

GLOBAL LENDERS IN SEARCH OF BORROWERS:

Reforming the IMF and World Bank to Rescue the Global Economy and Conquer Poverty

Remarks by Roy Culpeper, President, The North-South Institute at the National Press Club, Ottawa, June 22, 2006

Introduction

Three years ago, when President Bush was denouncing the “axis of evil,” (comprising Iraq, Iran and North Korea), civil society organizations meeting in Brazil at the World Social Forum, denounced what they called “the axis of dubious legitimacy”. They were referring to the World Trade Organization, the International Monetary Fund, and the World Bank, the world’s three principal global economic organizations. These organizations have also attracted considerable criticism over the years from developing countries, which have had to live with the adverse consequences of IMF and World Bank programs and trade liberalization under the WTO.

Ironically, during the past nine months the global economic organizations have come under heavy criticism not from developing countries or radical NGOs, but from the U.S. the U.K., and Canada. The critics have included David Dodge, Governor of the Bank of Canada, Mervyn King, his counterpart at the Bank of England, and Timothy Adams, a senior official at the U.S. Treasury. They have focused particularly on the IMF, accusing it of having lost its way, lacking legitimacy, and even questioning its existence. And U.K. Prime Minister Blair has called for a merging of the IMF with the World Bank.

In the past, when developing countries and civil society organizations called for the reform of the IMF and World Bank, little has happened. Yet, when the economic interests of the powerful industrial countries were at stake, they have seen to it that the IMF and World Bank have brought about changes in their operations (rather than “reforms”) to enable them to play an active role. For example, when the system of fixed exchange rates broke down in the 1970s, and during the financial crises of the 1980s and 1990s, the IMF and World Bank played a leading role in resolving the crises at the behest of their principal shareholders.

History may be about to repeat itself. The wind is in the sails of the industrial country critics, and we may expect to see change, if not reform, take place at the Bretton Woods institutions (the “Fund” and the “Bank”). The key questions are, will such changes be in the interest of the world community as a whole? What will be the process, and how will it be determined?

In these brief remarks, I shall talk about why the pressure for change (particularly at the IMF) has suddenly erupted among the industrial countries; what changes are likely to come about as a result; and finally, what *reforms* are actually needed. I shall also say a few words about Canada’s role.

Why the sudden pressure for change?

There are two acute, interconnected, pressures for change at the IMF at present: its largest borrowing members have stopped borrowing, and it is running out of money.

During the financial crises of the late 1990s, emanating from Asia, emerging market countries discovered what it was like to be at the receiving end of IMF and World Bank conditionality. It was not pleasant. They were forced to adopt draconian measures that drove them into recession, increasing poverty rates and leading to widespread social and economic disruption. As a result, the Asian countries decided to do what all industrial countries had done by the end of the 1970s: stop borrowing from the IMF. More recently (in December 2005), Argentina and Brazil prepaid their IMF loans amounting to \$25 billion.

To protect themselves from the possibility of future financial crises, emerging markets have built up huge foreign-exchange reserves. Eight East Asian countries (Japan, Singapore, Indonesia, China, Malaysia, the Philippines, Thailand and Korea) now have over \$2 trillion in reserves, which is *ten times* as much as the IMF has at its ready disposal (and that is what is available for *all* countries around the world).

There has been a similar but less pronounced trend at the World Bank, which has seen a 25 percent decrease in lending to middle-income countries over the past decade. This is not likely to change. As countries develop, they are likely to wean themselves from the IMF and World Bank, and seek whatever financing they require from private financial markets—which don't tie policy conditions to their loans.

Since the IMF's borrowers must pay interest, when they stop borrowing they also cut off a principal source of the IMF's income, which is projected to halve from \$3.2 billion in 2005 to \$1.4 billion this year. One account projects an income shortfall this year of \$116 million in the Fund's \$1 billion administrative budget. So we have the spectre of the IMF, with its reputation for telling poor countries to tighten their belts, contemplating some belt-tightening of its own.

It is not clear what could change this situation. Former U.S. Treasury Secretary Larry Summers has suggested that the IMF manage some of the Asians' reserves for a fee. Why would the Asian countries want to do this, having already distanced themselves from the Fund by accumulating huge reserves? It may be that a taste of its own medicine—a certain amount of downsizing and budget-cutting—is in order for the IMF.

Deeper problems of global governance

Beyond these immediate pressures, there are much larger “global governance” issues posing a challenge to the Bretton Woods institutions and indeed to the world generally. These relate, first, to the global payments imbalances, with huge and growing deficits in the United States (the current account deficit was \$805 billion in 2005, almost 7 percent

of GDP; while the fiscal deficit was \$319 billion), and huge and growing surpluses, as mentioned, in Asia. China is a particular focus of concern since it ran a merchandise trade surplus with the U.S. of \$202 billion last year. American lawmakers have threatened that unless China lets its currency appreciate significantly more than the 2 percent upward adjustment agreed last July, they will enact punitive tariffs against Chinese imports.

