INTRODUCTION

The world financial crisis of the late-1990s provoked a wide-ranging debate on the appropriate role of the International Monetary Fund (IMF) in member countries and in the global economic system. The IMF’s role in development has been central, either implicitly or explicitly. Financial crises are devastating for the poor, both in countries where a crisis originates and in countries hit by contagion effects. The IMF’s role in prevention and management of crises has thus become a serious development issue. Furthermore, over the years, the IMF has become a significant long-term lender to very poor countries—a departure from its original mandate—and this role has deepened with the transformation last year of its Enhanced Structural Adjustment Facility (ESAF) into the Poverty Reduction and Growth Facility (PRGF). In addition, the Fund has been centrally involved in the major initiative to relieve the debt of the poorest countries and target the proceeds to reduce poverty. The debate over the IMF’s role in development has only intensified with the departure of Michel Camdessus as Managing Director of the IMF and the selection of Horst Köhler as his successor.

To inform this debate, the Overseas Development Council (ODC) convened a Task Force of development experts to discuss what role the IMF should play in development and, where appropriate, make recommendations for changes in IMF functions. The impetus for this effort was a concern that the IMF’s role in developing countries was not being adequately reconsidered in light of new understanding of the institutional and policy complexity of achieving growth, development, and poverty reduction. The members of the Task Force were drawn from a wide variety of backgrounds, including academia, nongovernmental organizations (NGOs), and international financial institutions (see p.16 for the Task Force members). During discussions, the group focused on the IMF’s role in the poorest countries as well as its role in other countries and the international economic system.¹

This report and its recommendations reflect the discussions of the ODC Task Force. The report’s central argument is that the role of the Fund should be focused on three tasks: short-term liquidity lending to all countries hit by macroeconomic crises; advising through policy dialogue; and collecting information on countries with regard to macroeconomic policy and financial markets. The Fund should be the lead international financial institution analyzing macroeconomic issues and lending for stabilization efforts, and it should advise on macroeconomic policy environments for long-term development lending. But its provision of longer-term development finance and its involvement in deeper structural issues in economies—even in times of crisis—should end.

The report begins by discussing the evolution of IMF roles in the international economic system, par-
The IMF’s role at its creation in 1944 has long been overtaken by events. When the major currencies shifted to a floating exchange rate system in 1973, the IMF lost its original mandate of maintaining stable exchange rates. In 1978, when the IMF formally ratified the new system, its involvement with industrial countries became largely ceremonial. With commercial lending growing fast, the IMF’s clients became the poorest countries, to which no bank would lend, and those middle-income countries dealing with macroeconomic crises.

Long-Term Lending to the Poorest Countries

Fund involvement in the poorest countries initially tended to be of short duration during macroeconomic crises, and its programs focused on currency devaluations, budget cuts, higher taxes, and curbs on the supply of credit in the economy. However, after the Latin American debt crisis in 1982, the IMF began to broaden its policy agenda. This shift reflected the opinion of the Fund that these crises were not simply manifestations of temporary fiscal imbalance, but rather a reflection of a wide range of deeper problems that made it difficult to fix imbalances quickly. 2 “Stabilization” thus required “adjustment.”

This influenced the Fund’s activities in all its developing country clients, and the result was that the Fund stayed on longer in developing countries than it had in developed ones—often much longer. The vehicle for this deeper involvement was the IMF’s Structural Adjustment Faci-
Growth Facility (PRGF), a facility that for the first time makes reducing poverty one of the IMF’s explicitly stated goals. Specifically, the purpose of the new facility is “to support programs to strengthen substantially and in a sustainable manner [qualifying low-income members’] balance of payments position and to foster durable growth, leading to higher living standards and a reduction in poverty.” One of the key changes from ESAF is that the complementarity of macroeconomic, structural, and social policies will now be given greater recognition, and key measures of a country’s poverty reduction plan—such as land reform or eliminating obstacles to better health and education services—will be part of IMF programs.

This facility is available, as the ESAF was, to all qualifying poor countries, but it will be particularly important in the HIPCs, because it will continue to act as the trigger for debt relief.

Short-Term Lending

Although the Fund has been criticized for the expanded relationships it has developed with poor countries through ESAF and now the PRGF, it is its shorter-term crisis lending that has drawn the most attention in recent years. Beginning with the Mexican crisis in 1994, the IMF has become the organizer of massive rescue packages for countries experiencing crises that threaten the global economic system. The IMF’s actions in these crises, particularly in the Asian-Russian-Brazilian financial crisis of the late 1990s, were heavily criticized—both for not preventing it (or not sounding the alarm earlier) and for the initial austere policy prescriptions that were proposed. The effect of these crises—and indeed all macroeconomic crises—on poverty has been severe.

Therefore the question of whether the Fund could have done more to prevent the crises, or more to cushion the blow once they struck, is a profoundly important one for development policy.

THE BASIS FOR ANALYSIS: CURRENT UNDERSTANDING OF DEVELOPMENT

The Task Force examined both of these IMF roles: long-term development finance, and crisis prevention and management at the country and systemic levels. Its analysis was grounded in both the current realities for developing countries and, crucially, what is now known (and not known) about long-term sustainable growth and poverty reduction, and how international efforts can best promote these goals. In particular, the assessment rests on three analytical foundations.

