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Reforms for the World Bank and International Monetary Fund

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Next week, when the two most important international financial institutions, the World Bank and the International Monetary Fund (IMF), meet in Singapore, they will have to face two key questions. The IMF must ask what it can do to make itself relevant in a crisis-free world. The World Bank must ask how it can deliver foreign aid more effectively.

Can the IMF Reform?

During the past couple of years, critics and supporters alike have questioned IMF's relevance in today's world. The IMF was last involved in a major, high-profile crisis scenario in December 2001, after Argentina defaulted on $81 billion of sovereign debt. Today, the unusual abundance of liquidity throughout the world has afforded emerging economies easier access to private capital. As a result, there is far less need for IMF funds. In fact, some major IMF debtors, such as Argentina and Brazil, have paid off their debt.

Despite questions regarding the Fund's relevance, its supporters are working hard to come up with new ideas. The most popular idea is that the IMF should focus on "surveillance" and anticipate when countries are about to hit a financial crisis. This surveillance would be conducted mostly through the IMF article IV consultations, the annual review done by IMF economists that assesses the country's exchange rate, monetary and fiscal policies; financial sector issues; risks and vulnerabilities; and institutional and structural issues. Accordingly, the IMF supposedly would be able to detect potential risks that could lead to a crisis and help countries modify their policies to avoid a crisis. The surveillance policy assumes, however, that the IMF would have leverage in forcing countries to adopt the right policies. The IMF's history of working with countries suggests that such leverage is improbable. Moreover, countries now have easier access to more significant funds in the private sector.

Economists Charles Calomiris and Alan Meltzer of Columbia University and Carnegie Mellon University, respectively, have proposed an IMF reform plan based on Meltzer's commission report in 2000. In their view, the IMF would act as a quasi-lender of last resort, lending only to countries that qualify according to a set of pre-conditions. These pre-conditions include a sound fiscal policy; freedom of entry and operation for foreign financial institutions; and adequately capitalized commercial banks. Additionally, a recipient must regularly publish the maturity structure of its outstanding sovereign and guaranteed debt and off-balance liabilities.[1]

The Bush Administration should work with the U.S. representatives to the IMF board to propose a reform of the IMF lending practice so that it can effectively act as a lender of last resort. By lending

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to countries that pre-qualify, there will be no need to attach conditions, which are rarely met, to the loans, and lending to countries that pre-qualify will remove incentives for irresponsible behavior on the part of the borrowing governments.

Unfortunately, the debate over the IMF lending practice seems to take place mostly in academic and think tank circuits. