Order Code RS21330
Updated April 14, 2004

CRS Report for Congress
Received through the CRS Web

The International Monetary Fund: Current Reforms

Martin A. Weiss
Analyst in International Trade and Finance
Foreign Affairs, Defense, and Trade Division

Summary

In the wake of financial crises in Mexico (1994-1995), East Asia (1997-1998), Russia (1998), Argentina and Turkey (2000-2001), the IMF has been challenged to rethink both its core mission, its operations, and its lending activities. The IMF has responded to its critics with numerous reforms. The reforms fall into three broad categories: crisis prevention, crisis management, and the IMF's role in economic development. This issue is of ongoing interest to Congress, which plays an active role in the reform agenda and periodically is asked to appropriate funds for the U.S. quota in the IMF. This report will be updated as events warrant.

Background

The International Monetary Fund (IMF) is an international organization with a current membership of 184 countries. Conceived at the 1944 Bretton Woods conference, the IMF's core mission is to foster economic growth and increased international trade by supporting international monetary cooperation, exchange rate stability, and temporary financial assistance to countries facing balance of payments difficulties.

IMF operations and responsibilities can be grouped into three areas: surveillance, lending, and technical assistance. Surveillance involves monitoring economic and financial developments and providing policy advice to member countries. Lending entails the provision of financial resources under specified conditions to assist a country experiencing balance of payments difficulties. Technical assistance includes help on designing or improving the quality and effectiveness of domestic policy-making.

In the wake of financial crises in Mexico (1994-1995), East Asia (1997-1998), Russia (1998), Argentina and Turkey (2000-2001), the IMF has been challenged to rethink its core mission and how it operates its surveillance and lending activities. The IMF has responded with numerous reforms. The reforms fall into three broad categories:

- International financial crisis prevention;
- International financial crisis management; and
- Role in economic development and its relationship to the World Bank

After summarizing these reforms, a final section of this report will address other proposals for changes to IMF policy and operations.

Crisis Prevention Reforms

Changes that focused on crisis prevention include IMF institutional reforms, the creation of international standards and codes of good financial practices, and the active promotion in developing countries of sound and robust financial institutions.

IMF institutional changes have centered on improving transparency and accountability. As recently as ten years ago, IMF documents were not readily available for public release. Now, almost all IMF documents, including Article IV Consultations, are available on the IMF website. There are also calls for the IMF to release information on board decisions and votes, and other documents relating to sensitive discussions between the IMF and member countries. Proponents argue that greater openness might lead to better compliance regarding loan arrangements. Critics, however, note that greater openness might inhibit frank exchanges between the IMF and member countries.

Congress and the Administration played a substantial role in pressing for increased transparency and accountability at the IMF. In November 1998, as part of legislation authorizing the most recent IMF quota increase, Congress established the International Financial Institutions Advisory Commission (IFIAC) to recommend future U.S. policy towards the International Financial Institutions (IFIs). The commission submitted its final report to Congress on March 8, 2000 and proposed numerous reforms to the structure and operations of the IMF.[1] In addition, congressional pressure during the 1998 appropriations hearings, and codified in the ensuing legislation, sought to make U.S. support of the IMF and its quota increase conditional on numerous transparency and accountability reforms. Later, to avoid undercutting the replenishment, Congress agreed to make its policy demands advisory and not compulsory.

Other institutional changes have been suggested from within the IMF. The Quota Formula Review Group, for example, was created in 1999 to address the shifting balance in voting power among countries within the IMF.[2]

Another major initiative of the IMF, the United States, and other international financial institutions is the Financial Stability Forum (FSF). Started in April 1999, the FSF meets several times a year to promote international financial stability through

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[1] See CRS Report RL30635, *IMF Reforms and the International Financial Institutions Advisory Committee,* by J.F. Hornbeck.

[2] For a lengthier discussion of recent IMF institutional reforms, see: Houtven, Leo Van "Governance of the IMF: Decision Making, Institutional Oversight, Transparency, and Accountability." The International Monetary Fund, 2002.

information exchange and international cooperation in financial supervision and surveillance. The FSF has issued a "Compendium of Standards" that "provides a common reference for the various economic and financial standards that are internationally accepted as relevant to sound, stable and well-functioning financial systems."[3]

The FSF highlights standards in three areas: Macroeconomic Policy and Data Transparency, Institutional and Market Infrastructure, and Financial Regulation and Supervision. Two IMF codes addressing monetary, financial, and fiscal transparency and two IMF standards addressing the timely dissemination of accurate financial data, comprise the first area of FSF standards, Macroeconomic Policy and Data Transparency.