First, much more is known about how to achieve macroeconomic stability than about how to achieve long-term sustainable growth and poverty reduction.

On the one hand, there is little debate about the need to avoid large budget deficits, prudently manage debt, carefully monitor large current account deficits, avoid overvalued exchange rates, shun heavy reliance on short-term borrowing, and have enough reserves or emergency credit lines available to cushion against adverse shocks.

How to achieve long-term growth and poverty reduction, on the other hand, is far more widely debated. Growth has been shown to depend on a wide variety of local factors, including the degree of initial inequality, ethnic fragmentation, and even geography. And discussions of poverty reduction have widened over the years from considerations of economic growth alone to those of education, health, institutional strength, social norms, and many other factors.

Beyond broad macroeconomic fundamentals, and the importance of education and health, there is little consensus on the correct policy mix for pursuing growth and poverty reduction.

Second, the IMF’s use of policy conditionality beyond strict macroeconomic policy, ranging into deep structural and institutional changes, has hindered the effectiveness of the institution. When the IMF lent to the crisis-hit East Asian countries in the late 1990s, the conditions on its loans struck deep into the structure of those economies, including such issues as labor laws and the ability of foreign investors to acquire local businesses. This far-reaching conditionality can have two strongly negative effects. The first is that it discourages countries from coming to the IMF until they have no choice, so that the situation may be far more serious and difficult than if the IMF had been called in earlier. The second effect is that foreign investors may assume that the problems are not short term in nature, but rather deeply structural, delaying the return of invest-
ment. This not only has further harmful effects on the economy (especially in the poorer countries that are less well known to investors), but as in the recent case of the Asian countries, it can simply be wrong. The bounce-back of most of the crisis-hit Asian countries has been remarkable, and it has had little to do with the implementation of structural reforms since the crisis.

Furthermore, the use of policy conditionality without real endorsement by the government turns out to be an ineffective instrument for policy reform. Complex structural changes take time, and the use of policy conditionality as an instrument of policy reform has been shown to be far more effective in the short term than in the medium to long term.

Much of this has to do with the domestic political process that should rightly be involved in mediating such structural changes. Issues such as labor flexibility are deeply political, and governments must be fully behind such reforms in order to adopt and sustain them. If a country government does not believe in (or “own,” in the current wording of choice) a policy reform required by a loan, or if domestic political conditions are such that the reform is difficult to implement, the chances are overwhelming that the reform will not be sustained. This is why conditionality has, far more often than not, proven to be an ineffective way of influencing policy in the medium to long term.

When crises are caused by policy errors on the part of the government, it is reasonable that lending institutions should condition their loans on a restricted set of macroeconomic changes tightly focused on making repayment probable. Because many such policies can be altered quickly, stability can be restored. Outside of macroeconomic policy, however, and certainly in times of stability, conditionality should be used only as a tool for the country government to impose restrictions on itself, for example to reduce the temptation for inflationary spending. Outside these situations in which the government firmly supports the conditions, conditionality has not been effective in promoting structural and institutional reform. Moreover, the rapidly increasing number of conditions has been intrusive and burdensome, especially to poor countries with already limited institutional capacity.

The third analytical underpinning for the Task Force’s recommendations is that developing countries continue to need substantial inflows of capital. Private flows to developing countries reached $227 billion in 1998 and now far exceed aid flows in some countries. In fact, private flows now account for almost 90 percent of total resource flows to developing countries. But these figures are highly misleading. In 1997, before the financial crisis, 15 countries received 83 percent of the private flows to developing countries. That left about 140 developing countries (with about 1.7 billion people) sharing the remainder. The 61 low-income countries, as classified by the World Bank, were largely untouched by these flows. Whatever changes are proposed to the IMF’s activities in developing countries, there can be no doubt that these countries will continue to need financing. Therefore the financing available to these countries must be maintained (if not increased). The question is on what terms this financing should be available, for what purposes, and—one of the subjects of this report—which institutions should provide it?

THE IMF AND LONGER-TERM LENDING
The Poorest Countries

As discussed above, the IMF’s involvement in the poorest countries is primarily through two facilities: the new PRGF and the enhanced HIPC Initiative.

Both these instruments reflect a clear advance in understanding how international efforts to assist poverty reduction should be guided and in translating that understanding into policy. Both instruments are to be guided by a Poverty Reduction Strategy Paper (PRSP) prepared by the country government in close consultation with the IMF and World Bank and the country’s civil society and private sector. The PRSP is meant to combine a broad economic framework with the policy and institutional underpinning of growth (including institutional reforms and sectoral strategies). It is to be the framework for Bank and Fund activities in the country, with the country’s own targets and goals serving as the targets and goals the Bank and Fund monitor. This is certainly in line with the new understanding of the importance of “ownership” in policy making.

