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IMF credibility risks being caught between East and West

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The IMF's role in Greece, the potential inclusion of the Chinese yuan in its currency basket, the emergence of the AIIB and governance reform have combined to shine an uncomfortably bright spotlight on the perceived dominance of the fund by Western governments, and in particular, the US

Source: IMF Staff Photo/ Stephen Jaffe

Like money, credibility can prove hard to earn but easy to lose. When it comes to meeting the mandate of promoting global economic and financial stability that IMF managing director Christine Lagarde set out in July in a speech in Brussels, credibility is probably the most valuable asset the world's financial watchdog holds.

With just over six months to go before the process for re-electing Lagarde or selecting a new MD begins, the assessment of the IMF's track record at this week's meeting could play a key role in determining the direction of the fund over the remainder of this decade and beyond.

As this year's annual meetings begin, it is clear that a host of key issues and events have conspired to jeopardise that credibility. The fund's role in the eurozone and particularly Greece, the potential inclusion of the Chinese yuan in the IMF's currency basket, the emergence of rival institutions and the overarching issue of governance reform have come under the spotlight.

While these issues may initially appear to be unconnected, they share one factor in common — the perceived dominance of the Fund by Western governments and particularly by the US. "These issues are interconnected, but people tend to discuss them in isolation from each other whereas in fact they are really impacting on each other," says Sargon Nissan, IMF & finance programme manager at the Bretton Woods Project, an NGO (non-governmental organisation) critical of the fund.

As an estimated 13,000 finance ministers, central bankers, civil servants, NGO activists, thinktank experts and journalists descend on Lima this week, they will be reminded that the IMF leaves its Washington home to hold its annual meetings only once every three years.

The dominance by the US of the institution that still has a monopoly over international emergency financial bailouts has always been an irritant to critics of the fund but the anger looks set to come to a head this year.

GOVERNANCE REFORM

This December will mark five years since the IMF's Board of Governors agreed in 2010 to a package of reforms that would double the organisation's resources and change its governing structure in favour of emerging economies. The deal would:

• Double the fund's general financial resources;

• Recalculate the voting power of emerging economies to reflect better their growing share of the world economy and cut the combined voting power of the US and European Union to below 50;

• Take away two executive board seats currently held by EU member states.

Although the US was among those that voted in favour, President Barack Obama has been unable to secure the necessary backing of Congress. And approval of US senators and representatives is crucial, as both reforms require the backing of countries holding 85% of the fund's total voting power.

Since the US holds 16.74% of the votes, it alone has an effective veto on any reforms. As of late August, 147 members holding 77.25% of total voting power had accepted the amendment. Even if the other countries holding 6% of the vote fall into line, that will only deliver 83.25%. So close yet so far.

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Republicans have blocked implementation because they are worried the changes would reduce American influence at the IMF and object to US taxpayers funding some of the changes. The Congressional Budget Office last year put the cost of implementing quota reform at $315m.

Despite pressure from Lagarde, foreign leaders and the US government — in May Treasury Secretary Jack Lew said Congress “needed to act” — legislators have managed to force the deadline to be put back every year.

In June the IMF’s executive board publicly threw down a gauntlet to Congress urging them to sign up to the deal by September 15 or it would come up with an “interim” solution. The following month Lagarde said the interim step was “very much on the cards” and should be considered as a “down payment” on what was promised.

While the reforms remained in limbo, the IMF was forced to ask for loans from its members rather than the permanent resources that would come from the reforms. These loans, meant as a temporary bridge before the reforms entered into effect, need to be reaffirmed every six months.

Inevitably US Congress missed the deadline thanks to the small number of legislative days in the September calendar and the more politically important debates over the Iranian nuclear deal and the US Budget to avert a government shutdown.

NEW RIVALS

According to Jacob Kirkegaard, a former Danish politician and now senior fellow at the Peterson Institute of International Economics in Washington, the delays of the last five years are an indictment of both the global community and the IMF itself.