Less powerful and poorer countries incurring deficits, such as those being run up by the U.S. for the last several years, would become vulnerable to speculative attack, capital flight, and an emergency IMF bailout, replete with belt-tightening conditionality. However, when it comes to larger, more powerful countries, such as the U.S. or even China, the IMF does not have much leverage. In the case of the U.S., until and unless it succumbs to a financial crisis (which experts fear will inevitably happen unless there is a course correction) it has no incentive to change. Unfortunately, if a crisis of confidence sinks the U.S. dollar, it threatens to pull down much of the rest of the world as well. Moreover, the IMF barely had sufficient resources to deal with the Asian financial crisis, which would pale in comparison with a world crisis radiating from a meltdown in the U.S. So it is unlikely that anything will change, particularly with respect to the U.S. macroeconomic situation, until and unless there is a crisis, and then we are all in deep trouble.

The second problem of global governance relates to the Bretton Woods institutions themselves. The problem is that the leading industrial powers—the United States, Europe, Japan, and Canada—have a disproportionate voice in the Fund and the Bank by virtue of their voting systems, which reward relatively rich member countries. Europe is particularly over-represented: for example India, a country of over a billion people, has a voting share of 1.92 percent while Belgium, population 11 million, has 2.13 percent; China, with a population over 1.3 billion, has 2.94 percent compared to the Netherlands' 2.38 percent for a country of 15 million. In effect, the industrial countries control both institutions, and have a decisive influence on their policies, which explains why reforms demanded by the developing countries seldom get much of a hearing.

They also control the selection of the chief executive officer at both organizations: there is an unwritten but flatly indefensible rule that the United States selects the President of the World Bank and that the Managing Director of the IMF is a European. (Paul Wolfowitz was the controversial choice of the Bush Administration to head the World Bank last year.) Clearly, these appointments should be made on a much more transparent basis, open to the most qualified individuals from all member countries.

Voting shares at the Bretton Woods institutions do not reflect current realities. If emerging powers such as China, India and Brazil, as well as other under-represented countries such as Korea, Malaysia, Thailand, Turkey and Mexico, were to be given appropriate voting shares, the industrial countries' collective voting power would fall from over 60 percent to under 50 percent. Developing countries, with 85 percent of the world's population, would have a slim majority. That would alter the perception, and also the reality, that the industrial countries absolutely control the Fund and the Bank. However, there would also have to be measures to bolster the participation of the poorest

countries, particularly the 43 countries in sub-Saharan Africa, which are perhaps the least-well served members.

There is a good chance that some changes in the governance structure will take place. The silver lining in all this may be that if China and other emerging market countries were to be given their proper voice through voting adjustments in the Bretton Woods institutions, a bargain is conceivable in which the Chinese take a more flexible approach to managing the exchange rate (letting the yuan float upwards more substantially). However, we should be under no illusion: floating the Chinese yuan will not, by itself, resolve the world's huge global imbalances. The latter will require dramatic action by the United States to increase savings and curb consumption.

What reforms are needed?

Notwithstanding the need for deep-seated reforms to global governance, the global economic organizations must be reformed because they have made some serious mistakes over the last two decades. These include the aggressive promotion of economic liberalization with little regard to distributional impact. The IMF and World Bank also encouraged the accumulation of debt (much of it owed to the Bretton Woods institutions themselves) to the point where the debt overhang became an obstacle to the borrowing countries, requiring deep debt relief or cancellation. In the 1980s such policies came to be known as structural adjustment, and in the 1990s, as “the Washington Consensus”. There is increasing evidence that such policies have contributed to the widening inequalities within countries and between the richest and poorest countries.

By the end of the 1990s, it became clear that although there is agreement that certain macroeconomic policies are essential to ensure stability and growth, there is little consensus on a number of contentious liberalization policies such as privatization, deregulation, labour market policy, exchange rate policy, and capital account liberalization. However, there did seem to be a consensus that for any set of economic and social policies to be politically viable, there has to be a sense of “ownership” – in other words, the policies should spring from within each country, rather than being imposed by outside agencies such as the IMF and World Bank.

Given this history, reforms are needed in formulating economic and social policy and in interacting with borrowing countries. If the Fund and the Bank are serious about ownership, they should be prepared to support economic policies that work for each country. They should be prepared to support a diversity of economic and social policies when it comes to issues such as government ownership in the economy or labour market policy. For example, they should not oppose controls on capital flows as a legitimate way of tackling volatility and financial crisis.

To do this properly will require a change of behaviour for the IMF and World Bank. Instead of preaching “appropriate policy”, they need to listen to and work with their member countries—their governments, civil society, and the private sector—to understand local opportunities and constraints and to help design policies that fit these

circumstances. In short, the Fund and Bank should behave more like cooperatives, at the service of their borrowing members, rather than bankers making loans to “clients.”