However, the potential gains from these two initiatives have been substantially oversold. If anything has
been learned over the past 50 years about development, it is that poverty reduction takes time. It certainly takes longer than the three years allotted to one PRGF program. Ownership will help the sustainability of policy reforms, but ownership is not easily achieved. For example, given past dynamics between the Bank and Fund and the poorest countries, there is a concern that the Bank and Fund will heavily influence the PRSPs toward their own policy preferences. In some ways, they will do so even if they do not try, because countries will generally know the kinds of policies the Bank and Fund are likely to support financially. Even if this dynamic were to be overcome somehow, the question of who owns the document within a country will be largely political. For example, the process of consulting with civil society and the private sector is enormously complicated—who is a legitimate “representative” of either? And even if the country were indeed to produce a document widely owned, many developing countries lack the institutions to carry out their plans.

Thus, although the effort to ensure ownership is the correct approach in terms of development effectiveness, the design of the PRGF and the long-term nature of development ensure that the IMF will be involved in long-term development finance for decades. This is not appropriate for two reasons, one having to do with competency and the other with process.

First, the Fund’s core competency is in macroeconomic policy, in which it is uniquely qualified among international institutions. This gives it a unique role in the international system, including in poor countries: to advise countries on how to avoid macroeconomic crisis and to restore stability in the midst of such crises. It is often difficult to distinguish between periods of “stabilization” and “post-stabilization.” But a clearer distinction must be made between countries in crisis and countries that are simply poor. Because of its expertise on issues of macroeconomic policy, the IMF can provide valuable financial resources and advice in the event of crises due to terms of trade shocks, natural disasters, poor policy choices, or other causes. However, because the Fund does not have the wide expertise needed to advise on policies of long-term growth outside of macroeconomic ones, it should not be involved financially in countries for long periods of time, even if there are structural problems in the economy. Stability is an essential condition for growth. But, as discussed above, development is a process based on an intricate interweaving of factors, of which the macroeconomy is an important single factor.

Second, as discussed above, the IMF’s negotiation of policy reforms in exchange for financing is a method that is far more effective in the short term than in the longer term. As time goes by, the preferences of country governments will almost always prevail. Indeed, such policy changes are often appropriate from a development standpoint, as conditions imposed during stabilization—such as fiscal deficit reduction—are often not appropriate to post-stabilization environments.17

The IMF should focus on its core competencies, with regard to both substance and process. Instead of long-term lending, the institution’s proper role in development should be surveillance and policy discussions not based upon financial arrangements, and, in times of crisis, short-term, stand-by financial arrangements tied to focused policy conditions.

However, this does not mean that the money the IMF uses for long-term financing should simply go back to member countries. As discussed above, developing countries continue to need resource inflows, and simply abolishing the PRGF, which has averaged about a billion dollars a year in disbursements, would be damaging to the poorest countries. Because of the PRGF’s mandate on poverty reduction and growth, it should be managed by the World Bank, with the IMF advising on and monitoring the macroeconomic component of the country’s poverty reduction plan.

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component, and the institution with capacity in almost all other factors—the World Bank—should oversee the facility.

Putting the World Bank in charge of the PRGF would have a number of practical implications. It would, for example, mean moving the ESAF/PRGF Trust Fund from the Fund to the Bank. This should be done in its entirety, meaning that all assets and liabilities of the Trust Fund, including expected reflows, would be transferred to the Bank. This would mean the Trust Fund would not receive annual income from the IMF’s Special Disbursement Account (as it does now), but this is preferable to eliminating the Trust Fund altogether, or to leaving the Trust Fund in the IMF.18

In addition, moving the PRGF to the Bank would mean that the primary instrument through which the IMF could lend to the poorest countries would be its stand-by arrangements, which provide short-term balance of payments assistance typically for 12 to 18 months. These loans are made on nonconcessional terms, which means that the poorest countries would not be able to afford them. For this reason, the interest rate to these countries should be subsidized for the term of the loan. One source of this subsidy could be the money from the IMF’s Special Disbursement Account that is currently transferred into the ESAF/PRGF Trust Fund. Arrangements should also be made to encourage timely repayment and avoid the Fund becoming involved in long-term rollover of debt to these countries. This might be done by raising the interest rate to a nonsubsidized rate if the loan is not repaid on time.

Finally, because the PRGF is the trigger for debt relief through the enhanced HIPC Initiative, moving the PRGF to the World Bank would mean that a Bank program served this purpose rather than a Fund program. Because this Initiative has tied debt relief to poverty reduction, the Task Force believes this shift to be appropriate. The Bank is positioned to evaluate countries’ poverty reduction plans and monitor implementation of debt relief plans to make sure the resources are used efficiently. Furthermore, as the Bank will be the main institution lending to these countries, it will have more leverage in making sure the reflows that remain due after HIPC are in fact paid.

Debt relief should move as quickly as possible, contingent only on sound macroeconomic policy and a poverty reduction plan. Donors should also consider lowering the requirement for debt relief to only one PRGF program, in the interests of expediting the relief. After relief is given, much more restraint should be exercised in making new loans to countries whose macroeconomic policies indicate that repayment may be a problem. Obviously the Fund’s expertise on the viability of macroeconomic policies in developing countries would be crucial in this area.

