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Replacing the International Monetary Fund

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The International Monetary Fund (IMF) recently held its annual meeting in Istanbul on October 6th and 7th. On the surface, the world's largest gathering of finance ministers and central bank governors should have been a moment of celebration for the IMF – the organization rediscovered its role as lender of last resort to countries in crisis during 2008-09, received an extra $500 billion from member countries to triple its lending capacity, and in recent weeks has been positioned to manage the much-hyped "peer review" of countries' monetary, fiscal, and financial policies.

But just beneath the surface, the problems mount. The IMF's ability to fight and prevent crises has hit a brick wall, because of long-standing resentments regarding the extent to which the U.S. and Western Europe dominate the organization.

Shifting Attitudes Towards IMF

In 2007, Russia pushed hard for someone other than a West European to head the IMF; they lost. In 2008, Argentina's IMF board representative, Hector Torres, argued publicly that the IMF failed to spot the American subprime crisis because it does not hold the United States to the standards applied to developing countries. Additionally, the Chinese government continues to dispute the IMF's right to determine whether the renminbi is deliberately and massively undervalued.

In 20 years of working on economic crises (including across the table from the IMF in some stints), I've heard repeatedly and in great detail traditional concerns that the IMF forces too much austerity on countries in crisis and does not sufficiently protect social safety nets. It dovetails with much broader anger across the developing world – with which I agreed during my tenure as chief economist at the IMF – regarding how greed and bad policies in rich countries caused the recent global financial crisis.

Increasingly, many emerging market countries have become reluctant to borrow from the IMF and subject themselves to its conditions. Instead, they prefer to run current account surpluses – exporting more than they import- and holding the extra proceeds as foreign exchange reserves. For example, Brazil has over $200 billion in reserves, Russia has over $400 billion, and China has an eye-popping $2 trillion. Global foreign exchange reserves rose from less than 5 percent of world GDP in 1993 to its current levels of around 15 percent – with most of the change accounted for by emerging markets. This holds down global trade, keeping U.S. exports lower than they would be otherwise and makes it harder now to sustain a worldwide economic recovery.

Changing Ownership Structure

A Eurocentric ownership structure made sense when the Fund was set up, after World War II; these were the main countries of the capitalist world, and voting rights were carefully balanced between the U.S., the main creditor, and the likely European borrowers. Over the next 50 years, former colonies became independent, communism fell apart and – most importantly – several East Asian countries experienced rapid economic growth, therefore, becoming more integrated with world financial markets. However, the IMF did not adjust to these global shifts. Instead it remained dominated by the U.S. and Western Europe, with relatively little representation for the so-called "emerging markets," i.e., the 6 billion or so people who live in the rest of the world.

By the 1980's this US-European dominance was irksome to the developing world, leading to accusations that the IMF helped banks over borrowers during the Latin American debt crisis (e.g., in the case of Bolivia). It became more than irksome in the late 1990s, when the IMF backed deeply unpopular policies during the Asian Financial Crisis, including deep fiscal austerity for South Korea, Thailand, and Indonesia. Meanwhile, a hands-off approach to the U.S. and Europe eventually led to disaster in the 2000s, because the IMF was unable to prevent the United States and Western Europe from building up financial vulnerabilities on a mind-boggling scale.

To be effective, an international lending organization like the IMF must be trusted by potential borrowers. If a fire breaks out in your house, you want the firefighters to put it out as soon as possible – rather than first insist that you clean your basement. If the local fire department were run by a small group of rich people with their own self-serving agenda, wouldn't you worry?

A Way Forward: The Emerging Market Fund

There have been several schemes put forth for "reforming" the IMF, but all significant change is blocked now by either the U.S. (which has a veto it will not give up) or by the Europeans (who will not consolidate the 10 board seats they hold – out of 24 total seats). The recent Pittsburgh G20 summit endorsed a further "at least 5 percent" shift in votes towards emerging markets, but even if implemented, they will still end up with less than 50 percent of the total votes – not enough to address long-standing grievances and suspicion.

The crisis of the past 12 months gave the IMF some pressing tasks – including helping to rescue Iceland. But more broadly, the de facto rules around who will be supported, and on what basis, are becoming increasingly murky and subject to favoritism. For example, Eastern Europe, is receiving loan deals that in the past would never have been offered to troubled economies in Asia- nor in the view of India and China- will they be offered in the future.

The best way forward would be for emerging markets to form their own Fund (let's call that the Emerging Market Fund, or EMF). These countries have plenty of "hard" currency in hand – $1 trillion would actually surpass the cash resources of the IMF, which now has $750 billion. Leading emerging- market experts, such as Aaditya Mahoo of the World Bank and Arvind Subramanian of the Peterson Institute for International Economics, are making this case powerfully.

Ironically, in its attempts to address the concerns of emerging markets, the IMF has pioneered a new easy-to-access loan with very few strings attached. So far, the Flexible Credit Line (FCL) has been accessed by Poland, Mexico, and Colombia. This exact design could be the basis of lending by the Emerging Market Fund. The difference is that while the IMF has only managed to sign up three clients – because other eligible countries, particularly in Asia, still feel there is a strong stigma attached to any kind of borrowing from the Fund – the EMF would get dozens of customers and immediately play a stabilizing role.

The initial EMF membership could involve 20-30 countries, but as it will be open to all countries in Latin America, Africa, and Asia, membership could easily reach 100 countries. However, the U.S. and Western Europe will not be at the table. The EMF's management would be in the hands of emerging market crisis prevention experts – many of whom have experience within the top levels of the IMF. The loans would be easy to access, large relative to the size of economies, and contain low conditionality. This would provide a much needed buffer in a world of turbulent capital flows. The EMF could also work closely with the IMF, with the latter perhaps specializing in very difficult (or severe crisis) cases. The EMF would be your friendly neighborhood physician and pharmacy; the IMF can run intensive care.

Finally, an EMF would undermine European global pretensions, but actually be good for the United States. The U.S. wants China, South Korea, and other countries to avoid running big trade surpluses in order to accumulate foreign exchange reserves. The Obama administration feels this is destabilizing, but emerging markets still want vast (and increasing) hard currency reserves precisely because they can't rely on the IMF.

Encourage them to set up a Fund they can trust.

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