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IMF Reform: Attaining the Critical Mass

MOHAMED A. EL-ERIAN

The chapters in this conference volume provide an important basis for assessing the actual and potential role of the IMF in what has become an increasingly fluid and unbalanced global economy. From my reading of the chapters, two common themes emerge.

First, the Fund is in danger of losing relevance. For most analysts, this is an unfortunate development given the Fund's potential to contribute to high and sustainable global growth, the orderly resolution of payments imbalances, and the conveyance to individual countries of best policy and institutional practices. Tim Adams in chapter 4 of this volume, C. Fred Bergsten in chapter 13, and others summarize the issue by referring to the need for a more effective and adaptable organization and one that is no longer viewed as "asleep at the wheel"; and Barry Eichengreen (in chapter 25 of this volume) uses the image of the Fund as a "rudderless ship adrift on a sea of liquidity."

Second, there is no simple or single measure to counter this danger. Rather, one needs progress on a critical mass. Some of these measures are "urgent and important"; others are "important but not urgent." And there is a risk of being sidetracked by the "not important, not urgent"—a risk that assumes greater importance in the context of John Taylor's reminder in chapter 19 that reforms involve "many tough debates, negotiations, and compromises in the international finance community."

Mohamed A. El-Erian is president and CEO of the Harvard Management Company, deputy treasurer of Harvard University, and a faculty member of the Harvard Business School. Prior to joining Harvard in February 2006, he was a managing director at the Pacific Investment Management Company and a senior member of the portfolio management and investment strategy groups.

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I broadly share these two views. Specifically, the Fund has been slow to adjust to a set of structural changes in the global economy—changes that are being driven by three distinct factors:

- the emergence of a new set of systemically important countries on the world stage with greater influence on the pattern of international growth, trade, price formation, and financial flows;
- a bout of derivative-driven financial innovations that has significantly lowered the barriers to entry to a range of markets and, in the process, altered the nature of systemic risk and the Fund's effectiveness in alleviating it; and
- the important success the Fund has had in stimulating a substantial improvement in the dissemination of country information and analysis, thereby lessening the institution's comparative and absolute advantage.

When combined, these factors have served to change the playing field on which the Fund (as well as other policy-oriented entities) operates. Specifically, they have reduced the institution's traditional market influence, weakened its signaling role, raised questions about the adaptability and effectiveness of its instruments (and other modes of interaction with member countries), and eroded its ability to generate internal budgetary income to finance a reprofiling of its activities. Accordingly, the key challenge for the international community is to form an operational consensus to implement a critical mass of reforms that restores the Fund's role at the center of the international monetary system—this at a time when the underpinnings of the system itself are getting more economically unstable and technically volatile.

To shed additional light on these issues, the next section discusses a simple analytical characterization (the global "stable disequilibrium") to help anchor the analysis of the critical mass of needed reform measures. With this background, the following section compares the Fund's actual role with what would be deemed more desirable; in the process, it looks at challenges facing the reform process, some of which are easily addressed, although others are technically more difficult and a few require political courage and vision (including the willingness by some countries to give up increasingly outmoded and archaic entitlements). The next section discusses a proposed set of minimum deliverables, and the section after that addresses operational aspects. The final section concludes, reiterating the need to attach to IMF reform a greater sense of urgency caused by the manner in which the world is evolving. Indeed, the international community confronts a simple choice: either play serious catch-up now to shape an orderly future or face the prospect of an unpleasant and socioeconomically costly set of cleanup operations later.

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A Simplified Characterization—The Global "Stable Disequilibrium"

The recently issued report by Rodrigo de Rato, managing director of the IMF, postulates "globalization" as the defining theme for discussing the Fund's Medium-Term Strategy (IMF 2005a). Specifically, the report cites globalization's "pervasiveness for the membership," "its centrality to the Fund's mission," and "its potential as an organizing principle."

This serves as a useful beginning for us to derive a simple characterization to help anchor the process of defining and specifying a critical mass of reform measures. It is just a beginning because globalization as a phenomenon is not new; also not new is globalization's transformation from an occurrence that affects the cross-border flow of goods and services to one that also accommodates significantly higher flows of capital to finance unusually large global payments imbalances. Rather, what is new is the extent to which globalization is supporting a relatively rapid and fundamental realignment of economic and financial influence around the world, thereby altering the marginal price-setting dynamics for a range of variables and flows—and, in the process, changing the nature of systemic risk and the effectiveness of traditional policy reaction functions.

