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The International Monetary Fund 2015

Reform Needs and Options

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The International Monetary Fund 2015. Reform Needs and Options

The concentration on security problems in the first decade of the twenty-first century has curtailed the efforts of the global community to improve the stability of the international financial system. This is regrettable as the current phase of relative financial market stability offers an ideal environment to carry out a fundamental reform of the so-called international financial architecture.

The Asian crisis of 1997–98 impressively demonstrated the international community's difficulties in addressing the problem of financial crises. It was precisely the international community's main instrument for preventing and arresting such crises—the International Monetary Fund (IMF)—that proved to be a less than convincing crisis manager. That a comprehensive reform of the IMF is urgently needed was most recently underlined by Mervyn King, the governor of the Bank of England, in his highly regarded speech before the Council for Research on International Economic Relations on 20 February 2006 in New Delhi.

In reaction to the experience of the Asian crisis, the IMF introduced several suggestive reform initiatives. The regular publication of "Reports on the Observance of Standards and Codes" and the "Financial Sector Assessment Program" has led to considerable improvement in both the quantity and quality of the information about the economic and financial environment in IMF member countries. The adoption of the "Guidelines on Conditionality" and the "Framework for Exceptional Access" is another important step towards a more transparent and efficient lending process. However, despite this welcome progress, a fundamental institutional reform has not been undertaken to date. Such reform is, however, urgently necessary to enable the IMF to fulfil its core tasks more effectively and to prevent it from losing its influence on the economic policies of its member states.

This study sketches out a proposal for reform to increase the Fund's effectiveness in preventing and arresting financial crises and at the same time would maintain its ability to make available comprehensive financial data and advise its members on economic policy. The following recommendations comprise the core of this proposal:

- The IMF should introduce a graduated membership consisting of a basic membership that is open to all present members and a privileged membership that can only be awarded if additional conditions are met. Basic membership would include access to current IMF advisory services as well as credit up to the current limit of 100 to 300 percent of their deposits at the IMF. Credit beyond these amounts would only be awarded to privileged members who, by meeting clearly defined qualifications, have demonstrated a modicum of economic and financial market stability.
- Qualification criteria for privileged membership should be selected such that if met they would ensure a sustainable level of public indebtedness as well as a relatively healthy financial sector. For only if both of these are satisfied is it possible for the IMF to arrest a financial crisis by providing temporary, but generous liquidity assistance. If, however, these prerequisites are not met, the IMF should not grant loans but instead support the country in a restructuring of its external debts or in reforming its financial sector.
- Three criteria should be met by a privileged member as proof of sustainable public indebtedness. The level of its entire debt should not exceed 30, 45 or 60 percent of the gross domestic product (GDP) as defined in the "Debt Sustainability Framework," Secondly, short-term public debt in foreign currency should not be more than 25 percent of the entire external debt burden. Thirdly, privileged members should maintain considerable currency reserves to meet short-term foreign currency liabilities of their banking and public sectors.
- To guarantee a minimum of financial sector stability, privileged membership would be subject to the satisfaction of additional qualification criteria. First, the national supervisory authorities of privileged members should ensure that appropriate standards of capital are met and sufficient cash reserves are held by financial institutions operating in their banking sectors. Secondly, these members should agree to open their financial sectors to domestic and foreign competitors following an appropriate transitional period.
- To ensure universal co-operation amongst its members for the years to come, the Fund's loss of legitimacy must be restored. In this respect a reform of the distribution of voting rights in the decision-making bodies of the IMF is inevitable. Voting weights of emerging and developing economies in Asia and Africa should be increased to just under 50 percent at the expense of western industrial states while their under-representation on the Executive Board should be remedied.
- Germany's presidency of the G8 in 2007 offers a good opportunity initiate renewed efforts for the overdue reform of the Bretton Woods institutions in general and of the IMF in particular. The current phase of relative financial market stability provides an ideal opportunity for a fundamental reform of the international financial architecture. By initiating a new reform initiative, Germany would not only contribute to improve the stability of the global financial system, also demonstrate its willingness and ability to take on responsibility at a global level.

Introduction

As a result of the positive development of particularly Asian and Latin American economies, the debate about a reform of the international financial architecture seems to have lost its urgency. This is problematic in that the two factors that have contributed to this positive development will not necessarily last. Sooner or later low interest rates will start to rise while there is no guarantee that the high valuation of raw will be upheld. The weakening of the debate is also regrettable considering that the current phase of relatively stable financial markets provides an ideal environment to introduce comprehensive reforms free of external pressure to act. That a reform of the so-called international financial architecture is necessary has been demonstrated by the financial crises of the past decade. The economic consequences of these crises were not only painfully experienced by the people of the emerging economies affected; western industrial nations alike witnessed sharp declines in asset values as a result of the instability of international financial markets.

Especially the Asian crisis of 1997–98 and follow-up crises in other emerging economies underlined that the international community struggles to adequately address the problem of financial crises. As a result of this experience numerous initiatives to improve international financial market stability have been instigated. Many suggestions aimed at general measures such as the development of transparency standards, the taxation of financial flows or efforts to reduce exchange rate volatility. Others are designed to strengthen the effectiveness of existing instruments both in the prevention and in the management of financial crises. As the most important institution to promote the stability of the global financial system, the International Monetary Fund has been at the centre of the reform efforts.

This study will sketch out the most important challenges facing the IMF and propose ways of improving its ability to deal with these challenges. First of all it will indicate the main problems arising from the Fund's current lending policies. Following will be an outline of the two most comprehensive reform proposals developed by expert commissions in response to the Asian financial crisis Subsequently, the most important reforms that have been implemented by the IMF since then will be discussed. The subsequent chapter defines the Fund's central tasks in fulfilling its original mandate in today's economic and financial environment. It is followed by reform proposal aimed at strengthening the Fund's ability to carry out these tasks effectively.

Previous Reform Approaches

Since its founding in 1944 the core mandate of the IMF has been to guarantee the stability of the international currency and financial system and thus create a basis for sustainable economic growth. To this purpose it monitors economic policy, provides technical support and grants loans. Within the framework of its loan granting function, the IMF provided short-term credit to cover trade deficits up to the 1970s and thus facilitated a stable system of fixed exchange rates widely seen as the prerequisite for the strong economic growth between the 1950s to the 1970s. With the end of the Bretton Woods system and the rise of transnational capital flows, this form of lending lost in importance, as the stability of the international financial system was threatened primarily by distortions in the capital account of individual economies. Since the mandate to promote international market stability was retained, the IMF extended its responsibilities to respond to the new demands for the prevention and management of not only balance of trade but also of capital account crises. The need for fundamental structural reform was particularly evident during the efforts to overcome the Latin American debt crisis in the 1980s. It led the IMF to extend the requirements with respect to monetary and fiscal policy that its member had to fulfil in order to access IMF funds. It is primarily this development that led to the difficulties the IMF encountered in the Asian crises and that touched off the debate about a reform of the Bretton Woods institutions.

The main problem areas

Criticism to the Fund 's handling of the Asian financial crisis has been diverse; it can be divided into two main points of contention.[1] Firstly, the IMF did not recognise the danger to the Asian economies on time and failed to point out the problems to the governments concerned. Secondly, its strategies to deal with the crises contributed at least in part to reinforcing them in Thailand, South Korea and Indonesia: thus the restrictive and pro-cyclical financial, monetary and structural requirements, which were based on the Washington Consensus, intensified the negative economic development while the late, and partially incorrectly overdrawn description of their economic problems contributed to undermine the already weakened trust of international investors.

