

## The Globalizers in Search of a Future: Four reasons why the IMF and World Bank must change, and four ways they can

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The IMF and the World Bank have been effective engines of globalization. They employ the largest number of applied economists of any institution in the world, aggregating an awe-inspiring bank of economic data and applied research. Their data, standard-setting role, and global influence are prized by their wealthiest members. Poor countries borrow from them. In a globalizing world, we particularly need such institutions. So why are they now in decline?

Both institutions are under serious attack. It is no longer just radicals who accuse the institutions of “peddling poor quality economic advice,” serving American interests, supporting or even promoting corrupt and oppressive regimes, and hurting the poor. Sir Edward Clay, Britain’s former High Commissioner to Kenya recently accused the Bank of “feeding the pig of corruption.” The Governor of the Bank of England argued in February 2006 that the IMF has “lost its way,” and is joined in arguments for reform of the IMF by US Treasury official Tim Adams, as well as twenty Finance Ministers from the largest economies in the world meeting as the G20 Finance Ministers.<sup>1</sup> From several sides, the IMF and World Bank are being assailed for lacking legitimacy, independence, and effectiveness.

Four ailments afflict both institutions. The first is that their income is diminishing. The second problem is that their main clients no longer want to borrow from them. The third problem is that conditionality—their principal instrument for opening markets as well as safeguarding their resources—does not work. The fourth problem is that although they place great stock in advising countries on their economic policy, their advice is not seen by their members as impartial. For these reasons we need to think hard about improving the Fund and Bank.

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### **Four reasons why the IMF and World Bank have to change—and fast!**

Wealthy countries have long controlled the IMF and World Bank not just through their large proportion of weighted votes but through a tight grip on the management, mindset, and mandate of each organization. These wealthy members have also increasingly demanded a bundle of “global public goods” from the Fund and Bank. Paradoxically, they have simultaneously reduced their own contributions. This has led to a first reason why the institutions have to change.

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### 1. THEIR INCOME IS RUNNING OUT

Many people imagine that rich countries pay for the IMF and World Bank. Yet it is not the United States or the G7 who pay most of their budgets. Their contribution has waned rapidly over the past twenty years. As I trace in my recent book *The Globalizers*, a large part of the bill for the IMF and the World Bank was shifted to poorer or borrowing countries during the 1980s. By charging borrowing countries more for loans each institution built up reserves and investment income—relieving wealthy countries of responsibility—and at the same time

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creating resources which those same wealthy countries have deployed to demand a wider range of services from each organization.<sup>2</sup>

For wealthy countries the 1980s revolution in financing was a clever way to reduce their own liabilities

yet at the same time retain control of the organizations. They would continue to call the shots. But now borrowers would pay. However, the life and work of the IMF and World Bank would become dependent on their income from loans (and investments from the earlier proceeds of their lending activity).

The problem for the institutions is that income from their investments has diminished at the same time as their lending has slowed down. The IMF has relied for the lion’s share of its income on large emerging market borrowers. But by 2006 Brazil, Argentina, and other emerging economies had repaid large loans from the organization. As a result, by February 2006 the IMF was projecting that payments of charges and interest to the organization would more than halve from US\$3.19 billion in 2005 to US\$1.39 billion in 2006 and halve again to US\$635 million in 2009.<sup>3</sup> That puts a huge squeeze on the budget of the organization.

The World Bank has also relied on big borrowers. Its 2004 Annual Report reports a drop in income from borrowers’ fees and charges from US\$8.143 billion in 2001 to US\$4.403 billion in 2004, at the same time as its investment income dropped from US\$1.540 billion in 2001 to US\$304 million in 2004. Projected lending is also down as lending to China, Indonesia, Mexico, and Brazil slows. The Bank’s response has been to cut loan fees and to raise the lending limit for big borrowers in the hope that this will regenerate a desire to borrow from the Bank.

### 2. THEIR CLIENTS ARE TURNING ELSEWHERE

Some of the largest borrowers from the IMF and World Bank are now turning elsewhere for the kinds of development assistance loans and advice which the World Bank provides, and for the monetary and financial insurance package which the IMF is supposed to provide. In Asia, for example, the IMF foresees that monetary authorities will have amassed reserves reaching US\$1.430 trillion by 2006, up from a level of US\$496.9 billion in 2002.<sup>4</sup> The costs to these countries of holding reserves is very high, as can be the cost of private sector finance. So what is driving these countries away from the multilaterals?