The driver of this realignment is an undeniable—and, arguably, largely irreversible—change in the manner in which a set of emerging economies now interacts with the rest of the world. Led mainly (but not exclusively) by the accelerated economic takeoff in China and other Asian economies, emerging-market countries have become important contributors to global economic growth. They continue to gain international market share in goods and services (and, increasingly, at higher points of the value-added curve), and they are altering traditional pricing power and cost-plus inflationary dynamics. In the process, they have generated significant current account surpluses, and now account for large and growing holdings of US dollar–denominated financial assets, including treasuries, agencies, mortgages, and corporates (El-Erian 2005a, 2005b).

Given the specific transmission mechanisms, the immediate effect of all this is to support a higher level of US consumption accompanied by "unusually" low interest rates, a "surprisingly" strong US dollar, and an "unprecedented" imbalance in the current account. As a result, a wedge has developed between policy interest rates, market rates, and long-term equilibrium rates.

This general phenomenon has been accentuated by an equally unprecedented technical reduction in barriers to entry to various markets, made possible by the broad-based use of a range of derivative-based financing instruments. The range of such instruments starts with the single-name credit default swaps (CDSs) and extends to composites (such as the CDX, which is a basket of CDSs) and structured products (for example, collater-

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alized debt obligations [CDOs]). All this serves to augment the liquidity and leverageability of the cash markets, thereby making access to the underlying risk (or collateral, as it's called in the marketplace) easier for a range of investors. Such financing instruments also facilitate the pooling, subsequent tranching, and securitization of these risks, thereby adding to the potential pool of investors.

This development has widened the manifestation of financial imbalances to include historically unusually low pricing for risk premia pertaining to credit, volatility, and the term structure. No wonder policy discussion has been marked by references to "conundrums," "puzzles," and "aberrations." It is also not surprising that officials at the Federal Reserve have been cautious about commenting on the specification of the "neutral interest rate" and related concepts such as the nonaccelerating inflation rate of unemployment (NAIRU). And it is no wonder that some policymakers have been warning about excessive risk appetite, leverage, and bubble tendencies. Indeed, we are starting to see within official circles—national and international—a broad-based interest in a regulatory catch-up effort.

Notwithstanding the related appearance of short-term economic and market robustness and resilience that have accompanied the availability of greater liquidity—after all, a rising tide can raise many boats regardless, initially, of the boats' underlying robustness—the world is becoming increasingly vulnerable to two distinct sets of risks: those associated with policy mistakes and those pertaining to market accidents. Subsequent developments will no doubt be complicated by ongoing changes to structural relationships that underpin the host of traditional policy responses. Although there remains a considerable set of endogenous stabilizers in the system, their distribution is far from uniform. Moreover, certain market segments are starting from valuations that appear priced for perfection.

This combination of factors has allowed for what is best characterized as a stable disequilibrium in the global economy. The unprecedented level of global payments imbalances—and related mispricing in a range of national and international markets, most importantly housing—speaks to the disequilibrium dynamics. The willingness and ability of certain countries to finance these imbalances at unusually low (and some would say noncommercial) rates of return (unhedged and currency adjusted) speaks to the stability for now.

This characterization of stable disequilibrium serves as an operational middle ground for two more pointed analyses. The first comes from the writings of Michael Dooley, David Folkerts-Landau, and Peter Garber (2004). They used the "revived Bretton Woods" and "Bretton Woods II" characterizations to underpin a new type of interaction between major Asian economies and the United States, namely, the increasingly unbalanced exchange of financial claims for goods and services under what Lawrence Summers (2004) has labeled a traditional "vendor financing" re-

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lationship. The second analysis, which includes work by Nouriel Roubini and Brad Setser (2005), highlights the inherently volatile and unsustainable nature of the global imbalances.

The IMF's Role—Actual and Desirable

In a world characterized by a stable disequilibrium, the Fund would (and should) be looked at to shift the balance of risk away from the disequilibrium dynamics and toward greater long-term stability. In addition to direct consistency with the macroeconomic objectives contained in the institution's Articles of Agreement, this fits well in the risk-management paradigm developed at the Fund in recent years (particularly its emphasis on crisis prevention).