Middle-Income Countries

The Task Force believes that middle-income countries should be eligible, like all countries, to borrow from the Fund in times of macroeconomic crisis. And, like all countries, they should not be able to borrow from the Fund for extended periods of time. This means that the Fund’s Extended Fund Facility (EFF) should be terminated. The EFF supports medium-term programs that generally run three years and aims to overcome balance of payments difficulties stemming from macroeconomic and structural problems. By design, then, the EFF (and indeed any facility which lasts that long) inherently involves the Fund in structural issues in which it has little competence. The Fund can play a useful role in all countries through policy dialogue and technical assistance, but it does not need to lend money over the longer term to perform these tasks.

THE FUND’S WORK IN PREVENTING AND MANAGING FINANCIAL CRISES

Country Crises

Prevention of Country Crises. In the preceding section, this report has advocated that the Fund’s instruments of crisis prevention not include long-term lending. However, the Fund’s role in technical assistance and "surveillance" of a country’s policies remains very important. The Fund’s mandate to consult with each of its member countries enables it to monitor developments in the world economy and provide useful macroeconomic advice and training to almost every country in the world. If it were not to perform surveillance, its picture of the
world would be limited, and fewer countries would benefit from the knowledge of its staff.

It can be argued that the Fund’s policy advice will be less influential if it is not backed by long-term lending. But in many ways, breaking the link between advice and finance may improve the nature of interaction between countries and the IMF. Article IV consultations, the primary vehicle for the surveillance performed by the Fund, were originally intended to monitor exchange rate policies of countries, but they have now widened to a much broader macroeconomic agenda, including fiscal and financial policies. In addition, the IMF has now been asked by the international community to monitor adherence to the international “standards” that have been drawn up by many international institutions in response to recent financial crises. These standards include accounting, auditing, bankruptcy laws, and corporate governance.

This surveillance enables the IMF to have a clear picture of what is going on in a country in times of crisis, which is necessary if the IMF is to act quickly. And it is beneficial for the international community to have a “storehouse” of macroeconomic information regarding every country in the world.

However, the fact that this surveillance has been linked to longer-term lending has created an atmosphere that benefits neither the IMF nor the borrowing country. The counter-argument is that IMF conditionalities on policy reform—and the lending that accompanies them—“tip the scales” in a country’s internal political debates in favor of reformers. But such reformers will be strengthened by the fact that developing countries will need to adopt many of the policies the Fund advocates if they desire the inflow of private capital (which every developing country desires) and, often, World Bank lending.

To further encourage policy reform, the Task Force also recommends policy reviews by “peer” countries, such as occurs in the Organization for Economic Cooperation and Development (OECD). The IMF Board could divide itself into “sub-boards” of regional neighbors to review Article IV consultations and adherence to international standards. These sub-boards could consist of both Executive Directors and Alternate Executive Directors, to broaden the membership in the smaller groupings of countries, and they would report periodically to the entire Board. This would not only have the beneficial impact of lightening the workload of Board members, who now review all consultations, but it would also enable closer review of the country’s particular situation and policy options. It would also bring the force of “peer pressure” behind policy recommendations.

In addition, steps must be taken to monitor the detailed implementation of international standards. The IMF has itself said that “the degree of expertise required for surveillance of international standards, particularly in areas outside the Fund’s direct operational focus, is markedly less than that required to prepare independent assessments of economies’ observance of particular standards.” As the IMF does not have the expertise to perform this latter, more detailed task—and it is the firm opinion of the Task Force that it should not attempt to attain it—the question remains as to what extent the IMF should be responsible for monitoring adherence to these particular standards? One alternative is to encourage reviews that use the expertise of organizations that have designed the standards in the first place, such as the International Accounting Standards Committee, the International Federation of Accountants, the United Nations Commission on International Trade Law, and the Bank for International Settlements.

[T]he fact that this surveillance has been linked to longer-term lending has created an atmosphere that benefits neither the IMF nor the borrowing country.
Management of country crises. When a crisis does hit, in any country, the Fund should use its normal standby arrangements. Much has been learned about how the conditions in these short-term arrangements should be structured. They should not resemble the incredibly detailed loans given to the East Asian countries during their financial crisis. These included between 50 and 80 conditions (compared to less than a dozen on typical Fund programs 20 years ago) on, for example, breaking up the garlic monopoly in Indonesia. Even if all of the structural conditions on the loans were to be met at some point, this has not happened and will not happen soon. Yet East Asia has rebounded. Only months before the crisis, international institutions including the IMF were lauding the same countries for their sound “fundamentals.” Policy reform conditions placed on short-term crisis loans did not have to go so deep to achieve stabilization.

Much has been learned about how the conditions in these short-term arrangements should be structured. They should not resemble the incredibly detailed loans given to the East Asian countries during their financial crisis. The Fund can also improve the process by which it derives its recommendations on macroeconomic policy. For example, the external review of ESAF argued that ex ante impact assessments of IMF programs were vital to reducing their negative impacts on the poor. The review showed that during policy reform there are likely to be poor people permanently affected by the changes and that, for any given country, it should be fairly straightforward to tell in advance who these groups will be. Yet the IMF has not done these assessments in the past, nor have measures to protect these groups been put in place. The reason has to do with methodology and, again, core competency. Understanding the distributional impact of reform requires prior analysis of the incidence and causes of poverty and assessing the likely effects of, for example, price changes and changes in government expenditure on public services. This type of analysis in turn requires the use of a variety of country data sources, including household survey data on income or expenditures. These are areas of analysis that have been the domain of the World Bank and in which Fund staff have little competence. The Bank, on the other hand, has a microeconomic focus and broad expertise in the analysis of household- and firm-level data. The external ESAF review recommended that—before the program began—the Bank should estimate how various subsets of the poor will be impacted. The idea is that safety nets can then be targeted on those groups that will be hurt. While stabilization takes place, the incomes of these groups can be monitored, so that the policies can be adjusted if outcomes are not as predicted.