However, the global economic organizations must also bring to the discussion goals and objectives recognized as universal. In discussing policy options with borrowing countries, the key questions for the IMF and World Bank should be: First, do a country’s policies support the principles of the Millennium Declaration and help toward the achievement of the Millennium Development Goals, which include a substantial reduction in poverty and hunger over the next decade? Are the benefits of economic growth enjoyed at least as much by the poor as by the rich? Is development sustainable in the sense that it meets the needs of the present without compromising the ability of future generations to meet their own needs? If the answer to these questions is yes, then the Fund and the Bank should be supportive of policies commanding domestic ownership even if they diverge from policies preferred in Washington, in Europe or in Canada.

The World Bank particularly faces the challenge of fostering growth and poverty reduction in the world’s poorest countries. There are no easy answers in these countries. The problem is that the World Bank (and IMF, which is involved to a lesser degree) and, for that matter, the donor community as a whole, do not have any universally applicable blueprints. Also, there are many more factors involved in development than external aid, which may not be as important as trade, foreign investment, and international migration. However, the World Bank is a strategically critical actor in its influence over developing countries’ domestic and external policies. In view of the limited success of the Washington Consensus, the Bank needs to allow poor countries as much “policy space” as possible and help them to find the appropriate policies given their opportunities and constraints.

There is much more to be said on the reform of the IMF and the World Bank. For example, both organizations need to be made more accountable for the impact of their policies, not just to the taxpayers in donor countries, but more especially to the poor in developing countries. However, one issue that needs much more attention is the lack of coordination between the Bretton Woods institutions and other international organizations, particularly the United Nations family. Some halting steps have been made since the 2002 International Conference on Financing for Development held in Monterrey to bring the Bretton Woods institutions, the WTO and the UN into a single policy framework.

More can also be done to deepen the relationship with regional organizations such as the regional and sub-regional development banks, and with regional monetary cooperation. In an increasingly complex global environment, we should encourage greater subsidiarity, with the allocation of greater responsibilities and resources through regional and sub-regional entities. The global organizations should be at the apex of a network of cooperative institutions that work closely together on common objectives.

Canada’s role

Let me conclude with some thoughts on where Canada stands in all of this. Canadians like Louis Rasminsky (who among other things was Governor of the Bank of Canada from 1961-73 and subsequently Chair of the IDRC Board) were active at the 1944 Bretton Woods conference and Canada has always been an enthusiastic member of the IMF and World Bank ever since.

It is important to note that today member countries are typically represented in the IMF and World Bank through their Departments of Finance, which goes a long way toward explaining the culture of the Bretton Woods institutions. That is certainly true in Canada's case. Our Minister of Finance is Canada's representative at the Fund and Bank Boards of Governors, and the Finance Department typically selects an Executive Director to represent Canada's day-to-day interests at each institution in Washington. The Bank of Canada also has an active interest along with Finance in IMF policy issues.

This actually means the Finance Department plays a much larger role than is commonly realized in formulating Canada's development and international economic policies. It contributes about 10 percent of the aid budget through contributions to World Bank's aid facility, IDA. It also plays the lead role on debt relief issues. More important, the Department is the lead in instructing Canada's Executive Directors at the Bank and Fund, where key development and international economic policies are shaped.

In this context, much more needs to be done to integrate the Finance Department into Canada's international policymaking to make it more coherent across all departments and agencies. In the International Policy Statement issued by the federal government in 2005, it is worth noting that there were chapters contributed by CIDA, Foreign Affairs, International Trade and Defence, but none from Finance, despite its important role in the international arena.

To its credit, the Department has ongoing discussions with civil society organizations in regard to discussions at the Bank (but not at the Fund), a practice begun when Paul Martin was Finance Minister and being continued by Minister Jim Flaherty. As I mentioned, the Bank of Canada has recently become vocal about the need to reform the IMF. However, there has been far too little public discussion about IMF reform in Canada or indeed internationally. I would urge Minister Flaherty to seek input from the Canadian public and also to advise the IMF's Managing Director Rodrigo de Rato to engage others than Central Bank and Finance officials in discussions about the future of the Fund.

This may be a rare opportunity to reform the IMF and World Bank. However, let us hope that it does not stop there. There are parallel reform initiatives at the UN—CIDA's President Robert Greenhill is on a High-Level Panel appointed in February by Secretary-General Kofi Annan. The panel is seeking ways to enhance UN-System-Wide Coherence in Development, Humanitarian Assistance and Environment. It would be an opportunity missed if the Bretton Woods institutions were not included in this panel's recommendations.

By virtue of its long-standing enthusiasm for and involvement in the world's multilateral system, Canada should be a leader in calling for system-wide coherence, so that reform in the Bretton Woods institutions would be part of a larger plan of reform, including the UN and its specialized agencies. Now is the time; the window of opportunity may not be open for long.