“The biggest concern for the IMF as a credible organisation is the inability of the IMF to implement its own leadership reforms because of the unwillingness of the US Congress to do this,” he says.

“The reality is that every time the global community says it will give the US another year to get this sorted, Congress simply draws the lesson from this of ‘screw it, this is not particularly urgent; they’ll just give us another year and then the status quo will continue’. The only way to play with Congress is to play hardball and say ‘you do this or we will continue without you’.”

The issue could come to a head amid what Domenico Lombardi, director of the global economic programme at the Centre for International Governance Innovation (CIGI), calls an “exponentially growing frustration among emerging economies”. He says any interim measure to bypass Congress and give certain emerging markets greater voting share would be “very limited in scope”.

Whatever happens, it is clear the debacle will only add to the feeling that the US is becoming increasingly distant from the international financial stage. The US government strongly urged its allies not to join the Asian Infrastructure Investment Bank (AIIB), the Chinese-led multilateral lender that was launched this year. Their friends ignored the call, with the UK, France, Germany and Australia joining 53 other states to offer money.

While the AIIB is more of a rival to the World Bank than to the fund, the move was seen as a clear sign that China was fed up with the failure to implement the reform that would raise its vote share from 2.9% to 6.1%.

The AIIB is not the only new kid on the block. The Brics countries (Brazil, Russia, India, China, South Africa) have set up the New Development Bank and — more significantly for the IMF — a $100bn Contingency Reserve Arrangement (CRA), a pool of currencies intended “to forestall short-term balance of payments pressures, provide mutual support and further strengthen financial stability”.

In 2012 the Asean countries (Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) together with the so-called “Plus Three” countries (China, Japan and Korea) doubled the size of the Chiang Mai Initiative Multilateralisation arrangement to $240bn and introduced a crisis prevention function.

The reform issue has only exacerbated that resentment. “Its credibility as an emergency lender and bailout facilitator will be jeopardised by the unwillingness of the organisation to fundamentally reflect what the world economy looks like in the 21st century,” Kirkegaard says.

CURRENCY CLUB

Another key disagreement between the US and China that could impact on the IMF is Beijing’s request to include the renminbi (also known as the yuan) in the basket of currencies that is used to value the special drawing right (SDR), the IMF’s own currency club.

Opponents in the US argue that it would give a stamp of approval to the way China controls its exchange rate and refuses to liberalise its financial services, which they say give it unfair trade advantages. In a letter to the IMF, Democrat Senator Chuck Schumer and his Republican counterpart Lindsey Graham urged Lagarde “not to entertain the possibility”.

“China’s inability to adequately liberalise its own currency and its capital flows in a manner necessary to satisfy the IMF’s clear standards provides sufficient basis for the executive board to deny its inclusion in the SDR basket,” they wrote. “Before the yuan is considered a reserve currency, China must also make significant progress in strengthening its financial regulation and supervisory systems.”

Their argument appears to have carried weight. The IMF is scheduled to make a decision by the end of this year but in August it unexpectedly announced that even if it were to decide in favour of inclusion, the change would be delayed by nine months to September 2016.

The official explanation was that trading is relatively thin in the days before and after the New Year, while the possibility of a new currency being included in the basket has generated a "higher-than-usual level of uncertainty" for SDR users.

Although the decision was taken on August 4, the announcement came in the wake of the unexpected 3% devaluation of the renminbi on August 12 that added to fears that China's economy was slowing and triggered a global rout on world stock markets and commodity prices.

The paper that accompanied the announcement contained hints that the decision was resting on a knife edge. It said the yuan "trailed" the current four currencies in terms of being "freely usable" — a key criterion. It said the IMF was assessing whether recent reforms by the Chinese central bank had ensured sufficient access to the domestic bond market. "In other words, the case has not yet been made," says Andrew Kenningham, senior global economist at consultants Capital Economics.

The decision may be made next month, giving China a few more weeks to make the reforms that both China's critics and the IMF want. Robert Khan, senior fellow for international economics at the Council on Foreign Relations, says "good things" could emerge from the negotiation.