The Bank and Fund are currently testing this approach in a PRGF pilot phase, and the lessons learned should be applied to crisis lending. This sort of ex ante impact assessment is obviously much more difficult in the context of a crisis. However, by attempting it, the right questions with regard to policy options would be asked, and a heterodox and interactive approach to policy options would be encouraged. Furthermore, this process would likely help to separate the policy conditions necessary for loan repayment from those more structural in nature. The IMF’s conditions should be restricted to the former: those policy reforms without which there would be a significant probability the country would be unable to repay the loan on time.

This framework for collaboration between the Fund and Bank parallels the approach to the PRGF discussed above. The focus of the PRGF is poverty reduction and growth, in which the Bank has far more expertise than the Fund. However, because policy choices can negatively impact the macroeconomic environment in a country, the Bank should seek the Fund’s help in analyzing these impacts and preparing the program in a way that offsets them. Similarly, in a stabilization program, the focus is stabilization, and the Fund has the expertise and so should be in charge. However, we know that stabilization policies can negatively impact some poor groups, and so the Fund should seek the Bank’s help analyzing these impacts and preparing the program in a way that offsets them.

Systemic Crises

Prevention of systemic crises. It is highly unlikely that crises can be prevented from occurring in the future. The current official efforts to strengthen the “international financial architecture” should help, but they will be inadequate. An example is the push for more data availability.

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and transparency. The argument is that by providing investors better information, markets will work more efficiently. Yet the value of information lies in how it is interpreted. Many of the structural “flaws” of East Asia—including its “crony capitalism”—were plain to anyone who did business there. Yet the incentive to invest was such that no one paid attention. Similarly, today, China receives far more foreign direct investment than any other developing country, yet it would be difficult to characterize China as “transparent.” It is not even a member of the Fund’s Special Data Dissemination Standard, the core of the Fund’s work on data and transparency. Markets are guided by many factors—even “irrational exuberance”—and improving their access to information is unlikely to have more than a marginal effect. The true value of surveillance and data collection—and the reason they should be maintained—is that they enable the Fund to make better policy recommendations and, more importantly, to understand the situation in a country when a crisis occurs. But they will not prevent all crises.

The Task Force is similarly skeptical about reliance on an IMF-financed Contingency Credit Line (CCL) and any of its “pre-conditioned” relatives, at least as presently conceived. The success of Argentina and Mexico in obtaining emergency credit lines from the private sector show that the concept is workable, but problems arise with the IMF’s involvement because of the Fund’s important signaling function. There would presumably be a public list of countries who qualified for this type of program, and once a country was on it, the IMF would only be able to take it off the list at the risk of sparking a crisis in the country, due to investor fears. In fact, many countries will not apply for the CCL now, for fear that it will either look like they need such a facility (and therefore something is wrong) or fear that at some point they will be taken off the list. Membership in the program is therefore neither helpful to the country, nor a meaningful signal to investors.

Lacking failsafe mechanisms to prevent systemic crises, the IMF can more usefully provide sound policy advice to all countries. This sounds obvious, but a balanced and open approach to policy recommendations would likely be more stabilizing than any other instrument. The past few years have taught the IMF a number of lessons that should be heeded. These include:

- Developing countries need capital, yet there are some forms of capital—in particular short-term—for which the benefits of inflow are often outweighed by the dangers of outflow. For these types of capital, countries should not be discouraged from instituting controls on inflow, perhaps similar to those used by Chile. Countries should understand that such controls are unlikely to be completely effective and can be wasteful, particularly in the absence of good macroeconomic policies. However, the Fund should be open to their use.

- It is currently fashionable to claim that exchange rate regimes will be unsustainable if they are somewhere between purely fixed and purely floating, and it is certainly true that intermediate regimes have had a bad recent history. The Task Force would, however, like to add a note of caution: policy recommendations on exchange rate regimes are notoriously faddish. Whereas the IMF’s initial advice to transition economies not too long ago was to fix, now the institution’s mantra is to float. The proper exchange rate regime will vary by a particular country’s circumstances, and the IMF should remain open to the possibility of intermediate regimes. If nothing else, it should temper its push for floating regimes.

- Financial sector liberalization should be approached with caution. As Larry Summers once said, banking is like nuclear power plants: “free entry is not sensible.” There is no research consensus whatsoever that financial liberalization has net benefits for development. In fact, the ESAF external review indicated that premature financial liberalization was a cause of significant decline in income in some countries. Just as significantly, the IMF has no comparative advantage in guiding financial sector liberalization. Its recent collaboration with the World Bank, in the form of the Financial Sector Liaison Committee, masks the fact that neither of the institutions has a core competency in banking regulation or supervision. One critical issue for policymakers is how to build international capacity in this crucial area. An idea worth exploring is to build up (modestly) the staff of the Bank for International Settlements, so that they may accompany Fund surveillance missions to countries and advise the World Bank on long-term lending programs.
In macroeconomic policy discussions, there should be a more explicit acknowledgment of the potential tradeoff between economic stability and growth. Many policy choices will tilt a country in one direction or the other, and the IMF’s macroeconomic policy advice should make this choice explicit. Every country will make its own decision, but awareness of these various policy choices may enable the country and the Fund to be more prepared in the event of a crisis.

