develop in the most unexpected ways. The IMF's crisis resolution framework is a mix of policy adjustment, official finance, and private finance. On policy adjustment, there will inevitably be a tough judgment on how much is necessary and politically feasible. On official finance, the IMF's framework for exceptional access should provide increased predictability for markets and aid in the difficult differentiation between illiquidity and insolvency.

The real unresolved question is private-sector involvement and, in particular, sovereign debt restructuring. It is clear to me that a market-based approach to sovereign debt restructuring is preferable, and there remains no need for a sovereign debt restructuring mechanism. However, it is also clear that we will have to think creatively about how to improve the market-based sovereign debt restructuring process.

There has been considerable discussion about whether the IMF should set the "resource envelope" for debt restructuring through the primary fiscal surplus in a Fund program. It is helpful for a country and the IMF

to reach agreement on the primary surplus. This greatly facilitates a subsequent determination of whether the country is making a good-faith effort to resolve its defaulted debt to private creditors—a precondition for the IMF to lend.

Outside of the IMF, a natural step would be to build on the recent progress in collective action clauses in international bonds—a remarkable success story due in no small measure to my predecessor, John Taylor. We can also examine the extent to which the draft Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets complements official-sector efforts to clarify the crisis resolution framework.

## Low-Income Countries

Finally, partly as a result of the historic G-8 debt deal to end the lend-and-forgive cycle at the World Bank, African Development Bank, and the IMF, much of the discussion at this year’s annual meetings will revolve around the role of the Fund in low-income countries. The United States believes that the IMF has a very important function in helping low-income countries establish a sound macroeconomic framework through surveillance, technical assistance, a new nonborrowing program for countries that desire Fund engagement but do not need IMF finance, and IMF lending when appropriate.

However, the IMF is not a development institution, and it is clear that the IMF’s financial involvement in low-income countries has gone terribly awry. The IMF’s own work on Poverty Reduction and Growth Facility programs shows that not only do many countries not achieve the external adjustment targeted but what is targeted is not enough to restore external viability. There are also far too many follow-on programs and repeat borrowers—so much that the IMF has established “access norms” stretching out six programs. For example, in Guyana and Malawi, fiscal and debt sustainability remains elusive even after HIPC (heavily indebted poor countries) debt relief and multiple IMF programs.

The issue is not whether the United States favors concessional flows to low-income countries. We clearly do, and that is why we have substantially increased our contributions to International Development Association (IDA) and bilateral assistance programs. The issue is that the IMF should remain an institution that provides short-term financing in response to an actual balance of payments need. IMF finance is concessional so low-income countries can afford it. But it does not follow that the IMF should increase flows to low-income countries simply because they are concessional. IMF lending, while concessional compared with market rates, is far less concessional than IDA lending, while an IDA grant is 100 percent concessional.

## Conclusion

When faced with calls for reform, the typical response of any institution is that it is already undertaking it. The IMF can legitimately say it has already begun its work. IMF Managing Director de Rato has laid out a vision for his strategic review that can incorporate these priorities.

Yet UCLA basketball coaching legend John Wooden would warn us never to confuse activity with achievement. To achieve, the IMF needs to refocus and deliver. Ultimately, the IMF's relevance will be determined not by how much it broadens its mandate but how well it carries out its existing one.