The Fund's controversial lending policies and its deep interventions in the sovereignty of its clients has undermined the trust in the Fund among many of its members. The fact that the large majority of IMF members holds only a fraction of the voting rights of western Industrial nations and so see little possibility to influence its policies reduces the institutional legitimacy of the IMF even further. As a result of this loss in legitimacy, important emerging economies are increasingly turning away from the IMF and are searching for alternative approaches allowing them to address future crises more effectively and independently. The most important emerging economies in Southeast Asia have continued to expand their currency reserves in the past few years and have increased their participation in regional monetary co-operative efforts.[2] In 1997 Japan's suggestion to create an Asian liquidity fund was welcomed by members of ASEAN as well as by South Korea, and only prevented by massive pressure from the United States and China. Both developments point to the fact that East Asia's emerging economies want to avoid being dependent on IMF assistance in case of a liquidity crisis. At the same time, East Asia's build-up in currency reserves signals that their trust in the effectiveness of the Fund and in the implementation of the necessary reforms has weakened substantially.

1 For a more complete discussion, see Padma Desai, *Financial Crisis, Contagion and Containment: From Asia to Argentina*, Princeton, N.J.: Princeton University Press, 2003, and Heribert Dieter, *Die Zukunft der Globalisierung*, Baden-Baden: Nomos Verlagsgesellschaft, 2005.

2 See Philipp Lipscy, "Japan's Asian Monetary Fund Proposal," in: *Stanford Journal of East Asian Affairs*, Vol. 3, No. 1, 2003, p. 94.

Table 1
Currency reserves in East Asia (billion US dollars)*

	2002	*2003*	*2004*	*2005*
China	291	408	615	822
Hong Kong	112	118	124	124
Indonesia	31	35	35	33
Malaysia	34	45	66	80
Philippines	13	14	13	16
Singapore	82	96	112	116
South Korea	121	155	199	210
Thailand	38	41	49	51
Total	723	912	1212	1451

* The figures have been rounded off.

Source: Joint BIS-IMF-OECD-World Bank Statistics, April 2006.

The IMF's loss of legitimacy and the resulting loss of influence amongst many of its members is problematic in many respects. For despite its handling of the Asian crisis, the IMF remains the international community's most effective to prevent and arrest financial crises. No other institution has anywhere near its experience in dealing with financial crises, its macroeconomic know-how and its financial resources. Moreover, its technical advice and monitoring of economic policies are indispensable for the stability of the international financial system. If members begin to turn away from it, the Fund will continue to lose in importance, thereby not only hurting its effectiveness as crisis manager but also its role as advisor in terms of responsible and sustainable economic policy. The result would be a continued erosion of the stability of the international financial system. Surely, some members are in a position to reduce the risks of liquidity crises by building up currency reserves; but unilateral actions of this sort involve considerable costs: Currency reserves of a billion US dollars mean a year's loss of revenue yields of between 25 and 60 million US dollars.[3] For an economy the size of China's with currency reserves of more than 800 billion US dollars this amounts to opportunity costs of up to 48 billion US dollars per year: an amount that especially in emerging and developing economies could be used more for alleviating poverty and for fostering economic development.

3 See World Bank, *Global Development Finance 2005*, Washington, D.C. 2005, p. 60. The estimates of the World Bank are based on an assumed average interest difference between two-year US Treasuries and comparable emerging market bonds on 250 basis points. On the basis of an interest difference of 6 percent, Dieter even expects opportunity costs of up to 60 million US dollars for each billion of currency reserves in foreign government bonds. See Dieter, *Die Zukunft der Globalisierung* [and fn. 1], p. 286.

Existing reform proposals

The downward trend of the IMF's influence and legitimacy is not irreversible. A fundamental reform of the decision-making structures of the Fund and in particular its lending policies would not only stop but even reverse this trend. This, however, would require an improvement in the Fund's effectiveness as crisis manager while retaining its legitimacy as economic-policy advisor to the governments of its member states. In the wake of the Asian crisis, several proposals for reform of the IMF have been developed. The two most important stem from an expert commission of the Council on Foreign Relations and from the so-called Meltzer Commission, which was appointed by the US Senate. Although already presented at the end of the 1990s, their final reports include the most important concepts for a reform of the IMF that have been developed up to now. In none of the other numerous contributions to this topic have there been such detailed and comprehensive recommendations for a thorough reform of the lending process of the IMF as in the final reports of the Meltzer Commission and the Task Force of the Council on Foreign Relations. Despite the Fund's internal reform initiatives, its core demands have not been implemented so far even though none of them has lost its relevancy.

In addition to renowned economists, such as Barry Eichengreen, Paul Krugman und Martin Feldstein, representatives from the public sector, including the former head of the Federal Reserve, Paul Volcker, and from the private financial sector (George Soros, Maurice Greenberg) were appointed to the expert commission of the Council on Foreign Relations. The recommendations of the Task Force on the Future of the International Financial Architecture are aimed at encouraging emerging economies to further increase their efforts to prevent crises and to achieve a fairer burden-sharing between debtors and both private and public creditors. At the same time, capital flows into the most profitable regions of the world are to be upheld and promoted thereby allowing industrial nations contribute to the efforts for improving the stability of the global financial system.[4]

The recommendations also demand the IMF to publish reports on the maintenance of transparency standards and the sustainability of economic policy of its members. This is meant to help emerging economies pursuing a sustainable and transparent economic policy profit from improved access to international capital markets and better conditions on IMF loans. To counter the risks arising from short-term capital flows to economies with underdeveloped financial sectors, it is suggested that the IMF, in light of the advantages of a temporary taxation of short-term capital flows, should eliminate the current incentives for such capital flows as contained in the Basel II Accord. To strengthen market discipline and to promote a fairer burden-sharing between creditors and debtors in the case of default, so-called collective action clauses should be obligatorily inserted into sovereign bonds contracts. These clauses stipulate that creditors need no longer to unanimously agree on a restructuring but that a majority vote may suffice. In addition the IMF was advised to limit its loans to countries in a position to eventually emerge from their balance of payments difficulties.

The Task Force explicitly rejects fixed exchange-rate regimes in emerging economies and recommends that the IMF strictly exclude the support of such systems. This is justified primarily by the fact that in the past economies with fixed exchange-rate systems faced financial crises far more often than those with more flexible systems. In addition, the Task Force recommended that loans granted to emerging economies should be maintained with their existing range of between 100 and 300 percent of their IMF quota and to go beyond that level only in case of system-threatening crises. This would require a large majority of creditors to confirm the existence of such characteristics, but once established loans should be paid out quickly and without any additional conditions. In general, the IMF should focus its efforts on crisis prevention and cut back considerably on its loan-granting function. Whereas the Fund should monitor and promote responsible fiscal, monetary and exchange rate policies as well as the stability of local banking and financial sectors, structural reform initiatives should be returned to the field of activities of the World Bank.

