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Is the IMF business model still valid?

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This paper reviews the current business model of the International Monetary Fund and proposes changes to sustain its viability and improve its capacity to tackle future crises. Based on recent developments and on the demands of the IMF's prospective clients, it argues for an independent surveillance process, a redistribution of power and chairs on the Board, establishment of an automatic insurance facility and a substantial increase in the capital base of the IMF.

Thinking ahead for Europe

Introduction

Since the Asian crisis, the IMF has undergone a deep process of soul searching, trying to extract lessons from the experience. External criticism has been abundant, and basically all three of the IMF's main areas of work – surveillance, crisis prevention and resolution, and poverty reduction – have been called into question. Several years later, there is a feeling that not much has been achieved, and key questions remain unanswered. As the world business cycle matures, and thus the likelihood of further crises slowly increases, it is critical for the stability of the world financial system to discuss what the IMF's business model should look like.

The IMF has three core competences, representing a mixture of consulting company, central bank and NGO: pro-bono surveillance and technical assistance work; conditional lending at penalty rates to resolve external financing shortfalls; and conditional lending at concessional rates to alleviate poverty. The world economy has changed in some fundamental ways, and with it the needs of the IMF prospective clients. The IMF business model must be adapted to the new circumstances or the institution risks becoming largely irrelevant and losing its clients. Thus, a comprehensive rethinking of the IMF's business model is a priority. In addition, an agreement on the optimal business model of the IMF is a fundamental input for a comprehensive review of the governance and the financial viability of the IMF. If, as we argue below, some of these business areas are at risk of losing its customer base, then the financing structure of the IMF has to be reconsidered. In what follows, we review the outlook for the three core business areas of the IMF and discuss its implications for governance and financing.

Surveillance

What is the value of IMF surveillance? Traditionally, IMF reports were highly valuable because of the sophisticated analysis, its privileged access to generally unavailable data and also its privileged discussions with the authorities. Nowadays, the comparative advantage of the IMF in these three fields has declined. In no small measure because of the IMF's own data dissemination policies, economic and market data for a large variety of developing countries are now readily available. In addition, as a result of the post-1997 drive for more transparency in economic policies around the world – again promoted by the IMF as part of the crisis-prevention framework – open discussions between market analysts and policy-makers are now both frank and frequent, a far cry from the secrecy that was widespread a decade ago. Finally, the IMF continues to produce sophisticated analyses, but the distance between it and the markets has diminished – especially as regards the framework used – as investment banks have loaded their teams with former IMF staff. In addition, the widespread use of inflation targeting around the world, with its requirements of frequent disclosure of sophisticated economic analyses, has added to the reduction of the relative superiority of the IMF's analysis. The IMF still retains two main advantages. The first one is the longer-term focus, which allows it to concentrate on structural issues that markets may ignore, and the second is its cross-country work. But here competition, especially from the OECD, is tough too.

Over this diminished value hovers a big question mark, namely the independence of its analysis, especially for the big countries. And as more countries become big, the doubts about independence will spread further because

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voting power at the IMF Board is biased towards the larger shareholders.

The surveillance process is not independent. When the clients are the shareholders, incentive problems are sure to arise, and conflict is almost guaranteed between providing useful but friendly advice and signalling politically difficult problems. Topics and issues in Article IV consultations are typically negotiated ex-ante, with countries posing enormous resistance to the IMF analysing sensitive issues. This many times leads to a 'don't upset the authorities' mindset, which results in less effective work. Looking ahead, this mindset could be a major drawback in a world where some of the G10 countries pose a critical risk to the world economy. The IMF should certainly adopt a sharper role in uncovering the weaknesses of the developed economies and in providing sound and critical advice. When tough messages have to be hidden in the WEO[2] rather than being said plainly in Article IV discussions,[3] and when critical aspects of the economy are simply 'not for discussion', something is not working properly.

Independence would likely improve accuracy. In the context of central banking, Eggertsson & Le Borgne (2004) argue that delegating policy to an independent official implies awarding a long-term job contract; this, in turn, gives the official an incentive to put more effort into the policy-making process than an elected politician would. This extra effort translates, in expectations, into better forecasts and fewer policy mistakes, which increases social welfare – and the official's own utility – thereby making delegation compatible with the incentive. Note that this independence argument is unrelated to the need to ensure anti-inflation credibility, and thus it applies directly to the surveillance work of the IMF: the staff, and not the Board, should have the ultimate responsibility for surveillance.