While the benefits of accounting standards and information transparency may seem apparent, some critics note that the implementation of these standards may be difficult. Acceptance is voluntary, and there is no overt mechanism for enforcement. Countries are free to meet standards or not; yet for those seeking access to global capital markets, there is a strong incentive to be seen as making progress in standards such as data accuracy, its timely dissemination, and macroeconomic transparency. These criteria are fundamental for lending decisions in the private capital markets.

Crisis Management Reforms

In addition to preventing international financial crises, reforms have been targeted at improving the way the IMF uses its resources in managing crises. The objective of these reforms is to keep crises from spreading from country to country (contagion) and to minimize their damage. Many economists stress that because financial crises are unavoidable, the challenge is control and not their elimination.

Each financial crisis is different. There have been banking crises due to solvency or liquidity concerns (Asia), debt crises due to unstable debt levels (Argentina), and exchange rate crises due to macroeconomic difficulties (Turkey). While no general standards or set of economic polices will resolve all financial crises, the IMF has determined that excessive sovereign debt is a key cause of many crises.

Sovereign bonds (government issued debt) are the primary form of developing country debt. These bonds are held by many types of investors, both large and small, and represent a major shift in the types of developing country debt. When countries ran into economic difficulties 20 years ago, their debt consisted primarily of bank loans, issued by a small number of private banks. It was relatively easy for the banks to work together with delinquent countries and arrange terms to restructure the debt. There is now a much wider spectrum of investors in sovereign bonds, creating much costlier and more difficult resolutions. For example, Argentina defaulted on its sovereign debt in the fall of 2002 and is still negotiating with the IMF and its debtors. However, there is no formal mechanism to coordinate restructuring negotiations between bond holders and the Argentine government.

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[3] More information regarding the Compendium of Standards can be found at [http://www.fsforum.org/Standards/Home.html].

To address these problems, both institutional and policy reforms have been proposed and some have been implemented. The IMF has created two internal groups to conduct research and explore issues in international capital markets: the International Capital Markets Department and the Capital Markets Consultative Group. Both groups are expected to deepen the Fund's understanding of the international capital markets, the forces driving the supply of capital, and the constraints these capital flows place on economic policy makers. In March 2002, the IMF issued the first *Global Financial Stability Report,* a quarterly publication on the state of the global financial markets.

The IMF has also proposed a type of bankruptcy procedure to address problems of sovereign debt reform. Created by Anne Krueger, IMF First Deputy Managing Director, the proposal involves the creation of a so-called Sovereign Debt Restructuring Mechanism (SDRM). Her proposal would afford rights to defaulting countries similar to those afforded bankrupt companies in the United States under Chapter 11 of the U.S. Bankruptcy code. A standstill on debt payments would go in effect, while countries renegotiate their debt contracts. Also, a dispute resolution mechanism would be created under IMF auspices to coordinate debt restructuring. The creation of an SDRM could lead to a significant change in the IMF's role in the world financial system. However, its implementation could be difficult, since it may involve an amendment to the IMF Articles of Agreement, which requires an 85% special majority vote.

There are many other competing proposals for sovereign debt reform, the most prominent being a plan put forth by John Taylor, U.S. Treasury Under Secretary for International Affairs. Instead of creating a new body to resolve debt crises, Taylor's proposal would involve rewriting loan contracts to include collective action clauses. These clauses are meant to resolve the difficulty in renegotiating contracts between the issuer and a very large number of bond holders.[4] These clauses would also specify the procedure to be followed in the case of a default. Many commentators note that these two proposals are not mutually exclusive. Anne Krueger has commented that the SDRM and collective action clauses are the "two-track approach to improving sovereign debt restructuring" that will dominate policy discussions.

At the 2002 IMF annual meetings, the IMF won tacit approval for the SDRM. In its September 28th communique, the International Monetary and Financial Committee called on the IMF to go further and draft a concrete proposal for the SDRM, in addition to working with private sector and sovereign debt issuers to introduce collective action clauses.

Role in Economic Development and Relationship to the World Bank

While the first function of the IMF is macroeconomic stability, its second function is the support of its sister organization, the World Bank and its mission of economic

[4] For a more detailed analysis of the Krueger and Taylor proposals, see CRS Report RL31451, *Managing International Financial Crises: Alternatives to "Bailouts," Hardships and Contagion*, by Arlene E. Wilson.

development.[5] This has manifested itself in recent IMF reforms that give economic development and poverty relief heightened importance in IMF lending decisions.

Recent IMF reforms, such as the creation in 1999 of the Poverty and Growth Facility (PRGF), a concessional loan facility, have been implemented to help the IMF deal more effectively with its poorest members. The PRGF, an outgrowth of the earlier Enhanced Structural Adjustment Facility (ESAF), resulted in a clear mandate for the IMF to make poverty reduction a goal of its concessional lending. It was under this previous structural adjustment mechanism that much of the lending to Africa occurred.