Management of systemic crises. Systemic crises are likely to occur despite these recommendations. When they do, the Fund’s stand-by resources will need to be augmented by other sources of finance and assistance. For example, in addition to the countries in which the crisis originates, attention must also be paid to those countries that suffer indirectly through such factors as less demand for their exports or even a general chilling effect on investment in developing countries. These were problems for many African and Latin American countries as a result of the Asian crisis. The Fund’s Compensatory Financing Facility fills a useful role in this vein, by providing compensatory financing to countries experiencing temporary export shortfalls or increases in cereal import costs. It should be maintained.

IMPLICATIONS OF THE RECOMMENDATIONS

The Task Force’s recommendations would have implications for both the governance of the IMF and its relationship with the World Bank.

The Fund’s Governance by Its Member Governments

The IMF’s governance by member governments is manifested in various ways, none of which impart much “ownership” of the Fund’s activities to the large majority of its client countries. The Task Force believes this is an important issue for development for reasons of both legitimacy and effectiveness. In the IMF’s early decades, when countries such as Italy and the United Kingdom had arrangements with it, many of its likely customers had considerable voice in its decision-making. This is not the case now, as developing countries alone form the Fund’s clientele. Even under the changes proposed in this report, the Fund would continue to operate the majority of the time in developing countries, which are more likely than developed countries to experience a crisis. Yet developing countries have little say over the management of the Fund.

This lack of representation gives the impression that the IMF is dominated by the richest countries. Given that successful policy reform depends crucially on national commitment to the reform program, this impression [that the IMF is dominated by the richest countries] is harmful to the effectiveness of country-Fund relations.

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only “owned” by one of its member governments: the United States, which has 17.5 percent of the vote.\(^\text{28}\)

More work must be done on designing an appropriate voting scheme. In addition, the Task Force believes that the Fund’s legitimacy will be enhanced if the supermajority is set below the voting share of its Board’s largest shareholder. Experience in the Inter-American Development Bank and the World Bank, where this type of arrangement is in place, shows that such a scheme is viable and need not damage U.S. interests.

In addition to the Board structure, representation is compromised by the fact that Board members themselves are simply overwhelmed with information on the large numbers of country programs, making it difficult for them to focus on any one country.\(^\text{29}\)

This problem could be eased by creating “sub-boards” as discussed above, to review regional neighbors. Participation and ownership could also be increased by having at least one representative of the country present at Board meetings at which the country’s program is discussed. Having a country representative present will enable the Board to ask questions about the country, and it will enable the country to monitor the discussion.

However, changing the structure and operations of the Board is unlikely to have immediate effects on Fund policies, which are largely guided by G7 finance ministries in direct consultations with Fund management, not through the Board. This bypassing of the formal decision-making structure further undermines the institution’s perceived legitimacy. For example, the influence of the United States and Europe and the problems caused by it have been reflected in the difficulty of choosing a new Managing Director for the IMF. The United States and its European partners have once again participated in an outdated “gentleman’s agreement” regarding who will get the job and have received much international criticism because of it. The legitimacy and hence effectiveness of the IMF as an institution can only suffer as a result of this type of process. The process for choosing a Managing Director should be changed to one more neutral and transparent.

The process for choosing a Managing Director should be changed to one more neutral and transparent. . . .

Given the effects that the IMF’s policies have on citizens through reforms, the Task Force believes that the Fund’s consultations should be more broad based.

The Fund’s activities should also be subject to more external evaluation than presently. Already noted above is the Task Force’s belief that the IMF should conduct \textit{ex ante} impact evaluations of its work. In addition, a tightly focused, independent, external evaluation unit should be established to conduct its own \textit{ex post} impact evaluations and assess the Fund’s work and the predictions it made regarding program impacts. The Task Force understands that crisis circumstances are volatile and that therefore \textit{ex ante} evaluations will often contain predictions that do not come to fruition. But an external evaluation unit would be invaluable not only in assessing where errors were made regarding the impact of Fund policies in individual countries, but also identifying where \textit{systematic} errors occur in Fund predictions. The Fund’s external evaluations are now done on an \textit{ad hoc} basis, and while these have been valuable, there have been too few. In the original design, there were to have been two to three per year. At present, only three reports have been done in four years.

A small evaluation unit should be set up on a trial basis and report to the International Monetary and Financial Committee (IMFC).\(^\text{30}\) The IMFC should be responsible...
for designating the subjects of evaluation by the unit, although the unit should be able to recommend subjects to the IMFC. Citizens of member countries should be able to suggest evaluation topics both to their representatives on the IMFC and to the evaluation unit itself. When the unit does not contain the expertise to perform a study, it should hire outside experts as has been done in the three recent external evaluations, all of which have been of high quality.