It is thus clear that the IMF must regain an edge in its surveillance work, in order to strengthen its credibility and independence. It may become necessary to separate the process of surveillance from lending activities, with surveillance work not requiring the approval of the Board, given that no lending – and thus no financial risk – is involved. This would certainly improve the credibility and appeal of the surveillance work.

[2] World Economic Outlook, a semi-annual publication of the IMF presenting analysis and projections of global economic developments.

[3] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with member economies, usually every year.

Conditional lending to alleviate poverty

The recommendations of the Meltzer Commission[4] and recent research suggest that grants, and not loans, should become the bulk of the financing in the attempts by the developed word to alleviate poverty. The recent moves towards debt forgiveness in the context of the Paris Club are manifestations of this trend. The conclusion from economic analysis is not clear cut, however: there is a basic trade-off in which, for a given level of assistance, more concessionality means less repayment obligations but also less resources available for donors to offer to recipient countries. For the poorest countries, the result is unambiguous: providing them with larger (but less concessional) aid packages could negatively affect both their current and future growth performance through the accumulation of a stock of eventually unsustainable debt. In any event, however, it is clear that in the future grants will likely become a more important component of financing aimed at alleviating poverty.

This view is gaining increasing popularity and has shaped some of the features of the Heavily Indebted Poor Countries (HIPC) programme. The donor community is moving towards the view that any new HIPC borrowing (after debt relief is granted) should be on highly concessional terms and preferably in the form of grants. This would avoid repeating the mistakes of the past when large loans left poor countries poor and indebted. Countries that are (relatively) richer but highly indebted and/or have bad policy frameworks should also receive grants rather than loans, in order to minimise excessive debt accumulation and avoid exacerbating the suffering of the population due to the bad policies. Thus, at least in theory, lending would only be confined to the smaller subset of richer, less-indebted and better-managed countries.

In sum, it is a fact that the IMF's lending activities to alleviate poverty have been called into question, and it is likely that future developments will go in the direction of more grants and fewer loans. This will put further strain on the financing framework of the IMF.

Conditional lending at penalty rates to resolve external financing crises

Implementing sustainable macro policies, developing strong and sound financial systems and crafting robust institutions are objectives shared in principle by all countries. But this takes time, in many cases generations, and thus a bumpy road has to be expected in many cases. There will always be crises, and very likely they will be unexpected. The key is to reduce their frequency, duration and cost, and to minimise the scope for contagion. For

[4] International Financial Institution Advisory Commission set up by the US Congress under the chairmanship of Allan Meltzer to study the role and effectiveness of the International Monetary Fund and the World Bank (see Meltzer Commission, 2001).

those instances, robust frameworks for crisis prevention and resolution are needed.

Since the Mexican and Asian crises, there has been intense work on improving the crisis management capabilities of the IMF. Progress has been directed at two main areas: crisis prevention and crisis resolution. Progress in crisis prevention has been achieved mainly in the area of data dissemination, surveillance and transparency of policies. Progress in crisis resolution has been scant, to say the least. Conditionality has been streamlined and Collective Action Clauses have become more popular, but the failure of the SDRM (sovereign debt restructuring mechanism) and the elimination of the CCL (contingent credit lines) at the IMF means that we are basically where we were ten years ago. And, as the Argentinean saga shows, the current framework is ill-suited to deal with large-scale debt restructurings.

The main problem with the current and proposed frameworks for crisis resolution is that they do not bridge the passage between liquidity and solvency problems. A standstill – bankruptcy – process tries to minimise the costs of the resolution of a solvency problem, but it does not prevent a liquidity problem from spiralling into a solvency problem.

In the continuum of possible products, there is therefore a critical gap that the international financial institutions (IFIs) are currently missing. There is a framework to deal with poverty, a framework to deal with external solvency problems in developing countries and a framework to deal with solvent developed countries, but there is no effective framework to deal with temporarily illiquid but solvent developing countries. In other words, there are frameworks for crisis prevention and for crisis resolution, but not for crisis management.

The big difference between current account and capital account crises is that the latter develop very rapidly and easily become self-fulfilling through exchange rate/debt spirals. The key factor in these crises is a collapse in confidence, which, if not addressed quickly, can rapidly transform otherwise sustainable debt levels into unsustainable ones. The intensification of regional integration will probably reduce these confidence crises, but the heightened interconnection will probably lead to fewer but potentially more intense crises; thus, reducing the scope for contagion is a key strategy.