An additional, often-discussed proposal was made by the International Financial Institutions Advisory Commission created by US Congress in connection with the final increase of quotas. In March 2000 the Meltzer Commission, named after its chairman, economist Alan Meltzer, published its final report. It includes detailed reform proposals not only for the IMF and the World Bank but also for the World Trade Organization, the Bank for International Settlements and regional development banks. Like the recommendations of the Task Force, the proposals made by the Meltzer Commission are aimed to achieve several goals: to strengthen the international financial system, to improve the functioning of global financial markets and to offer effective incentives for responsible economic policy. According to the Meltzer Commission the IMF should limit its activities to three areas: First, as an international lender of last resort, it should award short-term loans to solvent members who are facing balance-of-payment problems. Secondly, it should collect, process and publish comprehensive data on the economic and financial situations of its members. And thirdly, it should continue to monitor the economic policy of its members as part of annual consultations and develop non-binding suggestions for improvement.

The reform proposal of the Meltzer Commission is radical in that it recommends giving up the aim of universal IMF membership and limits it to those countries that fulfil certain qualification criteria. Apart from the members' obligation to provide regular detailed reports on their economic and financial situation, the Meltzer Commission defined a number of additional requirements: For one, member governments should ensure the stability of the banking sector by implementing appropriate capital standards for financial institutions. Secondly, they should meet certain requirements as defined by the IMF with regards to fiscal policy and open their financial sectors to foreign competitors. The latter demand is justified primarily by a number of empirical studies showing a positive correlation between openness and the financial sector stability. Countries that meet these criteria and qualify for membership would receive generous liquidity assistance without having to fulfil additional requirements. The time period for short-term loans would be limited to 120 days and could be extended in exceptional cases by the same time period once only. In addition, interest applicable for

4 See *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture.* Independent Task Force Report, New York: Council on Foreign Relations, 1999.

IMF loans should be set above the market rate to avoid potential moral hazard problems. For the same reason the commission insisted that IMF loans should not be used to prevent insolvent businesses from going bankrupt or to avert losses for foreign creditors.

Reforms implemented since the Asian crisis

As a reaction to the Asian crisis and to the strong criticism that the IMF encountered as a consequence, a series of reform initiatives were launched and also under the helm of former managing director, Horst Köhler. As a result the IMF has over the past few years, become a much more transparent institution and focused more strongly on its core tasks. By introducing the regular "Reports on the Observance of Standards and Codes" and the "Financial Sector Assessment Programs," both the quantity and quality of information on the economic and financial situation of its members has improved considerably.

Even in terms of transparency and the effectiveness of its lending policies, improvements have been made. The "Guidelines on Conditionality," as passed by the Executive Board in 2002, are aimed at reducing the excessive number of requirements connected with the awarding of loans and have been focused on the original core competencies of the institution.[5] The reformed conditionality policy is based on several principles. Firstly, they require to bring about a stronger identification of borrowers with the reform programmes which in turn should be tailored more closely to the individual needs of member countries. Secondly, in general fewer and clearer, rule-based requirements should be defined for IMF stability programmes. Furthermore, continuous efforts are made to coordinate lending and conditionality policies with the activities of other international financial institutions, especially the World Bank.

With the "Framework for Exceptional Access," also adopted in 2002, the lending decisions of the IMF were made more transparent for member nations and for financial market actors.[6] The guidelines defined in the framework stipulate that liquidity assistance beyond the normal amount should only be granted in case of capital account crises.[7] Moreover, when awarding loans there should be a high probability that the borrower can service the increased debt burden and that he will be likely to gain access to capital markets in the near future. Loans above the normal upper limits should only be granted when the government of the receiver country credibly commits itself to implementing the necessary economic reforms, and if it is institutionally capable of doing so.

A substantial improvement in the ability of the IMF to handle financial crises effectively could also have be attained by a successful implementation of the so-called Contingent Credit Lines (CCL).[8] This credit instrument, introduced by the IMF in 1999, was developed especially for those countries that despite pursuing sustainable and responsible economic policies are nevertheless subject to massive capital outflows as a result of contagious crises in other economies. In such a situation Contingent Credit Lines would have opened the possibility to take advantage of short-term but substantial liquidity assistance from the IMF.

Access to these borrowing facilities was reserved exclusively for countries following a sustainable economic policy and requiring IMF assistance exclusively as a result of so-called contagion. At the same time they were to prove over a longer period of time that they meet internationally recognised standards and maintain a positive relationship with their private creditors. An additional qualification required that potential borrowers implement a reform programme supported by the IMF. Meeting these criteria would have resulted in providing responsibly governed countries with access to substantial liquidity assistance in the case of crisis. Loans with the framework of the CCL would have had a maximum maturity of 12 to 18 months and be subject to an interest premium of between 1.5 to 3.5 percent above the market-based IMF rate.

Despite an improvement in the conditions, the IMF withdrew these preventive borrowing facilities in 2003 after not one single member nation expressed interest in taking advantage of them. The main reason for the

5 See *Guidelines on Conditionality*, Washington, D.C.: IMF, September 25, 2002.

6 See *Access Policy in Capital Account Crises.* Report prepared by the Policy Development and Review and Treasurer's Departments, Washington, D.C.: IMF, July 29, 2002.

7 In comparison to financial crises that arise because of distortions in the balance of trade, balance of capital crises are the result of sudden but massive capital outflows. Whereas trade balance crises can be stemmed by manageable credit assistance, considerably more funds are needed to cope with balance of capital crises.

8 See *The IMF's Contingent Credit Lines (CCL). A Factsheet*, Washington, D.C.: IMF, 2004, http://www.imf.org/external/np/exr/facts/ccl.htm.

lack of demand may be found in the concern of potential applicants that expressing interest would result in mistrust arising in the financial markets. Furthermore, the conditions of the liquidity support within the framework of the CCL were not attractive enough to arouse sustainable interest on the part of IMF members. Finally, meeting the qualification criteria would not have automatically led to access to ample liquidity assistance from the IMF, as this help would have nevertheless required a positive vote in the Executive Board.

Although the reform measures sketched out above would no doubt have resulted in improvements, the central points of the reform proposals of both Task Force and Meltzer Report have remained unfulfilled. The IMF neither limited its loans to the ceilings laid down in its statutes nor did it reform its conditionality policy and replace the principle of ex-post with that of ex-ante conditionality. This is not surprising considering that both reform proposals would have massively cut back the ability of the members with the highest voting shares to orient the lending policies on national interests.

However, the recommendations of the Council on Foreign Relations and the Meltzer Commission are only partially suited to improve the effectiveness of the IMF in executing its two central tasks—crisis prevention and crisis management. The proposal to eliminate extensive liquidity support in general would considerably hamper the effectiveness of the IMF in its crisis management. The recommendation of the Meltzer Commission—to award IMF membership only to fundamentally stabile economies—would undermine the principle of universal membership and thus impair the effectiveness of the IMF in crisis management. Both—crisis prevention and crisis management—are, however, indispensable to improved the stability of the global financial system.

Present Tasks of the IMF

If the IMF is to contribute to an increased stability of the international financial system, it must be able to fulfil two central tasks. Firstly, it must strengthen the resistance of its member countries to financial crises by providing technical advice on economic and monetary policy and by monitoring the economic development of its member countries. Secondly, it must manage crises that nevertheless arise by implementing an effective lending policy. Furthermore, its monitoring and advisory function and its lending policies should be designed in such a way that IMF members receive strong incentives to pursue responsible and sustainable economic policies.

