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# A Latin American View of IMF Governance

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In this chapter I consider the role of the IMF and its governance structure from the perspective of an emerging-market country. I first discuss the objectives and missions of the IMF because they are not isolated from the goals that the Fund should follow. I then discuss the IMF's governance structure and current functioning based on what it actually does. In this instance, I compare the global regulation of trade and financial flows.

I conclude that, in the case of emerging-market countries, there is no good substitute for sound liquidity policies achieved through mechanisms like foreign reserve accumulation or stabilization funds that are built up to deal with exposure to potential financial crises. Although the role of the IMF as a global provider of liquidity has been controversial, to say the least, there are sound economic reasons for having the IMF as an international coordinator that can help achieve more orderly and timely restructuring of unsustainable sovereign debts. Taking into account how the IMF actually operates, we should in the meantime advocate strong governance reform that would enhance the IMF's legitimacy and thus allow it to better serve the stability of the financial system.

The standard tools of the theory of welfare indicate that a multilateral financial institution like the IMF should ideally focus on the following:

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- solving relevant collective action problems (in other words, internalizing those externalities that go beyond the national level, such as providing international public goods or mitigating the impact of an action of one country that affects other countries in a way that is beyond the scope of existing markets), and
- addressing full disclosure of information when there is a problem of asymmetries.

An example of such intervention in the global economy is the setting of tariffs. Acting on its own, each country has an incentive to exploit its market power, but if all countries collectively agree to lower their tariffs, all countries will be better off.

I believe it is the responsibility of every country to develop its own set of countercyclical policies that would help it weather limited access to financial markets without causing a significant impact on domestic variables. Building a precautionary cushion of foreign reserves is particularly important for emerging-market countries, where there is a tighter connection among monetary, fiscal, and financial stability. In today's world, not only Asian countries accumulate foreign reserves: The development of a liquidity policy based on the accumulation of foreign reserves has been a priority in most emerging-market countries, including Russia, Brazil, Mexico, and Argentina after their financial crises.

I acknowledge that holding reserves individually is costly and that pooling resources would lead to lower opportunity costs and diversification of risks, but using the IMF as a global provider of liquidity has already proved to be problematic.

Recent developments clearly show that the costs associated with the IMF playing the role of global provider have outweighed any potential benefit. The process has generated perverse incentives (moral hazard, among others), and the IMF has not been technically, financially, or even politically capable of acting in that capacity.

The fact that a growing number of countries are relying on their own resources to reduce vulnerability definitely shows a lack of credibility in the IMF as a liquidity provider. Actually, it would be fair to argue that the programs of building reserves that are taking place in several countries have been stimulated by the lack of clear rules and transparency in IMF decisions regarding crisis management and prevention.

This view also applies to industrial countries. Despite the global imbalances and worldwide financial turbulence that may impose severe costs on the world economy (the volatility of the world's major exchange rates have a negative impact on activity), the central banks of the Group of 10 countries, through their bimonthly meetings at the Bank for International Settlements, are probably better prepared to coordinate these issues. For the reasons mentioned above, the IMF is not in a position to coordinate the

adjustments. As a result, a case can be made for liquidity to be provided directly by each of the central banks.

The IMF can definitely promote financial stability, which is a public good for the global economy, by helping to solve one collective action problem: the lack of enforceability of contracts with sovereigns in the case of a crisis. A movement toward the establishment of an international bankruptcy court could help to address the enforceability problem. Such a court would allow countries to smooth out the adjustment process and let all parties assume their proper costs. This role for the IMF, which might include the creation of a statutory mechanism that could help achieve more orderly and timely restructuring of unsustainable sovereign debts, would be an achievable one. A statutory approach would resolve the collective action problem of coordinating a diverse and broad creditor base through a framework that would aggregate claims across instruments and would anticipate a dispute resolution forum with limited powers for the orderly conduct of the restructuring process.

This feature would provide credibility and legitimacy to both the institution and the restructuring process. It would also serve as a deterrence mechanism for financial crises by providing the right incentives to both creditors and sovereigns.

This role would complement strong domestic liquidity policies. It would also be consistent with the IMF's limited resources and with the reluctance of some members of the IMF to provide liquidity for private creditors and imprudent borrowers.