For the Fund to be effective, it needs to act and be perceived by its member countries as performing the role of trusted adviser (El-Erian 2004b), that is, an institution that is readily accessible as an unbiased source of top-quality information and analysis, consistent with the long-term interests of the countries and in the context of the multilateral framework detailed in the Articles of Agreement. Yet two major factors serve to undermine this: First, the Fund's traditional instruments of meaningful policy interactions with countries—Fund-supported programs—are less relevant in a world where emerging economies have become exporters of capital and holders of large reserves. Instead, the institution needs to rely on a mix of nonprogram bilateral surveillance and one-step-removed multilateral surveillance. History does not speak well of the effectiveness of this mix. Second, the Fund's comfort zone in terms of its usual macroeconomic analysis is being challenged by the growing importance of financial markets in influencing the design and impact of traditional policies.

As a result of these two factors, the Fund is at risk of losing influence when it comes to helping inform and shape national policy. Note that this consideration goes well beyond the increasingly common view regarding the need for enhancing the adaptability and effectiveness of the Fund's lending instruments. Indeed, it speaks to the more holistic manner in which the institution has interacted, and should interact, with member countries. Thus, the possible loss of influence affects the quality and depth of the policy dialogue, the ability to impart a multilateral consideration to national policy formulation, the effectiveness and timeliness of national cross-fertilization, and the spread of best policy and institutional practices.

Meanwhile, some member countries—which seem rightly sensitive (in a risk-averse manner) to the growing imbalances in the global economy—have chosen to pursue a significant degree of self-insurance. Indeed, the phenomenon has been so pronounced that, in a recent analysis published in the IMF's *World Economic Outlook* (IMF 2003), the institution has raised questions about the cost-effectiveness of self-insurance.

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Nowhere is the process of self-insurance more vivid than in emerging Asia. It is not just an issue of large and growing national holdings of international reserves, with implications for policy issues such as the conduct of exchange rate policy and the approach toward capital account liberalization. It is also evident in the increased interest to pursue a range of regional integration initiatives. In the past three years, these have included mechanisms for partial pooling of national reserves, financial-market deepening, and harmonization of standards (El-Erian 2004a and Henning in chapter 7 of this volume). There has even been renewed talk of an Asian monetary fund.

For understandable reasons, Asian countries are de facto engaged in a national- and regional-driven process of filling the vacuum created by an IMF that has lost part of its effectiveness and role at the center of the international monetary system. In an interesting but worrisome development for the IMF and its major shareholders, similar tendencies are starting to be evident elsewhere in the emerging world as a larger number of systemically important countries—for example, Brazil, Mexico, and Russia—move away from formal financial arrangements with the IMF. The consequence is not limited to the institution losing a direct instrument of influence on national policy dialogues; there also has been an erosion in the source of revenue for its internal budget. Specifically, the phenomenon of greater self-insurance among emerging economies has resulted in both a sharp fall in member-country interest in accessing Fund arrangements and an inclination by these countries to prepay existing liabilities to the institution.

Here then is another item that the international community needs to place on the radar screen for the longer term: The structural strengthening of emerging economies is lessening the Fund's ability to generate income for its budget. This will inevitably put into focus other possible means of generating income, none of which are readily agreeable to a core group of countries. Specifically, as yet, insufficient progress has been made toward assessing whether any or all of the following alternatives are feasible: gold sales as a means of endowing the Fund, market borrowing or a new General Arrangements to Borrow or both, more active asset and liability management, charging for technical assistance, and changing the underlying philosophy and modalities governing the rates of remuneration and charge.

The structural strengthening of emerging economies will also highlight the outmoded and archaic nature of some governance aspects. These pertain to politically sensitive topics such as IMF Executive Board representation, quotas, historic entitlements governing the allocation of management jobs at the Fund and World Bank, among others. It is striking the degree to which a consensus is now forming to address these issues. This is most evident in the discussion on increasing Asia's voice within the Fund (see chapters in this volume by Adams, Bini Smaghi, and Truman [chapter 9]; Buira 2005; van Houtven 2004).

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In highlighting long-standing global economic governance issues, the spotlight is not limited to the IMF. Light is also shining more brightly on other mechanisms for international policy coordination—most notably, as argued by Fred Bergsten in chapter 13 of this volume and by others, the increasingly outmoded specification and operation of the Group of Seven (G-7). Indeed, one must not forget the warning in remarks by Yu Yongding (chapter 28) in the concluding panel of this conference regarding the limited potential for China reacting to "pressure exercised collectively by the G-7."