The Fund’s Relationship with the World Bank

The recommendations in this paper would have great impact on the Fund’s relationship with other international institutions, most importantly the World Bank. Cooperation between the Fund and Bank is notoriously difficult. The Task Force admits that it has not proposed anything that is likely to facilitate that cooperation. But by focusing the institutions on their core competencies, it is hoped that the results of cooperation will improve. A serious question remains about how better cooperation between the institutions’ staff can be encouraged.

This is a report on the IMF—therefore it does not deal with the operations of other institutions. However, because the Task Force is recommending a major shift of resources to the World Bank, it must be said that this is based on an appreciation for the mission of the World Bank and not necessarily the way it is currently operating. Much work has been done regarding how the Bank’s financing to developing countries could be better structured and targeted for more effectiveness and ownership. Although the Bank is proceeding to incorporate these lessons, it has much work to do, as evidenced by its Operations Evaluations Department’s most recent Annual Review of Development Effectiveness.

Finally, with regard to institutional cooperation, there is the issue of institutional overlap. It is true that public resources are scarce and that institutional overlap in some cases can be detrimental and wasteful. However, some “redundancy” of effort can be worth the cost. In cases when there is uncertainty as to the outcome of actions, when failure is costly, and when there are reasonable odds another institution may provide a useful alternative, redundancy is desirable. In development, where the cost of failure is high and a lack of consensus exists on many issues, redundancy of effort is worth the cost in some cases. In this environment, diversity of ideas should be valued, not discouraged. This should of course be balanced with institutional capacity—this is why the IMF, for example, should not “compete” with the World Bank for the PRGF—but it means, for instance, that there is no inherent problem in the Fund and Bank disagreeing openly about some policy choices.

The collection of statistics is another example. The IMF and the World Bank both collect their own statistics, which are necessary to track development progress worldwide. Their methods differ, and so while they often come up with similar figures, they also sometimes have different results. Given the interpretive nature of data, this is valuable. However, the Task Force believes that while it is valuable to have differing sources of statistics, it is not appropriate that statistics operations be institutionally linked to lending programs. The Task Force is not accusing the IMF or the World Bank of dishonest reporting; rather, it is simply highlighting the possibility of conflict within each institution between showing the results of programs and reporting accurate information. Such conflict would not exist if statistics operations were housed in separate statistical agency. Currently, area departments in the IMF already use their own data to make projections, and the statistics department uses different formulations to produce documents such as International Financial Statistics. This statistics department should become an independent agency. An analogy can be made to the operation of the U.S. government, in which the executive branch uses its own data to produce its budget, and the
Congressional Budget Office serves as an independent assessing agency.

SUMMARY OF RECOMMENDATIONS

The IMF’s role has changed substantially from when the institution was created, and many of its activities now—including long-term development finance and crisis prevention and management—have important impacts on development and poverty reduction. This report makes recommendations for changes to the IMF’s role in development, based on current understanding of the institutional and policy complexities of achieving growth, development, and poverty reduction.

The proper role of the IMF in development is not long-term lending. The IMF is uniquely qualified in macroeconomic analysis, but it does not have expertise on poverty reduction, which is the major focus of long-term development finance. And while the IMF’s use of conditionality is effective in short-term stabilization situations, it tends not to be effective over the medium to long term. Its vehicle for long-term financing for development, the Poverty Reduction and Growth Facility (PRGF), should therefore be moved to the World Bank—the international financial institution with expertise in development. The Fund should play the lead role in analyzing the macroeconomic components of these programs, while the Bank should play the lead role in the many other aspects of poverty reduction and growth.

As the goal of the PRGF is poverty reduction and growth, switching it to the Bank would be more in line with the functional responsibilities of the Bank and Fund. The IMF’s financial capabilities would be focused exclusively on short-term macroeconomic crises, in the form of its established stand-by arrangements (the Extended Fund Facility should be terminated), and the World Bank would provide longer-term development finance. In addition, moving the PRGF would mean that a Bank program would be the trigger for debt relief through the enhanced HIPC Initiative. This is appropriate, since the relief is to be used for poverty reduction.

The IMF’s important surveillance and policy advice during times of stability would therefore not be backed up by long-term lending. The Task Force believes this should improve the transparency of relations between the IMF and client countries. At present, when a country signs on to an IMF loan, it appears to be accepting the policy conditions only on account of the money it will receive from the IMF and the World Bank (which does not lend for adjustment to countries without the IMF’s approval of the macroeconomic environment). If the IMF’s advice were not tied to lending, a country’s policy reforms would be more credible to external investors. The IMF’s advice should still play a significant role in determining World Bank lending, but it should not have a veto, as that would essentially maintain the current state of affairs.

In addition to the Fund’s continued consultations with all countries, there should be more use made of “peer reviews” to monitor country policies and adherence to the “standards” that international organizations have drawn up in response to the recent financial crisis. These reviews might be operationalized by the use of “sub-boards” of regional neighbors within the IMF’s Executive Board. These smaller groups could better focus on individual countries and bring the weight of “peer pressure” behind their recommendations. However, these reviews and the efforts of IMF staff will likely be inadequate to monitor detailed adherence to particular international standards, as the IMF lacks expertise in many of these areas. Such adherence could be monitored by reviews that tap the expertise of the appropriate international institutions (such as the Bank for International Settlements).