On the issue of countries providing accurate information, the IMF is in the best position to enforce accurate disclosure through a comprehensive assessment of the impact of the IMF's publication policies. Other means include further comparative analyses of relevant data and periodic reporting of progress made on a relative basis regarding disclosure. The growth of private capital markets indicates that the Fund must adopt a deeper and more thorough approach now. Although much progress has been made during recent years, further reliable and standardized information needs to be available. Countries with relatively weaker institutions and weaker economic fundamentals will have an incentive to limit the disclosure of economic and financial information. Not being able to act upon those countries, other countries might find it convenient to disclose less information as well. At the end of the day, the overall disclosure will be less than optimal.

The Fund should continue to improve its current work in this area. Even though staff assessments should not be disclosed for prudential reasons, a specific step that could be taken is the routine publication of information gathered during Article IV consultations. Unfortunately, the most recent reports have gone beyond the technical disclosure of macroeconomic fundamentals into discretionary opinions on policy issues. This is not the way to address adequate disclosure.

## Governance Issues on Trade and Financial Regulation

For a discussion of how the IMF actually performs in terms of its functioning and its governance structure, it would be useful to consider how the institutions that regulate the two largest areas of world economic integration—the trade sphere and the financial and monetary sphere—compare. During the past few years because of globalization, technological change, and economic growth, financial and trade flows have multiplied; however, it is possible to identify important asymmetries in both spheres.

On the basis of my experience, I can discuss recent developments in the international trade area, an area that is deeply institutionalized. Rules are clear, and a single process for resolving disputes yields high consensus among members as well as a growing number of countries desiring to join the multilateral system.

The World Trade Organization (WTO) is the sole international institution responsible for the rules that govern the flow of trade among nations. A comprehensive set of agreements and treaties (negotiated and subscribed by most of the countries taking part in international trade) constitutes the core of the WTO. In addition, within the WTO is a mechanism to resolve disputes because contracts and agreements usually need to be interpreted. Many countries have taken advantage of this unbiased and global mechanism to resolve disputes. Finally, the WTO serves as an international forum in which to negotiate trade agreements that promote further liberalization, which is reached slowly but firmly on the basis of consensus.

Thus, international trade takes place under a transparent set of rules and regulations that every country must follow, and the framework includes an established mechanism for enforcing regulations and clearing up disputes. Under such a framework, individuals, companies, and governments operate confidently, knowing the rules and policies in place will remain stable.

In the financial and monetary sphere, however, no single institution is responsible for leveling the playing field. Neither clear rules nor established mechanisms exist to enforce agreements or resolve disputes. What is worse is the lack of consensus about the current system because the lack of consensus weakens incentives to contribute.

Despite the multiplicity of institutions and forums, no single entity is responsible for regulating financial policies, monetary policies, and exchange rate issues. At this time, the most important channels in terms of monetary and financial regulations are the Basel Committee for banking regulation and supervision, the WTO for financial services negotiations, and multilateral financial institutions such as the IMF and the World Bank.

At this point it would be useful to revisit some of the questions that arose at the time of the IMF's creation in light of today's current issues: What does the IMF coordinate? What does the IMF prevent? What does the IMF monitor?

## IMF Governance and Performance

The traditional assessment of the IMF's performance during crisis management and prevention has been based on evaluation of two features: effectiveness (the accomplishment of goals) and efficiency (cost minimization). During the past decade, because of the perceived failure in the management of several crises and the dire effects that those failures have had on the populations and economic institutions of the countries involved, the focus has shifted to the IMF's legitimacy.

In particular, some countries and regions have voiced their concern about unequal treatment: Countries with a special geopolitical weight have received disproportionately large support, irrespective of the nature of their crises (solvency versus liquidity) and the quality of the macroeconomic policies they had in place.

In the case of Argentina's 2001–02 crisis, the Fund arguably committed gross mistakes in surveillance and crisis management:

- In terms of surveillance, the IMF went from skeptical critic of the currency board system (CBS), launched in 1991, to main cheerleader; and it failed to spot the glaring fiscal inconsistencies that eventually determined the demise of the CBS.
- In terms of crisis management, when the collapse became a self-fulfilling event, the Fund made a half-hearted attempt at salvaging the CBS; it then backtracked and stood aside while the country spiraled down into full-fledged financial and economic crisis. Critics argue that the resources spent in the doomed effort to sustain the CBS should have been used for engineering an orderly exit from the CBS.
- In the context of a transition from the traditional scheme—with the IMF acting as lender of last resort—to a new cooperative solution with the involvement of multilaterals, the private sector, and the government, the policies set up by the IMF were not well defined.
- The IMF did not provide fresh funds to the country and also received net payments, which limited the possibilities for Argentina to minimize the costs of its public-debt restructuring process.