Surveillance and advisory activities

Thanks to a number of reforms implemented since the mid-1990s, the IMF has met its monitoring and advisory function to a satisfactory degree. To secure this function for the future, it is important to achieve nearly universal membership in the IMF. It is thus necessary to halt the Fund's gradual loss of influence and to strengthen its legitimacy in the eyes of its members.

The legitimacy of the IMF has been considerably undermined by its controversial decisions handling of the Asian crisis. The affected economies, especially South Korea, felt that the Fund's conditionality policy was not only economically counterproductive but also an unjustified intervention into its sovereignty. In large parts of South Korean society, the view is held that many of the conditions that the IMF set for granting financial assistance reflected the demands of certain interest groups within western industrial countries, especially the financial sector. The lack of identification with implemented reform programmes during the Asian crisis is expressed in a speech delivered by the then Korean minister of finance to his people:

"I have come here to beg the forgiveness of the Korean people [...]. Please understand the necessity of the economic pain we must bear and overcome [...]. These pains and burdens are the cost our economy has inevitably to pay to revive and to recover our lowered credibility in the world finance society."[9]

The distribution of voting rights within the IMF is felt by a large proportion of its membership to be unrepresentative and unfair which has further undermined the Fund's legitimacy. The leading industrial nations of the western world—the US, Japan, Germany, France, the UK, Italy and Canada—hold just under 47 percent of total votes in the Executive Board where most important decisions about awarding loans are made. If the voting rights of Belgium, The Netherlands and Norway are added, the western industrial states, all of whom are creditors of the IMF, control more than 60 percent of votes. They are consequently in a position to veto all decisions taken in the Executive Board.

This means that proposals that are in the interest of all the other 174 members of the IMF have no chance of realisation if ten western industrial states oppose them. The Executive Board of the IMF is made up of 24 directors: 13 are nominated by industrial nations although this group only comprises 20 of the 184 members of the Fund. Most members of the IMF form groups and select a single director to represent them. As a result Belgium is represented by a director casting 5.2 percent of total votes whereas 44 African countries are represented by only two directors holding a total of just 4.4 percent of votes. As former executive director Cyrus Rustomjee underlines, this imbalance weakens the effectiveness and legitimacy of the IMF as well as the identification of debtors with reform programmes and thus creates bitterness among the majority of the members:

"The current margin of voting share in favour of creditors beyond that required to ensure a simple majority strikes at the foundation of the principles of collaboration and consensus decision-making upon which the IMF operates. It weakens the institution's legitimacy, erodes ownership of programs and policies by the collective membership, offers no tangible

9 Quoted in: Andrew Pollack, "Package of Loans Worth $55 Billion Is Set for Korea," in: *The New York Times*, December 4, 1997; see also Paul Blustein and Sandra Sugawara, "Seoul Accepts $55 Billion Bailout Terms," in: *The Washington Post*, December 4, 1997.

benefit to the collective membership, and has bred understandable resentment in the debtor group."[10]

To revitalize its legitimacy and in the interest of the effectiveness of its reform programmes, it is not only desirable but also absolutely necessary that a new distribution of IMF voting rights be implemented soon. To strengthen the Fund's institutional legitimacy, the voting share of developing and emerging economies, particularly those of the fast-growing Asian economies, must be increased considerably. This is only possible by reducing the voting share of the European member states. The most consistent, yet at the moment politically least realisable step, would be to combine the directorships of the euro-area countries in the Executive Board to a single EU seat with a proportional voting share.

If the most important creditor states of the IMF are not willing to give up their absolute majority in the Executive Board, the voting share of emerging and developing economies should be raised in an initial step to at least just under 50 percent—at the expense of the overly represented European members. Although the legitimacy deficit in the decision-making structures of the IMF would not be completely remedied, it would be reduced. The creditor nations have at least signalled their willingness to consider an increased representation of emerging and developing economies.

Overview 1
Guidelines for effective forecasting and advisory activities

Guideline 1
To ensure effectiveness and transparency, the IMF should only continue those activities that are required for it to fulfil its central mandate.

Guideline 2
In the interest of a successful continuation of its forecasting and advisory activities, the attractiveness of IMF membership must be maintained and the institutional legitimacy of the IMF strengthened.

Guideline 3
To maintain the trust in its forecasting and analyses, the financial situation of the IMF must continue to be linked with the quality of its own assessments.

Guidelines for surveillance monitoring and advisory activities

To properly carry out its tasks of advising on economic policy and making available detailed and well-founded information and evaluations on the economies of its members, the IMF should base its activities on the three principles listed in Overview 1.

The IMF cannot carry out its monitoring and advisory functions nor provide comprehensive and well-founded information about the economies of its members if they do not co-operate. The continued co-operation of sovereign member countries can only be secured with incentives that make a comprehensive co-operation with the IMF attractive. This means that the IMF can neither limit lending to those members who are particularly important for the stability of the international financial system nor to otherwise solvent members who face temporary liquidity problems.

The attractiveness of IMF membership and incentives to encourage the comprehensive co-operation of its members is undermined by the present legitimacy deficit of the IMF. To reduce this deficit, a reform of the distribution of IMF voting weights is absolutely necessary, a reform that would give both developing and emerging economies additional voting rights at the expense of the industrial nations. A reform of this sort can only be accepted politically if the possibility of a veto for the creditor countries is maintained for all major decisions. Since, however, only a simple majority is required for loan decisions, reform should be aimed at raising the voting rights of emerging and developing economies to just under 50 percent and the under-representation of Asian and African economies eliminated in the Executive Board.

To maintain the trust of international investors in the economic forecasting and assessments of the IMF, incentives must exist to encourage the IMF to perform realistic and quality assessments. Until now the credibility of its forecasts rely on the fact that the IMF itself faces a financial risk when lending to its members. The Fund must therefore continue to grant loans to members in crisis to ensure the credibility of its forecasts even if this is not absolutely necessary for preventing and managing financial crises. If an appropriate conditionality policy is upheld, the IMF will be able to continue to foster the implementation of eco-

10 Quoted in: Cyrus Rustomjee, "Why Developing Countries Need a Stronger Vote," in: *Finance & Development* (Washington, D.C.: IMF), (September 2004), pp. 21–23 (23).

nomic reforms by the governments of its member nations.

At the same time, for reasons of efficiency and transparency, it is important to avoid an overlap with the activities of other institutions. The IMF should therefore limit its activities to those areas that are necessary for the fulfilment of its mandate. Activities that are not effective in terms of crisis prevention or management or are not necessary for the fulfilment of its monitoring and advisory activities should be discontinued and left to other institutions.

Lending policy in liquidity crises: The IMF as lender of last resort

To improve the effectiveness of the IMF in addressing capital account crises, a comprehensive reform of current lending policy is imperative. In the process it must be assured that substantial liquidity support only be granted if this contributes to a long-term solution to the crisis. As the example of Argentina has shown, this is not the case for every kind of financial crisis but only for liquidity crises. The difference between crises of liquidity and solvency is of central importance in this respect.

If an institution or economy is experiencing a *liquidity crisis*, it *temporarily* lacks sufficient liquidity to fulfil its short-term financial obligations. In the long term, however, the sum of all foreseeable inflows exceeds the sum of future obligations. In a liquidity crisis short-term loans can thus prevent a default as the institution or economy is solvent in the long term and can pay its obligations at a later point in time. A *solvency crisis* is different: here the sum of all obligations exceeds the sum of present and future inflows of capital. At best short-term loans will delay the default but will not prevent insolvency as at a later point in time the institution or economy will inevitably struggle to discharge all of its obligations.