Speaking to any Asian officials in confidence, the answer is clear. The IMF is seen as a tool of US policy, offering advice which is too ideological and too prescriptive. Officials cannot trust it to be there for them in a crisis—without the kind of wish-list of conditions brought to South Korea in 1997. For China, Korea, or Japan to have confidence in the IMF as a genuinely global arrangement, deep changes are needed to the governance of the organization. Similar critiques of the IMF are made in Latin America and in Africa, although in these other parts of the world countries are less well-placed to “exit” from the IMF and instead are still seeking more voice within the organization.

Among borrowers from the World Bank similar concerns are raised. These did not abate when the US announced that former US Deputy Secretary of Defense Paul Wolfowitz would take over as President and the new management team he has appointed has heightened these concerns. Equally off-putting for borrowers is the “has-sle-factor” of borrowing from a large bureaucracy which has since the 1960s been accused of being overly slow and bound by red-tape.

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Countries seeking development resources and financial assistance are now turning to private markets—even if it means paying higher costs. They are also turning to regional arrangements. Nevertheless, for many poorer countries such as in Sub-Saharan Africa and Central America, the Bank and Fund remain a vital source. In exchange these countries must accept conditionality. But how effectively does this promote global development and financial and monetary stability?

### 3. CONDITIONALITY HAS NOT WORKED—BUT HAS NOT BEEN REPLACED

Conditionality has for twenty years been justified as a way to safeguard the loans of the IMF and the World Bank as well as ensuring that sick patients (governments who pursue wrong-headed policies) take necessary, even if unpleasant, medicine (principally, open up markets). The problem for both institutions is that conditionality has not worked. Some patients fail to take their medicine, others fail to recover.

Perversely, each institution has responded to the failure of conditionality by increasing the conditions they put on loans. When stabilization did not work, structural adjustment was added. When that did not work, good governance was added. Yet further conditionality (regarding participation and consultation) was added for countries wanting debt relief. Now each institution speaks of ‘streamlining’ or reducing conditionality and increasing ownership by borrowers. But their addiction to conditionality is proving difficult to beat. Conditionality sneaks back. Why?

Conditionality became a habit when the Bank and Fund had to avert a global financial crisis in the 1980s. That experience profoundly shaped them. Their work became pressing governments to agree to terms which had been written in Washington, DC. Their advice became a template of actions required of borrowers. Powerful incentives persist for this approach. The more a loan proposal conforms to a template of conditionality, the less a staff member will have to justify it to superiors. For the Bank and the Fund as a whole, the template makes it easier to claim that they are treating all borrowers equally.

Even once both institutions agreed that old-style conditionality did not work, they have found it difficult to replace. Mostly they have tried to restyle conditionality with “ownership.” Ostensibly the goal is to ensure that conditions are better adapted to country circumstances and that countries play a greater role in formulating their own economic strategy. But genuine local “ownership” is too tough for the institutions as they are currently structured. It throws up policies at odds with the mindset and habits of each institution. It requires trade-offs with each institution’s other aspirations, as recognized by the Bank in its 2002 World Development Report which notes the tension “between the Bank’s country focus and its implementation of more comprehensive and rigorous operational standards.” The problems with ownership point to deeper problems for each institution in giving policy advice.

### 4. THEY CANNOT BE IMPARTIAL ADVISERS

The Bank and Fund have long emphasized their valuable role as advisers. But not all borrowers value their advice as much as they would like. The most common complaint in the field is that Fund and Bank staff have no policy experience. Having completed doctorates in economics or finance, the staff are ill-equipped for the complex and messy work of the political systems in which they work. Democratic processes are seen as an obstacle to sound economic policy. As the Managing Director of the IMF recently declared in his Medium-Term Strategy “change is held back by politics.” This comment reveals the frustrations of economists faced with noisy fractious unpredictable politics. But in the rest of the world it reinforces the view (to quote the highly respected former Kenyan anti-corruption czar) that the Fund and Bank are “hard-wired to deal with authoritarian regimes.” It also overlooks that IMF and World Bank advice itself is infected with a good dose of “politics.”

