The Relationship between the international Monetary Fund and the G-20 nations is both symbiotic and conflicted. Like a long-married couple that habitually bickers and fights, the two can’t seem to live together, but neither can they live separately. The question of what to do about this difficult relationship is coming to a head in the run-up to the November G-20 summit chaired by South Korea. In the aftermath of the 1997-98 Asian financial crisis, many Asian governments have kept their distance from the IMF. Successive Korean governments, in particular, have seen approaching the fund as political suicide, given the domestic political reaction to the bailout conditions imposed during the financial crisis. No matter what the circumstances, South Korean leaders would rather jump off a cliff before negotiating even the most generous credit line with the IMF.

It is admirable, therefore, that the current government of President Lee Myung-bak has taken the lead in G-20 discussions on reforming the IMF’s mandate. It has contributed significantly to international thinking on the design of new lending facilities. This work is part of the G-20 effort to change how the IMF goes about its work, especially the two key dimensions of its mandate, crisis prevention and crisis management.

Crisis Prevention
To start with crisis prevention, this is done through bilateral surveillance, conducted country by country, on one- or two-year cycles, as provided for by Article IV of the fund’s Articles of Agreement.

The problem with these country surveillance exercises is that they are regularly relegated to
the “duly noted” bin. Governments receive them, file them away, and go back to doing exactly what they were doing before. Another problem is that the IMF’s bilateral surveillance focuses on the implications of a country’s policies for its own economic performance. Confined to a process involving the fund and an individual country, these exercises rarely address the implications of national policies for third countries and the international system. Surveillance of the United States under Article IV during the subprime mortgage boom said little about the potential implications of the country’s policies for the stability of the international financial system. Article IV reviews of China similarly have said little about the implications of its policies for global imbalances and the stability of the international monetary system.

To address such gaps, the IMF is beginning to experiment with “spillover reports” that would identify the cross-country impact of national policies and encourage governments to alter their stance when significant external ramifications are detected. This is an intellectual step forward. But in the absence of a solution to the earlier problem of getting countries, especially large economies, to take the fund’s recommendations to heart it is not clear that this will also be a practical step forward.

A similar critique applies to efforts to resuscitate the Multilateral Consultations Initiative established in 2006 to bring together a handful of IMF members for consultations on issues where their policies matter jointly rather than separately. The 2006 consultation on global imbalances involving the US, the euro zone, Japan, China and Saudi Arabia was an interesting exercise, but at its conclusion the countries involved simply returned to business as usual.

Article IV also gives the IMF a mandate to oversee the “effective operation” of the international monetary system. It is high time for the institution’s Executive Board to put some flesh on these constitutional bones. Staff and management should be tasked with producing a biannual report on the international monetary system. In it they should evaluate the sustainability of current account positions and prevailing exchange rates, and the adequacy or excessiveness of members’ foreign exchange reserves. The new report would sketch scenarios and recommend policies for eliminating excessive deficits and surpluses and describe what kind of exchange rate and reserve changes should accompany these adjustments.

It would probably be too delicate a task for the fund to attempt to act as an exchange rate “umpire” — to announce by exactly how much exchange rates were overvalued or undervalued and to declare some as seriously misaligned. Initially at least, it would have to settle for offering a range of assessments. If this proved successful, it could then move toward publishing more forceful, umpire-like decisions.

CRISIS MANAGEMENT

In order to better carry out the other half of its dual mandate — crisis management — the IMF has signaled that it will ask in Seoul for a further increase in its resources to $1 trillion, up from the $750 billion agreed at the G-20 meeting in London in April 2009. In the spring of 2010, the IMF committed €250 billion (upwards of $300 billion at current exchange rates) to southern Europe alone. Clearly, more firepower is called for.

But, in addition to more resources, the IMF needs a more effective way of deploying them. With input from South Korea, it has created a Precautionary Credit Line (PCL). This generalizes and extends the earlier — and recently expanded — Flexible Credit Line, or FCL. Under the FCL, countries with impeccable credentials are pre-qualified for automatic access to IMF credit. They are freed of having to negotiate onerous conditions. Unfortunately, only three countries,
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Mexico, Colombia and Poland, have signed up for an FCL. Others have hesitated either because they worry about not qualifying, now or in the future, or because, as in the case of the lingering hangover from the Asian crisis, they are still concerned about the stigma of associating with the fund.

The PCL can assist a second tier of countries with reasonably strong policies, but not strong enough to qualify for an FCL. This might help to break the deadlock, since countries qualifying for a PCL will only have to meet some relatively minimal and unobtrusive conditions negotiated through a streamlined process.

The problem of stigma could be addressed if the IMF was authorized to unilaterally pre-qualify a swath of countries for one facility or the other, although the members have shown no willingness to let the fund even go down this road.