Part of the problem has been created by the IMF's outdated governance practices and structure. My fellow panelists discuss a broad spectrum of those issues, ranging from redistribution of shares and chairs in the Executive Board to the processes for selection of management and staff.

These are valuable contributions although there are several question marks regarding the working of incentives in an Executive Board that grants a larger representation—voice and voting—to emerging markets that have typically been recipients of aid contributed mostly by the countries that today dominate the board. This issue probably goes some way

toward explaining the perceived resistance of the recipient countries in reforming the structure of the board.

Nevertheless, there is an obvious representation problem. Emerging-market countries show an increasing share of world output, international trade, and financial flows. Countries like China, India, Brazil, and Mexico are among the largest economies in the world. In addition, IMF decisions affect millions of people in emerging-market countries that contain most of the world's population. A small group of industrial countries controls the decision-making process while an increasing number of emerging-market countries are still a minority in terms of voting.

From the point of view of the typical medium- or small-sized emerging-market country, whose representation at the Executive Board will not be much changed by the proposed rebalancing of chairs and shares, the main concerns are still effectiveness and efficiency: The effectiveness of the IMF's programs is often hampered by the high costs that its programs impose on recipient countries.

The IMF has shown its limitations in preventing, detecting, and managing financial crises. The problems that the Fund now faces have thus changed in terms of both their size and their nature. All recent crises have had much more effect on the financial markets compared with the traditional balance of payments type of crises.

Fund resources have declined significantly compared with financial flows and trade flows. The most evident proof of this is the size of the quota compared with the size of the foreign reserves held by member countries. In a sense, the IMF is now too small to deal with global issues, and its capacity to meet a growing demand for global financial stability has been severely limited.

Countries, including Argentina, that have had in place sound macroeconomic policies during recent years have followed a countercyclical policy of foreign reserve accumulation as a preventive mechanism to reduce vulnerability and ameliorate volatility caused by external shocks. Between 1993 and 2004, foreign reserves grew 200 percent worldwide. The ratio of the IMF quota to foreign reserves dropped from 17 percent in 1993 to 8 percent in 2004.

During recent years the IMF has expanded conditionality to cover issues that are beyond the scope of its goals and missions. Recently, in fact, the IMF has placed greater emphasis on promoting economic reform in several areas than on monitoring macroeconomic performance. This practice along with its limited financial resources relative to the flows overseen by the Fund has diminished IMF efficiency in meeting its primary objective.

## Concluding Remarks

The current state of the IMF's functioning and governance structure calls out for much to be done. First, we should advocate for enhanced repre-

sentation of emerging-market countries. This would increase the IMF's legitimacy vis-à-vis its member countries and would have a positive impact on effectiveness and efficiency.

After the IMF reestablishes its legitimacy through significant reforms, we will be in a position to provide it with a greater financial capacity. We should increase the quota of emerging-market countries but only under clear and nondiscretionary rules for the availability of these funds. In particular, established rules for disbursement that are based on explicit macroeconomic indicators that reflect the medium-term dynamics of the economy should be set forth in order to allow countries to have immediate access to their financial resources.

Going forward, it is important to determine whether these changes will be enough. An alternative path would be to split the functions of the IMF into two different institutions. One institution would have a role similar to the role of the WTO on trade: a global coordinator through which rules over monetary and financial issues are established and disputes resolved. The second institution would be similar to the actual IMF: an organization focused on financing the adjustment process and on preventing and managing crises. The extent of its operations would be defined by clear and transparent rules that would set forth the requirements for access to funding and would set up mechanisms to prevent and manage crises.

In this chapter I stress the need for emerging-market countries to consider developing a strong domestic liquidity policy given that the role of the IMF as a global provider of liquidity has proved to be problematic. The IMF can ideally play an important role in complementing these domestic policies by providing an established mechanism for coordinating the adjustment processes in countries under financial stress and by supplying further reliable and timely information. Because we are probably a few years away from this role for the Fund, it is necessary to discuss the improvement of its performance in its current mission. In the short run, we should advocate for a deep reform of governance, which would enhance representation of emerging-market countries. This would increase the IMF's legitimacy before its member countries and would have a positive impact on effectiveness and efficiency, thereby providing incentives for countries to actively participate and upgrade the financial capacity of the IMF.