Emerging markets are clearly signalling with their actions their desire for a crisis management framework that can tackle modern capital account crises. The process of regional integration in South East Asia and the development of regional cross-country initiatives – including the Chiang Mai Initiative and the Asian Bond Fund – and the accumulation of reserves by the region's central banks are clear moves towards the development of an insurance framework that minimises the risk of solvency problems stemming from liquidity crunches (see Azheiman et al., 2004, for a theoretical discussion). As Kawai (2004) describes it, the Chiang Mai initiative is a liquidity support facility designed to manage regional currency attacks, contagion and crises.

One main principles of management theory is to listen to your customers. Prospective Asian IMF clients are saying that they are not really interested in its current services of crisis resolution, that they would rather have (and pay for) an insurance framework that enables them to prevent crises and not have to resort to an IMF programme to resolve them – after all, by the time an IMF programme is put in place, a significant output loss has already been incurred. Another set of prospective IMF clients, the emerging economies of Eastern Europe, are gravitating towards the EU and counting on the EU's anchor to avoid future recourse to the IMF. Liquidity crunches during the convergence process cannot be ruled out, but as soon as they enter ERM2, the ECB will play a larger role in ensuring currency stability. They have, de facto, secured an insurance framework with the EU.

There is therefore a strong drive towards securing regional insurance mechanisms that reduce the risks of a liquidity crisis. In its current form, it seems clear that only countries deprived of a strong regional anchor are likely to continue to form the client base of the IMF. And even those would likely prefer to have some form of insurance that minimises the need for a fully-fledged IMF programme: in fact, Brazil has already proposed the establishment of a facility that prevents crises, particularly those related to changing market sentiment unrelated to emerging markets.

In order to pre-empt the criticism that an insurance facility could lead to moral hazard, let's stress that there is very little empirical support to the existence of moral hazard. As Frankel (2004) points out, a political leader in a developing country is twice as likely to lose office in the six months following a currency crash than otherwise. As far as lenders' moral hazard is concerned, there is a clear confusion in terms. There may be at times a problem of 'too big to fail', or 'too big to unwind in an orderly fashion', which prevents the correct pricing of risks in some instances, but not a problem of moral hazard. And this applies to all large countries, emerging or not. Why is the United States being lent money at very low interest rates despite its large fiscal and current account deficits, if not because it is considered too big to fail?

There is an additional advantage of an insurance facility: countries will be more likely to implement structural reforms if the expected pay-off from these reforms is higher (see Cordella & Levy-Yeyati, 2005, in the context of emerging markets and Gros et al., 2004, in the context of monetary policy in the euro area). An insurance device would extend the planning horizon of policy-makers and improve the incentive structure to undertake costly structural reforms.

What would an insurance facility look like? I would argue for an insurance mechanism that, through a liquidity window at pre-determined interest rates, provides eligible countries with a line of credit that caps the rollover cost in the event of a liquidity run (the technical details would be

along the lines of Cordella & Levy-Yeyati (2005): countries could temporarily borrow from the facility, with a spread above pre-crisis levels but capped at a level that does not threaten solvency). It would, in many respects, be similar to the liquidity assistance provided by a central bank to its banking sector. If a country, after using the facility for a short period, is still in need of assistance, an IMF programme would them be negotiated, the same way the central bank starts the process of Prompt Corrective Action.

In a parallel to the central bank liquidity provision framework – where all banks are covered by it – this IMF insurance system should be inclusive: all emerging countries not currently under the umbrella of an IMF programme would be eligible for this insurance facility – after all, if they do not need a programme their solvency seems not be under discussion, and this facility may lead to deeper assessments of whether countries are indeed solvent. Inclusiveness would eliminate the problem of the CCL – countries did fear a negative impact of applying for it – and the threat of being declared non-compliant would provide enough incentive for countries to implement reforms – similar to the convergence process under ERM II. The Chiang Mai initiative is also inclusive with a surveillance mechanism to ensure soundness of policies through peer pressure. Article IV consultations and ad-hoc staff visits would provide the necessary monitoring, similar to the regular supervisory visits to the banking sector. Under this framework, all IMF member countries would be covered by an IMF facility: developed countries by surveillance, solvent emerging markets by the insurance, insolvent emerging markets by the standard IMF programmes, and poorer countries by the poverty-alleviation programmes.

How would this mechanism be financed? Ideally, it would be through a large increase in quotas buttressed by open-ended lines of credit from the main shareholders that could be tapped automatically in moments of stress. Like any line of credit, this would pay interest to the lender, and thus it would not represent any further use of taxpayers' money – a point that must be stressed to the American audience. The key to the credibility of any insurance device is that it has to be able to deploy more-than-needed resources – the Colin Powell military doctrine applied to financial markets. In its current form, the IMF would certainly not be able to perform this role.