Politics has always influenced the advice offered by the IMF and World Bank. South Korea’s first standby agreement with the IMF in 1997 was clearly decorated with conditions which had been added at the behest of the United States. In Russia through the 1990s, political pressures in the G7 pushed the Bank to make loans which were never used (but for which Russia had to pay charges), and pushed the IMF to turn a blind eye to failures to meet its targets. World Bank projects are sometimes covertly shaped by pre-existing agreements for contracts between large companies backed by powerful governments and borrowers.

Even the seemingly technical parts of IMF and World Bank programs are infected with political judgements. Growth targets and projections in many programs often reflect subtle manipulations required to get the figures to work in order to present an approvable loan. In their work for HIPC debt relief, staff in the Fund and Bank had to rework projections of countries’ macro-economic growth, tax collection, and fiscal balances to ensure that HIPC sustainability and MDG criteria were met within the envelope of resources donors were prepared to put on the table.

Finally, there is an inbuilt bias in the work of the IMF and World Bank towards changing the policies of individual borrowing members rather than changing international conditions that give rise to problems. For example, the IMF has put little priority on addressing the external causes of deficits within countries such as their inability to increase export earnings, short-term fluctuations in commodity prices, volatility among key currencies, and financial contagion. The World Bank has targeted advice on individual countries—such as exhorting African countries to increase

their exports of cocoa or other commodities—without properly analyzing the negative consequences of all countries doing the same thing (and thereby seriously reducing the world price of the commodity). The bias towards individual country reforms is understandable since this is where the Fund and Bank have leverage but it is also paradoxical since they are uniquely placed to tackle the international aspect of problems.

## Four ways the institutions could reform

The loudest calls for reforming the Bank and Fund are coming from the wealthy countries. Is this surprising? Borrowers have long put up with little voice and even less influence in the Fund and Bank. Their calls for change have long been dismissed as special pleading. Some have voted with their feet. Others remain resigned to using the institutions as a last resort.

By contrast wealthy countries are now in a bind. They need the IMF and World Bank help to globalize finance and manage crises, to open up new markets, and to offer a minimum of global coordination. But they now face a tough choice. Either they will probably have to pay more for the institutions. Or they will have to make them more attractive to borrowers. In fact they could do a lot in respect of the latter.

### A FIRST REFORM: EYES AND EARS TO THE GROUND IN BORROWING COUNTRIES

A surprising thing about the IMF and World Bank is how little attention they pay to listening, learning, and satisfying their fee-paying clients. Having become dependent on income generated by loan fees and charges paid by developing countries, one might expect they would be out discovering how better to satisfy their clients. But this does not happen. By far greater attention is spent ascertaining and meeting the wishes of powerful non-borrowing members.

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Both institutions need better eyes and ears in borrowing countries, and this is different to their increasing presence on the ground. Both institutions have created one-way communication systems with many of their borrowers. Their Resident Representatives and Country Directors are seen as an excellent way better to deliver policies and information. But there is return communication used by management in Washington DC to listen and to “learn” from the field.

Travelling across three continents one is immediately struck by the gaps separating what the Fund and Bank provide and what their clients want. In Sub-Saharan Africa, policy-makers wanted the IMF to understand how financial transmission mechanisms work in their economies (the Fund has never studied this). In Serbia-Montenegro policy-makers wanted alternative scenarios and detailed case studies of World Bank-advised privatizations which would enable them to make informed choices (they did not get them). In Latin America policy-makers wanted detailed and expert advice on how to liberalize their financial sectors, but did not get it.

Local knowledge is vital for the Fund and Bank to be useful to their borrowers. It is a far cry from the templates discussed above and from academic economics where high theory is privileged over applied work. Both institutions need concrete incentives for staff to learn about specific economies (the Bank is often perceived as doing this better than the Fund). They should deploy staff to one country for much longer periods of time, to leverage their learning and experience and also better to link staff efforts with outcomes in that country (in a couple of instances the Bank has done this very effectively). They should establish ways to pass on this learning and experience to each other—reducing the burden they place on already-overstretched policy-makers who currently have to spend time explaining the specificities of their economies to transient IMF and Bank staff.