For this reason the management of solvency crises requires, as in the case of Argentina, a restructuring of its public debts; temporary loans are not sufficient for a lasting solution. To contribute to a successful management of a liquidity crisis, short-term funds in the required amount must be paid out as quickly as possible. At the same time it is important to ensure that the existence of such loans does not act as an incentive to reach overly risky lending or borrowing decisions.

An institution that fulfils these functions is referred to as a lender of last resort. To secure the stability of domestic financial systems, the central bank normally takes on the role of the lender of last resort for a national economy. In case of a bank run—a situation in which as a result of a loss of trust in a bank, its customers withdraw their savings and thus temporarily endanger the solvency of the bank—central banks grant solvent financial institutions that face temporary liquidity gaps substantial credit and thus protect them from insolvency. The function of a lender of last resort is important in that the insolvency of an individual bank often leads to the insolvency of other financial institutions and also of non-financial enterprises, resulting in loss of growth and increasing unemployment. Often, however, the mere existence of a lender of last resort can contribute to strengthening the trust of savers in the banking sector and thus prevent a run on banks from the outset.

It is conceivable that a comparable institution could promote the stability of the international financial system. Not only former IMF deputy director Stanley Fischer pointed out the positive role that a lender of last resort could play for the international financial system;[11] also the Meltzer Commission suggested that the IMF be changed into a so-called *quasi-international lender of last resort*. Such an international lender of last resort would award short-term loans to basically solvent economies that because of high capital outflows within a short period of time are facing liquidity problems and whose inability to pay is endangering the stability of the international financial system. Emerging and developing economies are particularly prone to this danger, as their borrowing in contrast to that of industrial nations is almost always in foreign currency. Since the increasing instability of the international financial system has an effect on economic growth world-wide, financial crises can result in growth and unemployment problems for industrial nations. The global community thus has an interest in preventing financial crises from developing in national economies and spreading to the international financial system.

In practice, the concept of a lender of last resort can only be transferred to a limited degree to the international financial system. Walter Bagehot, who intro-

11 See Stanley Fischer, *On the Need of an International Lender of Last Resort*. Paper prepared for delivery at the joint luncheon of the American Economic Association and the American Finance Association, New York, January 3, 1999.

duced the concept as early as the late nineteenth century, argued that such an institution should loan funds generously in case of a crisis at a not-too-low interest premium and only on appropriate collateral to institutions facing liquidity problems.[12] The lending policy he recommended cannot be implemented, however, in an international framework for two reasons. Firstly, an international lender of last resort could only provide credit to a certain degree. In contrast to a central bank, which due to the possibilities available to it for obtaining money has theoretically unlimited liquidity, an international lender of last resort would be, as is the IMF, restricted to the funds that its members provide. These funds can be substantial but never unlimited. Secondly, the demand that loans be granted on appropriate collateral is not feasible in an international context. Only a minority of economies would be in a position to offer sufficient collateral such as future revenues from the sale oil or gas. If emergency funds could only be granted against adequate collateral, a majority of potential countries in crisis would not qualify for credit from the IMF; the effectiveness and legitimacy of an international lender of last resort would thus be considerably undermined. Furthermore, in view of national sovereignty, it would be very difficult indeed to actually take possession of collateralised assets in the case of a debtor's insolvency.

Guidelines for effective liquidity assistance

Nevertheless, the IMF can be reformed in a way that in case of liquidity crises it can act according to principles similar to those used by central banks as national lenders of last resort. A central principle, whose importance Walter Bagehot emphasised, is the limitation of liquidity assistance to solvent debtors who face temporary liquidity shortfalls only. For only loans given to such debtors can prevent bankruptcy not only in the short term but also in the medium and long term. If a debtor is insolvent, however, additional loans will only contribute to delaying his insolvency and subsequent bankruptcy. They cannot prevent bankruptcy in the long run. Liquidity assistance for debtors of this sort is thus not only ineffective; it is an illegitimate form of preferential treatment of certain groups of creditors as it allows for the repayment of some but not of all obligations.

Provision of credit is only effective in cases of temporary liquidity shortfalls if liquidity is made available quickly and in sufficient amounts. If the decision-making process takes too long, obligations cannot be met on time. As a result the debtor becomes insolvent. In order to shore up or restore confidence of creditors and avoid a run on banks, a lender of last resort must provide credible assurance of the prospect for sufficient liquidity support. A lender of last resort must therefore have access to sufficient amounts of liquidity to provide the necessary loans to all debtors that encounter temporary liquidity gaps despite resting fundamentally solvent. Otherwise the outbreak of a panic is unavoidable since creditors cannot safely assume that their debtors will have access to sufficient means in order to service their short-term obligations.

If a loan provided by a lender of last resort is to fulfil its purpose, it must also be assured that liquidity assistance is effectively utilized by the loan recipient. This is not only necessary because the funds of a lender of last resort are limited in an international context but also because these funds consist of taxpayers' money that must be carefully administered and whose repayment must be guaranteed. In the case of sovereign debtors that have encountered financial crises, the effective employment of international liquidity assistance includes the granting of loans to solvent financial institutions that are temporarily burdened with liquidity difficulties as well as the servicing of public obligations in foreign currency.

The limitation to financial institutions is based on their importance for the economy as a whole. To be sure, the bankruptcy of institutions that are not active in the financial sector can also have negative effects on an economy. However, fundamental scarcity does not permit unlimited loans and thus requires the definition of priorities. The servicing of public obligations vis-à-vis international creditors is necessary since the insolvency of a country could destroy the confidence of international investors in its economy and in its wake have a negative impact on growth and employment.

12 "In a crisis, the lender of last resort should lend freely, at a penalty rate, on good collateral" (quoted in: Walter Bagehot, *Lombard Street: A Description of the Money Market*, New York: John Wiley & Sons, 1999 [1873], pp. 196–197).

Overview 2
Guidelines for effective liquidity assistance

Guideline 4
Liquidity assistance can only be granted if it will likely prove effective in preventing or eliminating financial crises.

Guideline 5
In order to be effective and credible, liquidity assistance by the global community must be disbursed timely and in sufficient amounts.

Guideline 6
In light of limited resources, liquidity assistance should be devoted exclusively to its most effective uses.

Proposal for a Reform of the International Monetary Fund

To improve the effectiveness of the IMF in preventing or arresting financial crises and at the same time to ensure that the Fund continues to fulfil to the full extent its tasks of economic-policy advice and the provision of economic forecasts, one possible approach can be found in the introduction of a *graduated membership*. Under such an approach all IMF member states would continue to have access to IMF loans within the current ceilings of 100 to 300 percent of their quotas. This access option would continue to serve as an incentive to co-operate with the IMF. In this way the Fund could retain its privileged access to the economic data of its members and continue its advisory activity in the context of its annual Article IV consultations. Since loans within the current ceilings would continue to be conditional on meeting economic and financial requirements, the IMF could continue to demand economic reforms from its member countries. For the majority of countries, the introduction of a graduated membership would thus bring about no fundamental change.