Some critics, such as the Meltzer Commission, argue that this new involvement creates an overlap between the IMF and World Bank, and that the two institutions need to restrict their operations to their core functions. Other analysts assert that IMF/World Bank overlap is not only desirable, but necessary.[6] These analysts argue that the joint tasks of economic development and capital and currency markets integration necessitate significant IMF/World Bank cooperation.

Another example of IMF involvement in economic development concerns the promotion of financial institutions in developing countries. The IMF, through the FSF, is promoting standards reform and the creation of sound financial institutions in developing countries. The IMF often requires specific institutional policy reforms as a condition for a loan. However, in many instances, the IMF lacks the capacity to help implement these reforms. The World Bank and the multilateral development banks have taken the lead through loans and reform programs to address these concerns.

A joint IMF and World Bank effort initiated in May 1999, the Financial Sector Assessment Program (FSAP), aims to promote the creation of sound financial institutions in member countries. These reforms most likely will be implemented by the World Bank and the Multilateral Development Banks through IMF-sponsored adjustment programs.

In April 2004, the IMF created a new mechanism — the Trade Integration Mechanism (TIM). This was designed in order to help developing countries resolve balance of payments difficulties that may arise as many countries lose preferential trade access to the rich countries as part of the Doha Round negotiations of the World Trade Organization.

Finally, IMF/World Bank coordination was a major concern of a two-year review of IMF conditionality that led to new guidelines on the design and implementation of conditionality in IMF-supported programs approved by the IMF Executive Board on September 26, 2002. During the review, directors noted that it would be useful to create a "lead agency" in different policy areas that would design and monitor conditionality for

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[5] Kenneth Rogoff, IMF Economic Counselor and Director, Research Department,"Reflections on One Year at the IMF," Speech to the National Economists Club, Washington, D.C. September, 5 2002.

[6] Bird, Graham. The International Monetary Fund and Developing Countries: A Review of the Evidence and Policy Options. *International Organization*, Vol. 50, Issue 3 (Summer 1996), 477-511.

both World Bank and IMF programs. The IMF anticipates closer coordination between itself and the World Bank will increase the effectiveness of PRGF arrangements.

The Future Reform Agenda

The IMF-initiated reforms discussed in this report address some of the principal critiques of IMF activities. However, some major concerns remain. Prominent among them is the need for the IMF to devise programs, on one hand, which meet the needs of its borrowers, while retaining, on the other hand, the confidence and support of the major countries that provide the hard currencies which fund its operations. In many cases, the gap between the goals and expectations of the borrower countries and the donor countries is great. For example, many of the major countries which finance the IMF's operations subscribe to the basic concepts embodied in the "Washington Consensus," and make them the core policy requirements for IMF assistance.[7] Many borrower countries, by contrast, believe that these policies are too narrow and lack sufficient appreciation for their real needs and the limits of their political and economic situations. As developing countries are now the primary recipient of IMF assistance and policy advice, divergence between lenders and creditors has grown, with increasing protests against the IMF in general and specific IMF loan programs.

A sizable number of the public in both the developed and developing countries have strongly negative views of the IMF. This tends to both encourage and hinder the process of reform by intensifying, polarizing and complicating public and official discussion of these issues. Fundamentally, the IMF is an economic and financial institution. However, many other issues also seem relevant to the issues its programs seek to address. A challenge for the IMF in future years is to retain a sound financial and economic basis for its operations while also responding to relevant social and political issues. In addition, as a member-based organization, the IMF only has relevance and utility if member countries view it as institution whose policy advice is appropriate and worth implementing.

Politicians and scholars, both inside and outside the IMF, are currently debating whether the policy tools and methods used by the IMF are appropriate for current world conditions. As yet no consensus has developed for an alternative model which is likely to be more effective in promoting stabilization and development in poor countries. At least, no alternatives have been proposed that do not require some type of long-term budget support and subsidies from the richer countries. Few developed countries seem willing to make long-term unrestricted financial transfers of this sort. In the meantime, controversy and debate about the IMF's basic principles and the scope of its operations will remain an ongoing concern.

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[7] "The Washington Consensus," a term coined by International Institute for Economics Senior Fellow, John Williamson, in 1989, refers to a set of policy reforms including fiscal discipline, tax reform, interest rate liberalization, a competitive exchange rate, trade liberalization, open capital markets, secure property rights, privatization and deregulation. For more information, see: John Williamson, "What Should the World Bank Think About the Washington Consensus," available at [http://www.iie.com/papers/williamson0799.htm]