A different kind of research is desired by borrowers: practical case-studies rather than high-tech theory. And advice which is not ideological or selectively screened to push a particular point of view. This requires shifting resources into the field and evaluating research against borrowers’ needs. Finally, borrowers often state that the Fund and Bank would be more useful if each hired staff with a broader sets of skills and experience and in particular with policy-making experience. This is not a new suggestion. Efforts in each institution to diversify staff have produced some results. But a much more serious re-staffing now needs to take place.

## A SECOND REFORM: MAKING OWNERSHIP REAL AND ENRICHING RATHER THAN HIJACKING POLICY DEBATES

Some conditionality may well be called for in Fund and Bank programs. But experience shows that anything more than a couple of tough conditions is simply a recipe for non-debate, non-compliance, and opportunism on the part of both lender and borrower. Self-restraint on this will require serious institutional changes within each institution. A first step for each would be to take ownership more seriously.

For the Fund and Bank to contribute usefully to debates about economic policy within countries they need first to find mechanisms for genuine dialogue with policy-makers and with economists working in individual countries. At present negotiations take place on the basis of an agenda set by the Fund and Bank. What the institutions hear are reactions to their own proposals rather than a proactive agenda probing and debating what a country's needs and priorities might be.

A simple test of whether the "ownership" they are sponsoring is real is to ask: where did the proposed policy or project originate? Was it in the government or community it is designed to serve? Equally, one could ask what resources the borrower is putting in—a clear reflection of their prioritization of what is proposed.

If the Bank and Fund can make ownership real, they will open up a space in which their expertise could genuinely inform (rather than hijack) debates about economic policy. In many countries, important economic choices have been lost in a simplistic battle between "reformers" (supported by the Bank and Fund) and those who "refuse to reform." This sacrifices alternatives which we take as a given in industrialized countries.

## A THIRD REFORM: INVOLVE BORROWERS IN DECISION-MAKING AT THE TOP

Some powerful members are now proposing radical change to the governance of the Fund and/or Bank. Get rid of the resident Executive Board in the IMF, Mervyn King has proposed. Or make it independent, several others have argued. Equally radically, some have questioned the secretive and shambolic procedure by which the U.S. selects the World Bank President and European countries select the Managing Director of the IMF. They are right. Leadership selection skews the accountability of a whole organization (as does the location of headquarters). Staff in both the Bank and Fund report to a manager who is in the end seen as accountable to the United States or Europe (who appointed them)—and this in spite of the fact that staff and management salaries are mostly paid by borrowers. Altering leadership selection is a vital way to rebalance accountability across each organization.

The Board is the other element of management. What should the Board in each organization do? Unlike companies, the Bank and Fund are public sector institutions, funded by taxpayers, which make decisions creating winners and losers—and not just in borrowing countries. They are lobbied from all sides. Within wealthy countries, corporations who bid for World Bank contracts or investment funds hoping for an IMF intervention will gain or lose from decisions. Other special interests also lobby both their own governments and the institutions directly. These interests cannot be simply wished away.

What each institution needs is a Board that can mediate competing interests in a way that is representative, transparent, and accountable. Adequate representation does not necessarily mean a UN-style system of one-country one-vote that would render the boards unwieldy. The present board structure offers a potentially useful framework for representing all members yet being small enough to be workable.

Lacking is an incentive for the most powerful vote holders to consult and build coalitions across a wide range of members when they can command an easy majority of voting power among themselves. Yet this could be simply achieved by requiring a majority of countries as well as voting power when the Board makes decisions. This would give powerful vote-holders an incentive to consult and join forces with those who have few votes but represent a larger number of borrowing countries. Equally, it would give borrowing members an incentive to participate more actively, more constructively, and with greater input into the strategic decisions made in each organization.