The introduction of a *privileged membership* would, however, considerably improve the Fund's ability to prevent and arrest financial crises. Privileged members would have the right to financial support that transcends the normal limits when they encounter liquidity difficulties. In the case of a crisis the required liquidity assistance would be timely and non-bureaucratically; it would not be necessary to fulfil additional requirements. For members with privileged status the IMF would thus function as a lender of last resort and in this way would contribute to stabilising the international financial system.

Privileged membership would be open to members that fulfil a number of conditions in addition to those required under present IMF membership rules. Even in the case of a crisis, loans that transcend the normal ceilings should only be granted if it is highly likely, on the basis of these additional conditions, that they will prevent or contain a liquidity crisis. This likelihood only exists, however, if a member country encounters temporary liquidity problems but can nevertheless be regarded as solvent in the medium to long term.

The decision on whether a member country should be regarded fundamentally solvent should be based on whether its public debt rests within sustainable levels and on whether its financial sector is robust enough to cope with short-term liquidity gaps. Such liquidity gaps arise almost exclusively in connection with external debts, that is the obligations of the private or public sector in foreign currency and vis-à-vis foreign creditors. Since both private and public institutions in emerging and developing economies are able to borrow in international capital markets almost exclusively in foreign currency, the major portion of total debt in these countries consists of foreign-currency obligations. At the same time national central banks can provide credit in sufficient quantities in local currencies only. Foreign-currency obligations can thus only be serviced out of currency reserves or via liquidity assistance from third parties.

If an economy has excessive debts, liquidity assistance by the international community fails to offer a lasting solution; it can only delay but not prevent impending insolvency. Only a restructuring of public debt can bring about a lasting solution. Debt restructuring is thus the only way for an economy to regain the confidence of international investors and receive renewed access to capital markets.

Equally important as a stable and sustainable level of debt for the confidence of international investors is a sound financial system. If markets question the stability of a country's banking sector, confidence in the positive development of the whole economy will be tarnished. The result are increased outflows of capital that further weaken the banking sector thereby inducing even more capital outflows. The success of temporary liquidity assistance in arresting financial crises thus depends not only on the extent and quality of public debt but equally on the stability of the financial sector of the economy in question.

It is not easy for central banks to realistically assess the solvency of financial institutions in a national context; it is all the more difficult to assess the solvency of entire economies. In acute liquidity crises, central banks issue short-term loans only when sufficient security is offered. Since quick lending decisions are necessary, central banks, as lenders of last resort, accept the collateral of a debtor as a substitute for a lengthy solvency analysis. This procedure cannot be transferred to an international context since sovereign debtors are only partially able to provide the necessary collateral in exchange for sufficient amounts of liquidity assistance. Since a state's income sources are much more complex than those of a financial institution, only insufficient conclusions can be drawn regarding the financial situation of a country on the basis of the provided security.

Consequently, a general test of the solvency of government borrowers is necessary to determine whether additional loans are suitable to avert or contain a financial crisis. Pre-qualification or ex-ante conditionality, in which the access to extensive liquidity assistance is made conditional on the prior fulfilment of particular conditions, are the most promising approaches for a general solvency test of government debtors. As such it is not surprising that the introduction of pre-qualification has been a central element of the reform proposal by the Meltzer Commission.

The reform proposal outlined in the following presents the basic elements of the structure and lending practice of a reformed International Monetary Fund on the basis of the principles discussed above. It presents the requirements that states should meet to qualify for basic or privileged IMF membership. Its central aim is to increase the Fund's effectiveness in preventing and arresting financial crises and at the same time to ensure that it also continues to provide comprehensive economic information and performs its forecasting and advisory activities to the extent required.

Basic membership

The conditions for basic membership are designed in such a way that all current members of the IMF can meet them with relatively few problems. The present, virtually universal IMF membership could thus be preserved. To promote the stability of the international financial system and to strengthen the ability of the global community to act pragmatically in the case of insolvency, members would have to meet two requirements in addition to the standard conditions for IMF membership.

Firstly, they would have to obligate themselves to comply with the Fund's Special Data Dissemination Standards (SDDS).[13] These standards were developed in 1996 to provide countries seeking access to international capital markets with detailed guidelines for the required transparency and economic information to be disbursed. Although membership has not been conditional on commitment to the SDDS, more than 60 IMF members already meet these requirements voluntarily. A universal requirement to comply with the SDDS guidelines would considerably improve the ability of international investors to gain a detailed picture of the economic and financial situation of public debtors and thus enhance the stability of the international financial system. Following an adequate transition period, all 184 IMF members should be in a position to meet the SDDS transparency requirements with relative ease.

Secondly, all members should be required to include so-called collective action clauses in their underwriting contracts when borrowing on international capital markets. Collective action clauses ensure that a majority of creditors can carry out a debt restructuring even if a minority of creditors is opposed to a restructuring. A universal introduction of collective action clauses would considerably strengthen the ability of the international community to develop pragmatic approaches for developing emergency help for insolvent public debtors. There is a broad international consensus that the universal introduction of collective action clauses in underwriting contracts of both public and private sector bonds is desirable. Several emerging economies have already placed government bonds containing collective action clauses with investors. Moreover, empirical studies suggest that in general collective action clauses have no negative effects on the interest costs paid by the borrower.[14]

13 See *Guide to the Data Dissemination Standards.* Washington, D.C.: IMF, 1996, and: *The Special Data Dissemination Standard: Updated Guidance*, Washington, D.C.: IMF, February 1998.
14 See Barry Eichengreen and Ashoka Mody, *Would Collective Action Clauses Raise Borrowing Costs?*, Cambridge, Mass.: National Bureau of Economic Research (NBER), 2003 (NBER Working Paper 7458), und Barry Eichengreen and Ashoka Mody, *Would Collective Action Clauses Raise Borrowing Costs? An Update and Additional Results*, Cambridge, Mass.: NBER, 2000 (Update to NBER Working Paper 7458).

Overview 3
Conditions for basic membership

Condition 1
Members should commit themselves to comply with and enforce the guidelines and recommendations of the Special Data Dissemination Standards.

Condition 2
Members should commit themselves to include collective action clauses in their underwriting contracts when borrowing money on international capital markets.

Basic membership would provide all members with access to the control and advisory services of the IMF, while the IMF, on its part, would obtain privileged access to the economic and financial data of its members. It could thus continue to carry out its forecasting and evaluating activities to the same degree as before. All members would also have access to IMF loans within clearly defined upper limits as in the past. Loans would be granted within the framework of the already existing Stand-By Agreements (SBA) and Poverty Reduction and Growth Facilities (PRGF). All other credit facilities should be eliminated. Loans within the framework of SBA and PRGF would continue to be dependent on meeting IMF agreed conditions. As such the Fund could continue to promote economic development and strengthen the trust of the capital markets in the economies of its members. In contrast to lending practices of the past, liquidity provided to countries with a basic membership would be limited to the official upper limit that exists today—100 to 300 percent of the member country's quota at the IMF. Granting loans to countries with basic membership exceeding these upper limits would strictly excluded.

A strict limitation of financial assistance to countries qualifying for basic membership only is necessary for several reasons. Primarily it is due to the fact that funds available for members are limited since the IMF must maintain sufficient liquidity in order to arrest financial crises resulting from the capital account. Credit to holders of basic membership serves primarily to maintain the universal attractiveness of IMF membership and to promote a sustainable economic policy and support economic reforms. Extensive short-term loans for the management of liquidity crises are consciously earmarked for privileged members only.