Specifying the Deliverables

So much for the challenges; how about the solutions? The chapters in this volume contain most, if not all, the answers.[1] Indeed, and especially after the deliberations at this conference, the question is not about identifying the elements of a solution. It is about coming up with the operational critical mass in terms of content, sequencing, and the timely ability to gain sufficient implementation traction.

For this to happen, you need leadership with an operationally contained focus, especially in view of John Taylor's chapter 19 reminder about the transaction costs associated with reforms. This focus needs to secure the minimum deliverables of a reform process—another way of stressing outputs rather than inputs.

Four minimum deliverables are at the top of my list:

- The Fund must become an unquestionable trusted adviser for individual economies, especially those in the emerging world facing new challenges and opportunities.
- The Fund must become a center of excellence on multilateral surveillance issues pertaining to both macroeconomic and financial issues.
- The Fund must have more modern and stable modalities for financing itself, thereby facilitating the type of institutional evolution or reinvention that is an inevitable part of being at the center of an increasingly fluid global economy.
- The Fund should have a more legitimate governance structure.

The key to a successful reform of the Fund is to obtain timely and broad-based sign-off on these four minimum deliverables. In doing so, the international community would commit to a significant change in the mind-set

1. Refer, for example, to the summary discussion contained in Truman, chapter 2 of this volume.

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governing the manner in which the Fund interacts with member countries. Indeed, such a change is inevitable if the Fund is to regain its role at the center of the international monetary system.

The change would inevitably shift the culture of the institution to more of a listening mode, especially in the context of the headquarters-based process of preparing briefing papers for the annual Article IV consultations. It would involve a higher frequency of contacts with country officials as well as carrying out the contacts in a somewhat less formal manner than what most Fund officials have traditionally been used to. Indeed, these considerations constitute necessary, though not sufficient, conditions for the Fund to evolve into the role of trusted adviser.

The change would also be reflected in a small but notable shift in the balance of internal skills—another necessary condition for the trusted adviser role and, more broadly, for the Fund being viewed widely as a center of excellence for analysis of bilateral and multilateral surveillance topics. Given the realities of the global economy, the shift in the skill mix of the Fund staff would inevitably involve a marginal reduction in emphasis on traditional, generalist, macroeconomic attributes in favor of greater emphasis on specialist skills, particularly in the financial sector. Management would thus have to spend more time on enhancing this adaptation and on "connecting the pipes." Fund management is already aware of this, judging from the appointment of an external advisory group (chaired by Bill McDonough, the highly respected former president of the New York Federal Reserve) to review the approach to financial-sector issues. Fund management would also need to review the set of internal rules governing promotions, career streams, and mobility within the institution.

One must not underestimate the managerial and resource challenges associated with these changes, which would need to be addressed in the context of inevitable constraints on the Fund's overall head count—perhaps even a more binding constraint given the above discussion on the erosion of the Fund's ability to generate budgetary income over the medium term. Management would thus have to turn down—more forcefully—initiatives that do not command widespread support among the membership as a whole although the initiatives are pushed by individual member countries.

Some Operational Aspects

How about issues pertaining to operational implementation? Let us start with the timeline and then consider the catalyst for change and related monitoring aspects.

If the Fund were judged by the standards of the private sector, the time for reform would be overdue. After all, the institution's revenue outlook is uncertain, its once dominant market position is eroding, and it is in-

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creasingly recognized that its products need to be modernized.[2] But the IMF is not in the private sector. Yet, there is urgency. The world is getting more unbalanced, thus increasing the risk over time of significant costs in terms of forgone global income and financial disturbances.

Now that we have discussed content and urgency, let us assess the probability of timely implementation. Here, again, history provides important insights.

The reforms cited above are not automatic; they need a catalyst or an agent for change. This role can be performed by one (or a combination) of the following factors: an internal driver in the form of bold management action; an external driver in the form of increased activism among a group of member countries or outside constituencies; or an environmental driver in the form of a crisis with systemic importance.