## A FOURTH REFORM: FOCUS ON WHAT EACH INSTITUTION IS 'UNIQUELY PLACED TO DO'

The IMF was created to foster monetary cooperation, financial stability, and to ensure that governments were not forced to take measures destructive of national prosperity. This is where the institution's real value-added lies. In a world economy driven and energized by global capital markets, public institutions have an important role. Markets create externalities and sometimes fail in ways which produce systemic risks, irrational behaviour, contagion, spill-overs from other countries' bad policies, and currency crises.

The IMF can do a number of things to complement and mitigate the sharpest excesses of markets. A reformed Fund could win back the trust of its Asian members and act as a mutual insurance fund for all countries facing the risk of financial crisis. A reformed Fund could offer advice to governments on how best to mitigate and manage macroeconomic and global risks, including on precautionary measures, and on how different

macroeconomic responses to a crisis will impact social distribution and recovery (an issue the Fund has never investigated). Finally, a reformed Fund could operate as a forum for monetary cooperation among its members, including on exchange rates, peer monitoring, and standard-setting. The Fund cannot play this role at present because so many of its members perceive it as little more than an extension of the G7 (or sub-G7). Yet the recent enthusiasm for G-groups (G22, G20, G8 plus) is testimony to the need for a more inclusive discussion.

The potential role for the World Bank is different. The Bank can raise funds from capital markets (as well as from individual members) to lend to members needing to borrow for development or for post-war reconstruction. A reformed Bank would continue to offer such loans—but with more attraction for borrowers. A reformed Bank could also play a useful role in the coordination of aid which is notoriously fragmented, duplicative, and cluttered with a large number of donors tripping over each others' bilateral as well as multilateral efforts. However, at present borrowers prefer the costs of dealing with multiple donors to the risks of control by an institution in which they have little voice. Finally, a reformed Bank could feed, fund, and draw together research (in borrowing countries) which reflects the priorities and needs of its borrowers.

In short, four compelling trends are pushing the Bank and Fund to change. A useful future could be assured for each if they focus their eyes and ears on their borrowers, contribute to rather than hijack policy debates, involve borrowers in their decision-making, and focus on those roles for which each has a unique capacity. That will not just require that the staff and management break long-held habits. It will also require the wealthiest shareholders of each institution positively to push for these reforms.

## References

- 1 Mervyn King (Governor of the Bank of England), Reform of the International Monetary Fund, Speech given at the Indian Council for Research on International Economic Relations (New Delhi, 20 February 2006). Timothy D. Adams (US Department of the Treasury), The US View on IMF Reform, Speech presented at the Conference on IMF Reform, Institute for International Economics (Washington, DC, 23 September 2005). Meeting of G20 Finance Ministers and Central Bank Governors, Xianghe, Hebei, China Communiqué, October 16, 2005 (see [www.g7.utoronto.ca/g20/](http://www.g7.utoronto.ca/g20/)).
- 2 On top of this, in the 1980s the US insisted (successfully) that borrowing countries in each institution should shoulder the costs of bad loans, and that in the IMF more income should be used to pay wealthy members for lodging their 'quotas' of reserves. By 2003 the IMF was spending twice its total administrative expenses remunerating its wealthy non-borrowing members.
- 3 See [www.imf.org/external/np/tre/tad/extfor1.cfm](http://www.imf.org/external/np/tre/tad/extfor1.cfm)
- 4 IMF, *World Economic Outlook 2005*, p.259.

## Related CGD Work

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*A New Era at the Inter-American Development Bank: Six Recommendations for the New President.* Report by the Latin American Shadow Financial Regulatory Committee and the Center for Global Development. (Washington, DC: Center for Global Development, 2006).

*The Hardest Job in the World: Five Crucial Tasks for the New President of the World Bank.* CGD Working Group Report. (Washington, DC: Center for Global Development, 2006).

Kemal Dervis and Ceren Ozer. *A Better Globalization: Legitimacy, Governance, and Reform.* (Washington, DC: Center for Global Development, 2005).

Kemal Dervis and Nancy Birdsall. "A Stability and Social Investment Facility for High Debt Countries." CGD Working Paper 87. (Washington, DC: Center for Global Development, 2006).

Steven Radelet, "The Role of the IMF in Well-Performing Low-Income Countries." CGD Working Paper 83. (Washington, DC: Center for Global Development, 2006).



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