Privileged membership

Members who due to weakened confidence in international financial markets temporarily face liquidity difficulties but in the medium to long term are considered solvent should have the option of attaining privileged membership. For only under such circumstance will short-term liquidity assistance prove effective in preventing or arresting financial crises.

If an economy is fundamentally insolvent, short-term credit will only help to delay an ultimately unavoidable restructuring of the public debt. Short-term credit similarly unable to re-establish the trust of international investors in an economy if its financial system is characterised by a high degree of instability. This is because, firstly, such instable systems more frequently experience runs on banks, and, secondly, the banking sector is greatly limited in its ability to provide businesses with capital that would facilitate sustainable economic growth. In both cases short-term IMF loans would make it possible for debtor countries to respond to the demands of a limited group of creditors, but fail in contributing to a reduction of capital outflows that usually cause a financial crisis in the first place.

The qualification criteria that IMF members should fulfil to obtain privileged membership should thus be designed in a way ensuring public indebtedness remains at sustainable levels and safeguarding a minimum of financial market stability. If this is not the case, either a fundamental financial sector reform or a debt restructuring inevitable to arrest the crisis: short-term loans would be insufficient. Granting financial assistance under such circumstances would thus not only be ineffective but also problematic terms of creditor equality and the misrepresentation of taxpayers' funds. While the fulfilment of adequate public debt criteria should be taken as proof that the public debt of a privileged member rests within sustainable levels, holding to appropriate capital standards in the banking sector would secure the required minimum stability of the financial system.

A privileged membership would provide fundamentally solvent members with a stable financial sector access to liquidity beyond the normal upper limits in case massive capital outflows, brought about by the insecurity of investors, should result in a liquidity shortfall. The use of such loans would be limited to the servicing of public-sector obligations and to the provision of loans to financial institutions by a central bank acting as a lender of last resort. The use of IMF loans for intervening on foreign exchange markets should be ruled out entirely. The latter is based on the fact that for such an intervention to be successful a much greater amount of funds is required than that available to the IMF, even after potential quota increases. Moreover, interventions to stabilise the exchange rate of national currencies have proved ineffective in the majority of cases.

IMF loans beyond the standard upper limit should be of short maturity, extendable only under exceptional circumstances, and subject to interest costs above market rates. This would ensure that privileged members would only resort to IMF funds if credit intake in the needed amount cannot be secured in international capital markets. At the same time an interest-rate premium would offer incentives to pay back the loan as soon as possible, which in view of the limited funds available to the IMF appears highly desirable.

Public debt criteria

To qualify for privileged membership, countries should meet the following criteria regarding public indebtedness. First, debt denominated in foreign currency should rest below an appropriate upper limit. Secondly, short-term liabilities should make up no more than 25 percent of the entire public debt in foreign currency. And thirdly, national central banks should maintain sufficient currency reserves to service the short-term foreign currency debts of both the banking and public sectors.

The ceilings defined in the Debt Sustainability Framework for government debt in foreign currency are based on the results of empirical analyses that demonstrate that public debt above these thresholds has strong negative effects on the economy in question.[15] These ceilings are thus equally suitable as debt criterion for privileged IMF membership.[16] They vary depending on the quality of the economic policy and of the institutional environment of every member country evaluated by the World Bank in its Country Institutional and Policy Assessments.[17] This flexibility reflects the fact that professionally governed countries can bear a higher debt burden than countries that in the past have demonstrated poor economic policies and an unstable institutional environment.

By upholding a ceiling of 25 percent of short-term to total external debt, members should furthermore demonstrate a sustainable debt structure. The financial crises of the past few years have demonstrated the dangers connected with an excessive share of short-term foreign-currency denominated liabilities. Not only the liquidity crises in Southeast Asia, but also Mexico's tequila crisis to a large extend resulted from an unusually high share of short-term debt. A variety of empirical studies have shown the connection between a high share of short-term debt and the probability and severity of financial crises.[18]

The third criterion—the requirement of sufficient currency reserves to service an economy's short-term external debt—is also meant to prevent a liquidity crisis even in case of public debt remaining within sustainable levels. Studies by the IMF Policy Development and Review Department point to the relationship between currency reserves and short-term foreign currency liabilities as the single most important indicator for a sustainable liquidity management.[19] Since the Asian crisis, most Southeast Asian economies have strongly built up their stocks of currency reserves and more than fulfil this criterion already today. Many emerging economies in Latin America also hold much higher stocks of foreign currency than they did five or ten years ago. Over an adequate transitional phase, and at least following a successful debt restructuring most IMF members should be in a position to fulfil all three debt criteria.

15 See Eduardo Borensztein, Marcos Chamo, Olivier Jeanne, Paolo Mauro, and Jeromin Zettelmeyer, *Sovereign Debt Structure for Crisis Prevention*, Washington, D.C.: IMF, 2004 (IMF Research Paper).
16 International Development Agency (IDA) und IMF, *Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications*, Washington, D.C.: IMF, February 3, 2004, http://www.imf.org/external/np/pdr/sustain/2004/020304.pdf.
17 The evaluation in the context of these assessments is based on the analysis of twenty equally weighted indicators that are used for an estimation of the political and institutional performance of World Bank members. For each indicator the World Bank assigns a value of between 1 and 6.
18 See also Dani Rodrik and Andrés Velasco, *Short-term Capital Flows*, Cambridge, Mass.: NBER, 1999 (NBER Working Paper 7364).
19 See *Debt- and Reserve-Related Indicators of External Vulnerability.* Paper prepared by the Policy Development and Review Department, Washington, D.C.: IMF, March 23, 2000.

Table 2
Ceiling for sustainable public indebtedness

	Economic-policy and institutional environment		
	Weak	*medium*	*strong*
Debt to GDP	30	45	60
Debt to exports	100	200	300
Debt to public revenue	150	200	250
Debt-service to exports	15	25	35
Debt-service to public revenue	20	30	40

Source: International Development Agency (IDA) and International Monetary Fund (IMF), *Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications*, Washington, D.C.: IMF, 3.2.2004.

Criteria for financial market stability

The stability of domestic financial systems depends on the stability of the banks that operate inside these systems. The qualification criteria for a privileged IMF membership, devised to demonstrate that a financial system maintains a sufficient degree of stability, are aim primarily at the implementation of suitable capital standards and reserve requirements for financial institutions by national supervisory authorities. In addition, opening the banking sector both for new local as well as international competitors has proved to be necessary for a stabile financial sector.

