DEUTSCHE BUNDESBANK
EUROSYSTEM

Legitimacy of IMF endangered

Guest editorial of Professor Axel A Weber (Frankfurter Allgemeine Zeitung, 30. September 2009)

The international financial system has stabilised recently. At the national level, extraordinary government measures, including extensive monetary and fiscal policy support, played a key role. At the global level, the International Monetary Fund (IMF) made important contributions to the stabilisation within the framework of its surveillance and lending activities. At around US$160 billion, the volume of its lending commitments is currently almost twice as high as credit utilisation during the Asian crisis in the mid-1990s.

In April 2009, the G20 responded to concerns as to whether the IMF had sufficient financial resources by massively increasing these resources. Thus the amount of funds which the IMF has at its disposal under bilateral credit lines and under the New Arrangements to Borrow (NAB) will increase from US$50 billion to US$550 billion. Furthermore, to boost global currency reserves, up to the beginning of September, the IMF allocated new Special Drawing Rights (SDRs) to its members, raising global SDR holdings from US$33 billion to US$316 billion. The problem with SDR allocations is that liquidity is provided on a permanent basis “at the stroke of a pen” without any binding conditions (conditionality).

The measures taken by the IMF must be viewed against the backdrop of an extraordinary crisis situation. Therefore, as national governments plan to phase out their rescue measures, so the IMF, too, must develop strategies for an appropriate exit from its own crisis policies and their financing through member countries’ currency reserves. An IMF exit strategy is required to ensure sustained stability, to avoid setting the wrong incentives (moral hazard) and to create appropriate liability patterns.

An IMF exit strategy should, among others, take the following into account.
In addition to a review after two years for assessing whether the allocated SDRs should be completely or partly cancelled – as is possible under the IMF’s Articles of Agreement – an exit strategy should, above all, ensure that the IMF remains a quota-based institution. The quotas, ie the currency reserves the member countries make available to the IMF on a permanent basis, have important functions for the organisation of the IMF as a "fund" (in the sense of a credit union), as they are used to determine the member countries’ voting rights, the level of their payment obligations to the “Fund” and the individual volume of SDR allocation. Furthermore, they determine the extent to which members can access the IMF's financial

assistance. The overall quota volume currently stands at US$344 billion, of which around US$100 billion is still available for loans to crisis countries.

Following the huge expansion of the IMF's credit resources, the regular quotas no longer play the crucial role of the past. The IMF's financing out of credit sources will be almost twice as high as its regular financing out of quotas. As a result, the traditional relationship between quotas and credit resources has been turned upside down. In order to restore a suitable balance between regular quotas and temporary credit financing, the quotas should be increased in line with the IMF's permanent liquidity needs and, conversely, the level of NAB resources should be reduced after the completion of the quota increase and should be foreseen as an emergency reserve only.

The necessary strengthening of the IMF as a quota-based institution is also important for the Fund's legitimacy. The IMF is being accepted as an advisor and lender as long as its members feel to be fairly represented. Fair representation relates to the allocation of quotas and voting rights in the IMF, as well as to the representation in its decision-making bodies. Adapting the quotas and voting rights to reflect the changes in economic weight in the global economy was the key element of the April 2008 reform. Dynamic emerging market economies, such as China, Korea, Mexico and Turkey, have been the main beneficiaries. However, the quota reform has regrettably not yet entered into force because many countries – including important G20 countries – have not yet ratified it.

But even once the reform of April 2008 has entered into force, some emerging market economies and developing countries, as well as some industrialised countries, will have considerably smaller quota and voting shares than their weight in the world economy would justify. Therefore, at their meeting in Pittsburgh, the G20 agreed to increase the quota shares for dynamic emerging market economies and developing countries by at least five percentage points, at the expense of overrepresented countries. However, some proposals go considerably further, for instance, by calling for a significant reduction in EU countries' representation on the Executive Board of the IMF in favour of emerging market economies and developing countries even though these already occupy half of the seats.

Such kind of request would be inappropriate, given the important economic weight of EU countries and given existing IMF rules. A one-sided reduction in the number of directors from EU countries would be incompatible with the principle of equal treatment of all IMF members. Such a step would abolish the indispensably tight equivalence of financial obligations and representation. In June, the Heads of State or Government of the EU member states urged to

leave this relationship intact. Germany and the EU countries must continue to be treated as fairly and justly as all other IMF member countries.

The Executive Board of the IMF as well as some G20 members are seizing the current economic and financial crisis as an opportunity to seek to extend the IMF's mandate. It is planned, for instance, to directly finance budget deficits with central bank money which the IMF has at its disposal; this amounts to monetary financing, which is prohibited in Europe for good reasons. Moreover, the IMF shall also obtain a role as a global insurer or guarantor covering financial and economic risks of its member countries. Extending the IMF’s mandate in such a way would result in a fundamentally different business model for the IMF and would risk overstretching it.

Insuring against the vagaries of volatile capital flows would, for example, have far-reaching consequences for the incentive and liability patterns of debtors and investors, as well as for financial stability. The risk of having to cover losses with owned capital is a key feature of the market economy; it forces investors and debtors to dispose of of financial resources prudently. By contrast, were loss risks to be generally assumed by the IMF, the risks for the financial integrity of the Fund, for its underlying financing out of national currency reserves and thus ultimately for IMF shareholders themselves would increase.