He says it is important the US made the right call on the issue especially after the "fiasco" surrounding the American objection to the establishment of the AIIB. "The US position should support China making some significant steps ahead of the decision, including regarding transparency and continued moves to a more market-oriented exchange rate. The ultimate objective for the IMF will be a package of measures that can get the US to say 'yes'."

The issue will probably come off the boil in the wake of the turbulence in China's economy, says Nissan at Bretton Woods Project. "While it would be nice for the Chinese to have the renminbi as a global reserve currency, their priority in the short to medium term is on internal economic management and on sustaining demand, which has implications about the exchange rate, which may not be immediately compatible with ambitions for the renminbi to rival the dollar in the short to medium term."

GREEK RETREAT

But it is probably the way the IMF has intervened to help eurozone countries teetering on the edge of bankruptcy — and Greece in particular — that has caused most anger both outside and within the fund's Washington headquarters.

The fury broke out into the open in 2013 when 11 Latin American countries refused to back an IMF move to keep bankrolling Greece, citing risks of non-repayment. In an unusual move, Paulo Nogueira Batista, Brazil's executive director at the IMF, who also represents 10 small nations in Central and South America and the Caribbean, said the deal confirmed "some of our worst fears".

"Implementation [of Greece's reform programme] has been unsatisfactory in almost all areas; growth and debt sustainability assumptions continue to be over-optimistic," says Batista, who was critical of the 2010 bailout that he says was based on "Panglossian" assumptions.

However, some independent experts believe the IMF was right to take into account a "high risk of international systemic spillovers". Kirkegaard says a forced restructuring of Greek debt to enable the IMF to meet its criteria would have caused a run on other peripheral countries and a worse financial crisis than happened after the failure of Lehman Brothers.

"Not to do that in 2010 for systemic stability reasons was exactly the right decision and the idea that you could have done it then and nothing would have happened is naïve," he says. Assuming political stability after the forthcoming elections, implementation of structural reforms and a stimulus from the bailout, the Greek economy could grow 3% in 2016.

"The IMF will look pretty good and not least its managing director, who is up for re-election in July next year. She has been even-handed handing out reform requirements to Greece and being tough on the creditors so I would expect Lagarde to get a second term."

Lombardi at CIGI agrees, saying a combination of a desire by the US to continue its control of the top job at the World Bank and a lack of a unifying figure among the Brics would keep the job in European hands.

But even if Greece rebounds it will do little to assuage resentment that the IMF lent more money to the eurozone than to any region in the past. "Eighty percent of the IMF's money is in Europe — that's a huge proportion," says BWP's Nissan.

However, the fact that the IMF reluctantly agreed to act as a junior partner and let the European institutions lead the eurozone bailouts has established a protocol that should enable the fund to step back. "There is a choreography occurring where the IMF is easing itself out and in so doing is trying to recover some of its credibility with the broader membership by being more publicly critical of Greece's debt sustainability dynamics," Nissan says.

One ironic consequence of the European bailouts and the way eurozone finance ministers treated Greece was to make regional institutions less likely to rival the IMF. "The extent to which those alternative sources are sufficient in a crisis is limited," Nissan says. "Who's going to put their money at risk and then have to enforce conditionality in the way Germany does with Greece when there's the IMF to do that for you?"

He says there is a "strong case" that the IMF has been rejuvenated by the eurozone crisis because countries could not see a realistic alternative solution on the horizon. "The governance dimension is not such a problematic issue as a result, but in time it could drive those alternatives into being achieved faster than they have been," he says.

However, he says the IMF's board could lower the heat over the eurozone bailouts by announcing that the next managing director would be selected through a fully open, meritocratic process that would lead to a non-European taking the helm for the first time.

“That could let some of the steam out of the pressure cooker. The IMF remains a very important institution, but that is not to say it will do as good a job as it could do were it to have the governance reforms that we call for,” he says. “That would make it truly representative of all its membership and have a particular space for the voice of developing countries.”

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