Different people will no doubt attribute different probabilities to each of these possibilities. If history serves as a guide, the world will most likely wait for the third catalyst—a crisis with systemic importance—before it sees major reforms to the Fund. This would be unfortunate. Reforms conducted in such circumstances would likely face greater transitional problems and, by definition, not be consistent with an orderly resolution of the global stable disequilibrium.

Operating through both the Executive Board and the International Monetary and Financial Committee (IMFC), as well as less formalized forums, individual countries can provide the catalyst for reforms. In the past, this type of leadership would typically come from the United States, in close consultation with one or more European governments. Such a lineup may be more uncertain these days. The United States has become the largest contributor to the global imbalances although there is a debate as to the extent to which this represents either US overconsumption or deficient aggregate demand on the part of the rest of the world.[3] Europe's ability to play global leader is undermined by the reality that it has most to lose in terms of modifications to quotas and IMF Executive Board representation; and this comes at a time when internal EU-related tensions have risen.

An alternative would be for a group of emerging economies to come together and act as an agent of change. Brazil, Russia, India, and China—the BRICs—constitute a natural potential grouping in terms of their systemic importance, especially if complemented by South Africa, which is increasingly seen as the voice for Africa.[4] This would also facilitate the

2. See, for example, the analysis in the papers prepared for this conference that discuss changing or introducing new instruments.

3. The issue is discussed in Bernanke (2005) and IMF (2005b).

4. Trevor Manuel, South Africa's minister of finance, is currently a highly influential participant in global economic discussions.

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needed consultations with outside constituencies, including nongovernmental organizations.

Of the three drivers—internal, external, and environmental—the most desirable is the one that sees Fund management take the lead by defining the core set of reforms and gaining sufficient political backing for them up front. Indeed, the new managing director, Rodrigo de Rato, could use this issue to define his tenure at a time when the global economy is in obvious need of better modalities for policy consultation, coordination, and leadership. Rather than having individual countries trying to micromanage the process, the international community ideally would hold Fund management accountable for the deliverables, leaving the details to the judgment of management and staff.

It is likely that the international community would be more amenable to such an approach if it were to come with a robust monitoring mechanism. In addition to holding the IMF reform process accountable on a timely basis, such a mechanism would allow for the type of midcourse correction that is often needed when implementing significant reforms in a fluid operating environment. The biannual IMFC discussions provide a good instrument for monitoring, supplemented with periodic consultations with key external constituencies.

Concluding Remarks

The IMF faces an important and comprehensive reform challenge if it is to restore its role at the center of the international monetary system. Simply put, it must adjust to the new realities of the international economy, including a change in the traditional marginal price-setting dynamics for global GDP, trade, inflation, and financial flows.

The urgency of this challenge is accentuated by the combination of the unprecedented imbalance in global payments, national policy reaction functions that are becoming less effective and predictable, increasingly weak international policy coordination mechanisms, private markets that are even more highly leveraged through a spaghetti bowl of derivative relationships, and a group of emerging countries whose growing influence on the global economy is being accompanied by legitimate concerns about their underrepresentation under the increasingly outmoded governance structure that presides over the Bretton Woods institutions.

This timely conference has served an essential role in highlighting the nature of the challenge and the implications for both the Fund and the broader functioning of the international monetary system. Indeed, there is a degree of agreement today that would have been almost unthinkable just a few years ago. Consequently, and especially against the background of the detailed discussions of the papers for this conference, there can be

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little doubt about the urgency of the problem and the components of the solutions.

In my remarks for the concluding panel of this conference, I have sought to bring together some common reform themes as a means of defining a set of minimum deliverables and discussing issues pertaining to design, execution, and monitoring. The resulting operational requirement could well appear overwhelming to some. It is not. After all, the Fund has many structural advantages, and they are significant. They include a pool of world-class talent in the form of a well-trained, committed, and energetic staff; a deeply entrenched philosophy and process (including the command-and-control structure) that respond well to firm leadership from management; a universal, albeit unbalanced, membership; and the unequaled access to member-country governments afforded to the institution by the obligations of membership under the Articles of Agreement.

It is thus my hope that the depth and range of discussions that have dominated this conference will serve to shift the probability of the eventual catalyst for IMF reform away from a crisis-driven process to one that is managed by the institution, or its shareholders, or both. In the process, instead of having potentially to suffer from the multifaceted dimensions of a possible crisis, with the poorest segments of national and international societies being most at risk, the world would engage in a timely exercise of orderly catch-up and pre-emption.

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