A more fundamental problem with the FCL is what would happen if the IMF disqualified a previously pre-qualified country. The effects would not be unlike those of a downgrade from the credit-rating agencies. The markets might take this as an indication that the country’s policies had deteriorated significantly, in turn precipitating a crisis. This danger would be lessened if prequalification was not simply a yes-or-no decision: if there existed a range of facilities for which countries could be pre-qualified, and if, as circumstances and policies changed, they could be moved between them. But it is not clear that this would be enough to remove the danger that an IMF decision, taken in response to deteriorating country policies, might precipitate a crisis. As always, the devil is in the details. Perhaps we will learn the details in Seoul in November.

THE G-20 DILEMMA
The G-20 has been at the center of these discussions and has been a driver of the process of reforming IMF quotas to give greater weight to emerging markets. The decision at the height of the financial crisis to triple IMF resources was a product of the April 2009 G-20 summit, as noted above. And now, in the run-up to Seoul, the G-20 is again leading the debate over IMF reform.

The emergence of the G-20, with both developed and emerging markets as members, is an important step forward relative to the G-8, an exclusive club of high-income countries. But no one appointed these 20 countries to run the world. Low-income countries, with which the IMF does much of its business, are entirely excluded from all of these groupings. Argentina is in, while Colombia, which has a stronger economy, is out. Not only do the Europeans have five of 20 seats, they have unilaterally invited Spain, making six, and the Netherlands has invited itself, making seven. Part of the IMF’s image problem, not least in Asia, revolves around legitimacy, or lack thereof. Having the G-20, whose legitimacy is also in doubt, calling the shots on IMF reform does not help.

There is an alternative, of course — namely, the IMF’s own International Monetary and Financial Committee (IMFC), which mirrors the composition of the Executive Board. The IMFC has 24 members, some of which represent individual countries, others of which represent groups of countries (known as constituencies). Some constituencies have a practice of rotating the country that represents them on the IMFC and the Executive Board. As a result, all countries have a voice, directly or indirectly, in the IMF’s ultimate decision-making body. These practices are legitimized by the fact that they are provided for in the Articles of Agreement.

An obvious solution to the G-20’s legitimacy deficit would therefore be to reconstitute it to match membership in the IMFC. All countries would then have a voice. And the G-20 would possess the legitimacy conferred by a written constitution accepted by 187 governments.
If, as the global financial crisis now recedes, the G-20 evolves from a crisis-management grouping into the key body setting the agenda for strengthening the global financial architecture, this will be a sacrifice worth making.

Some will object that rotation will complicate the G-20’s deliberations. This is true, but rotation wouldn’t have to occur every month. Others will object that requiring G-20 members to report to constituencies — that is, to multiple governments — would make its discussions more cumbersome. Maybe so, but what the G-20 would lose in efficiency it would gain in legitimacy. If, as the global financial crisis now recedes, the G-20 evolves from a crisis-management grouping into the key body setting the agenda for strengthening the global financial architecture, this will be a sacrifice worth making.

PHYSICIAN, HEAL THYSELF
Meanwhile, the G-20 can offer other suggestions for enhancing the legitimacy and effectiveness of the IMF. It can focus on quota reform, insisting on faster steps to increase the votes and quotas of rapidly growing emerging-market countries. It can recommend eliminating the virtual US veto on important decisions in the IMF that require an 85 percent supermajority, with the US possessing more than 15 percent of the votes. It can get serious about correcting European overrepresentation in the fund.

In addition to altering voting shares, the G-20 can push for more fundamental changes to IMF decision-making. One idea worth contemplating is double-majority voting, where decisions require both a majority of votes and the support of a majority of member countries. Double-majority voting is already used in leadership selection at the African Development Bank, the Inter-American Development Bank and the Asian Development Bank. At the IMF, it might first be adopted for leadership selection, and, having proven its usefulness there, be cautiously extended to other issues.

The G-20 can also take steps to streamline and simplify the process of increasing the IMF’s lending capacity. It could recommend the creation of an independent committee of central bank governors and private experts to decide quota increases. If additional special drawing rights (SDRs) are required to augment global reserves, then the committee could similarly be empowered to authorize this.

If the G-20 wants to go still further, it could vest the power to make these decisions not in an independent committee of outsiders but a more independent IMF Executive Board. The latter would be able to take decisions quickly, as required in a crisis, without having to kow-tow to governments. The G-20 could plump for greater transparency in IMF deliberations. It could push for votes on policy questions as opposed to decisions by consensus, which can be relatively opaque. It could insist on releasing transcripts of board meetings, analogous to the transcripts published by the monetary policy committees of central banks. Greater transparency would be a logical quid pro quo for greater independence. It would be a way of ensuring that the more independent IMF Executive Board was adequately accountable to its stakeholders. And it would extend the class of relevant stakeholders beyond governments, to civil society and non-governmental organizations.

Most of all, the G-20 can help the IMF heed the familiar dictum: physician, heal thyself.

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