Concluding, an insurance framework is missing in order to make the IMF business model of crisis management viable and attractive to its customers. An inclusive and automatic insurance mechanism would bridge the existing gap in the international financial architecture and significantly reduce the potential extent and impact of financial crises. Otherwise, countries will continue to develop their own – probably imperfect – insurance schemes, which probably exacerbate global imbalances, and recourse to IMF programmes will likely diminish dramatically.

Implications for the governance and financial viability of the IMF

There are two main conclusions from the discussion above. First, the IMF, especially in its surveillance activities, must be made more independent. Second, the IMF needs to greatly enhance its capitalisation, as it faces a greatly reduced revenue stream from its core activities and the insurance facility proposed here would require a sizable increase in resources.

As argued above, eliminating the need for Board approval in its surveillance activities would greatly enhance the credibility of the surveillance work. In addition, overall independence would be greatly enhanced by fixing the current model of shared chairs on the Board, starting with the EU representation on the Board. Under the current system, the combined EU countries exercise about 32% of the total voting power, and provide 15 of the 48 Executive Directors (plus one ECB observer). This could sound excessive, compared to one US Executive Director and an 18% vote, and one would think that the EU exerts too much power in the Board. But the reality is precisely the opposite. Despite attempts at coordination, each country pursues at the end its own agenda, which in the cases of shared chairs has to be negotiated with the other constituencies. Just as a hypothetical example, it is unclear that the joint chair Spain/Mexico/Venezuela could have had a policy towards Argentina that is fully in line with the policy of the EU – assuming the EU had a unified policy – given the very diverse interests at play. This shared agreement clearly undermines the influence of each of the three countries. The result is that the US has no effective power offset at the Board, and therefore the IMF is perceived as the hand of the US administration, thus denting its credibility.

Therefore, in a world economy with a clear trend towards regionalisation, the current arrangement of shared chairs makes little sense, and a redistribution of chairs to better reflect current economic realities is long overdue. At a minimum, the EU chairs should be integrated, and the South East Asian economies should be re-arranged to map their increasing regional integration and economic power. A regional distribution of chairs would make much more sense. In addition, the dominance of the US at the IMF looks increasingly anachronistic. With increasing doubts about the role of the dollar as reserve currency and about the long-term solvency of the US economy, with the increasing role of the euro as a reserve currency, and with the increased weight in the world economy of many emerging markets, it makes little sense that the US continues to have veto rights on the IMF Board. The world is no longer the post-war world where the US provided the bulk of financing for a battered world; in fact, the US represents today one of the main risks to the global economy. Voting shares – and quotas – should be redistributed to better reflect the new realities of the world economy, allocating more votes and financing burden to the emerging developing economies. Increasing the voting power and financial burden of the major emerging economies will, in addition, have the positive side effect

of better aligning their incentives with their risks, perhaps leading to better economic policies.

In terms of financial viability, it is critical to understand that as countries pay back their loans and as some loans are converted into grants, the main revenue stream of the IMF will disappear. And if our hypothesis is correct, and countries do try to avoid requesting IMF assistance through self-insurance mechanisms, then the financial outlook is grim. A large increase in quotas is therefore long overdue. The total size of quotas has declined from 1.4% of world GDP in 1978 to barely above 0.5% today, while the size of global capital markets has increased several times. This quota increase, supported by additional credit mechanisms to be tapped in times of stress, would adapt the IMF capitalisation to the realities of the global economy and allow for the redistribution of power argued above. Given the strong opposition to a quota increase in the US, the EU should take the lead in this process by offering the unification of its chairs at the Board. Such a move could be the catalyser for this long-overdue reform of the IMF, and hopefully lead to the implementation of some of the proposals argued here.

In this vein, selling the IMF's gold for debt-relief purposes makes little sense. The IMF needs more, not less capital, and selling gold would permanently deplete the capital base of the institutions. Debt relief, if there is agreement about it, should be accomplished with budgetary allocations from the member countries, many of which are still far away from allocating the agreed 0.7% of GDP to official development assistance (ODA).

Concluding, in this paper we argue that the changes in the world economy, both in terms of size and policies, are rendering the IMF's business model increasingly obsolete: substantial changes may be needed to adequately face the risks that future crises will pose. There is a fair amount of guesswork in forecasting the shape of future economic developments but, when the customers are demanding change and acting on it, it is always wise to listen. A more independent surveillance process, a change in the distribution of power and chairs at the Board, an insurance facility and a substantial increase in the capital base of the IMF are changes that will enhance the stability of the world economy.

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