When any country experiences a macroeconomic crisis, the IMF’s regular stand-by arrangements should be available, but the rate of interest should be subsidized for the poorest countries. The loans should be conditional on a restricted set of policy reforms focused exclusively on those changes necessary to ensure timely repayment of the loan. Deeper structural issues should not be a part of these conditions. Furthermore, the process by which those conditions are derived should be augmented by ex ante policy impact assessments performed by the IMF in cooperation with the World Bank.

Preventing country crises from becoming systemic crises has been the focus of much of the efforts to improve the “international financial architecture,” but the impact of the changes made so far will be marginal. The most effective way the IMF can help avoid systemic crises is to provide sound policy advice to all its member countries. Given the experience of recent years, those lessons include: an open, yet cautious approach to controls on inflow of short-term capital; an understanding that exchange rate policy is faddish and that the proper exchange rate arrangement will vary by a country’s circumstances; that financial sector liberalization should be approached with caution; and that there are sometimes tradeoffs between policies that favor economic stability
and growth, and countries should be aware of these tradeoffs and make their own choices.

When systemic crises do occur, the IMF’s stand-by resources will need to be augmented by other finance and assistance. For example, the Fund’s Compensatory Financing Facility can play a useful role in helping countries handle export shortfalls as a result of decreasing demand during such crises. This facility should be maintained.

The Fund’s continuing important role in developing countries necessitates changes to its governance structure. In its early decades, many of the IMF’s potential clients had a large voice in the institution’s decisions. Today, the IMF’s main clients have little influence over the institution. This lack of representation is harmful to the IMF’s effectiveness, as client countries see the Fund as dominated by rich countries and do not regard it as impartial. While this is not the only reason that Fund programs have been less than successful in many developing countries (certainly poor governance has played a major role), it does play a role in whether or not governments are likely to buy into proposed policy reforms. The Fund’s Board should be realigned both to better reflect current economic realities and to give more representation to the poorest countries, which are as likely as any to experience macroeconomic crises. Furthermore, in pursuit of a more broadly “owned” institution, no country should have a veto in the institution.

In pursuing more effective crisis prevention and management, changes should also be made to the channels through which the IMF interacts with member countries, and to the way the Fund’s programs are evaluated. Given the effects that IMF policies have on citizens through reforms, the Task Force believes that the Fund’s consultations in countries should be more broad based. In addition, a small external evaluation unit should be established, reporting to and receiving direction from the International Monetary and Financial Committee.

These recommendations would have large consequences for the Fund’s relationship with other international organizations, particularly the World Bank. Efforts should be made to improve cooperation between Bank and Fund staff, and the Bank must continue to reform itself to make more effective use of the resources allotted to it. In the areas in which the Bank and Fund work together, their efforts should be based on the understanding that in development, where there is a lack of consensus on many issues, diversity of ideas is important. This makes effective dialogue and cooperation even more critical.

Implementation of these changes would lead to a more focused and effective IMF role in development.

### Notes

1. By “poorest countries,” this report means those eligible for concessional lending from the International Development Association of the World Bank. This typically means a GNP/capita below $895 per year.

2. Such problems included lack of tax collection, tariff and other import barriers that effectively taxed exports, and a lack of competition in the banking sector.


16 See, for example, Tony Killick with Rumani Gunatilaka and Ann Marr, Aid and the Political Economy of Policy Change (London: Overseas Development Institute, 1998).


18 In the year to April 30, 1999, transfers from the IMF’s Special Disbursement Account to the ESAF Trust totaled 250 million Special Drawing Rights (SDRs).


20 International Monetary Fund, “Experimental IMF Reports on Observance of Standards and Codes” (Washington, DC: International Monetary Fund, 1999).


24 In an ODC Viewpoint in January 1999, entitled “Shock-Resistant Growth?” Joan M. Nelson argued that safety nets were in fact an integral part of growth strategy—i.e., they should be designed and instituted in times of stability, to ensure that they are in place in times of unpredictable crises.


26 See, for example, the proposals of the U.S. Congress’s International Financial Institution Advisory Commission.

27 Quoted in The Economist (September 20, 1997).

28 Such votes include change in quotas, allocation and cancellation of SDRs, and amendments to the Articles of Agreements.


30 The IMFC, formerly known as the Interim Committee, is made up of Finance Ministers (or someone of comparable rank) from the 24 countries that appoint a member of the Executive Board. These countries include Algeria, Argentina, Australia, Belgium, Brazil, Canada, China, Denmark, France, Gabon, Germany, India, Italy, Japan, Mexico, Netherlands, Russia, Saudi Arabia, South Africa, Switzerland, Thailand, United Arab Emirates, United Kingdom, and United States.


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ODC is an international policy research institute based in Washington, DC, that seeks to improve decision making on multilateral cooperation to promote more effective development and the better management of related global problems. Its program focuses on the interrelationship of globalization and development, and improved multilateral responses to these linked challenges. ODC’s Chairman is Peter D. Sutherland, and its President is John W. Sewell.