Compliance with suitable capital standards is indispensable for the stability of financial institutions. Capital standards define binding lower limits for the ratio of capital to total financial assets. They are intended to prevent banks from using too high a proportion of savings deposits for high-risk investments, thus disproportionately increasing the danger of insolvency in case of major losses. At the same time an adequate capital ratio assists the monitoring of loan transactions by the private sector through shareholders. The option of a privileged membership should thus be linked to the enforcement of suitable capital standards by national supervisory authorities. Here the capital standards approved by the Basel Committee on Banking Supervision in 2004, commonly known as Basel II, provide a good foundation but should be better tailored to the needs of emerging and developing economies and to the conditions prevalent therein.[20] This requires both the development of more transparent and more easily implementable guidelines for determining the credit risks that held capital must offset as well as higher minimum capital requirements in comparison to industrialised countries. A 2004 World Bank study suggests 15 percent as a suitable capital standard for emerging and developing economies.[21]

The resilience of banks during liquidity crises can be further strengthened by requiring them to hold sufficient amounts of cash reserves, usually at the central bank. In developed industrial countries today, such minimum reserves play only a minor role since in case of crisis central banks are able to act as the lender of last resort to their economy. Whereas in the United States the minimum reserve ratio is still stands at ten percent of the credit balance on transactions accounts, in the euro area it is only two percent, whereby a larger number of investment vehicles are subject to the requirement. However, especially in less developed economies minimum reserves play a more important role. Minimum reserves in Russia, for example, have been as high as fourteen percent and up to twenty percent in Argentina. This discrepancy is not surprising since the effectiveness of capital standards is often limited in less developed financial systems whereas minimum reserves contribute much more to the stability of banks than in advanced industrial countries.[22] In order to increase the stability of

20 See Andrew Powell, *Basel II and Developing Countries: Sailing through a Sea of Standards*, Washington, D.C.: The World Bank, 2004 (World Bank Policy Research Working Paper 3387).
21 See Giovanni Majnoni, Margaret Miller, and Andrew Powell, *Bank Capital and Loan Loss Reserves under Basel II: Implications for Latin America and Caribbean Countries*, Washington, D.C.: The World Bank, February 2004 (Working Paper).
22 See Liliana Rojas-Suarez, *Domestic Financial Regulations in Developing Countries: Can They Effectively Limit the Impact of Capital*

Overview 4
Conditions for privileged membership

Condition 1
The public debt of privileged members must lie under the ceiling defined in the Debt Sustainability Framework by IMF and the IDA.

Condition 2
Short-term government obligations in foreign currencies, defined as obligations with a maturity of less than three months, must comprise must comprise no more than 25 percent of total government external liabilities.

Condition 3
Privileged members must maintain sufficient currency reserves in order to satisfy the short-term foreign currency obligations of the banking and the public sectors.

Condition 4
For privileged membership it is necessary that the responsible national supervisory agency enforce a capital standard for financial institutions of 15 percent.

Condition 5
The national supervisory agency of privileged members must commit financial institutions to maintain cash reserves of likewise 15 percent.

Condition 6
Privileged members must commit themselves to open their financial sectors to domestic and foreign competition within a appropriate period of time.

financial systems in developing countries, a privileged member should be obligated to maintaining minimum reserves of between ten and fifteen percent.

Highly developed financial systems are not only marked by the existence and observation of capital standards and minimum reserve requirements but also by free access for foreign competitors. The IMF has long favoured an opening of the banking sector for foreign competitors and has often made this a condition for granting loans. Although it is often assumed that western financial institutions only crowd out local institutions when banking sectors are opened, in fact both international competitors and above all the economies in question themselves profit from an opening of their financial sectors. Empirical studies confirm that an internationalisation of the banking sector and the accompanying improvement of quality, quantity and efficiency of financial services contributes to the stabilisation of national financial systems.[23] Moreover, in 2001 a World Bank study found a negative correlation between financial market stability and existing barriers to access to the local banking sector.[24] In addition, with the takeovers of local banks by foreign financial institutions, an alternative source of capital is opened up that contributes to increase the stability of the affected institutions. Opening-up the banking sector to international competition should thus stand as the third qualification criterion for privileged IMF membership.

Account Volatility?, Washington, D.C.: Centre for Global Development, 2004.

23 See Stijn Claessens and Tom Glaessner, *Internationalisation of Financial Services in Asia*. Paper presented at the conference Investment Liberalisation and Financial Reform in the Asia-Pacific Region, August, 29–31, 1998, Sydney, Australia.
24 James Barth, Gerard Caprio, and Ross Levine, *Bank Regulation and Supervision: What Works Best?*, Washington, D.C.: The World Bank, 2001 (Working Paper).

Conclusion

The introduction of a graduated membership would enable the IMF to fulfil its core tasks in a considerably more effective manner. Moreover, it would be a consistent realisation of already approved but only half-heartedly implemented reform initiatives. In attempting to introduce contingent credit lines, the IMF has already implicitly recognized pre-qualification as an promising approach to effective crisis management. The failure to implement them can be attributed to two causes: Firstly, the introduction of qualification criteria for IMF members would not have assured a firm claim on timely and unconditional liquidity assistance, since loans would still have been conditional on prior approval by the executive committee. This, in turn considerably lessened the attractiveness of utilizing this facility. Secondly, countries were concerned about arousing suspicion in international capital markets when opting for qualification. Both of these problems have been addressed in the reform proposal offered above: Qualification for privileged membership would be a justification for a claim to sufficient liquidity support in case of crisis and at the same time would send positive signals to international investors.

In a similar way, the implementation of the Framework for Exceptional Access in 2003 indicates the awareness both within the IMF and also among its members of the significance of clear and transparent guidelines for access to liquidity assistance beyond the existing upper limits. This is significant insofar as transparent guidelines limit the flexibility of precisely those members with the highest voting weights in loan-granting decisions. The current distribution of voting weights also accounts for the fact that the approval of the Framework has had little influence on the Fund’s lending practice: In the case of the two loans granted to Brazil and Argentina that transcended the normal upper limits, an internal evaluation of the IMF conceded that the guidelines had been violated.[25]

If the reforms that are necessary for increasing the effectiveness and legitimacy of the IMF are postponed, the Fund’s influence on the economic and monetary policies of its members will continue to weaken. This is due to the fact that their willingness to follow IMF policy recommendations depends largely on the extent to which they recognise the Fund as a legitimate and effective institution. If the Fund is seen primarily as the executor of the interests of western industrialised countries, this willingness will necessarily decline. The latter problem applies especially to the rapidly growing economies of Asia and Latin America, whose importance for stability of the international financial system has continuously risen. With the accumulation of extensive currency reserves, they are already much less dependent on IMF loans than they used to be. Co-operation with the Fund and the implementation of its policy recommendations has thus in recent times been largely voluntary.

An example is China, whose monetary policy has largely resisted the demands of western industrialized countries for a yuan revaluation. Since China is not dependent on the IMF for liquidity support, the Fund has only limited means to influence its stand regarding a revaluation. The United States seems to have recognised that a revaluation of the yuan can hardly be brought about by foreign-policy pressure but only by the slow process of persuasion.[26]

If the erosion of IMF influence on the economic and monetary policies of the leading exporters among the emerging economies continues, the Fund difficulties in fulfilling its mandate will continue to rise. If this development is not halted and reversed, the global community will lose its most effective instrument to promote the stability of the international financial system. However, global financial stability is just as important for economic growth in the industrialised world as it is for growth and development in emerging and developing economies.

25 See *Review of Exceptional Access Policy*. Report prepared by the Policy Development and Review and Finance Departments, Washington, D.C.: IMF, March 23, 2004.

26 See Robert Rubin, *In an Uncertain World: Tough Choices from Wall Street to Washington*, New York: Random House, 2004, p. 227.

Abbreviations

ASEAN	Association of Southeast Asian Nations
CCL	Contingent Credit Lines
G8	Group of Eight (the seven leading industrialised countries + Russia)
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Countries
IDA	International Development Agency
IMF	International Monetary Fund
NBER	National Bureau of Economic Research
PRGF	Poverty Reduction and Growth Facility
SBA	Stand-By Agreement
SDDS	Special Data Dissemination Standards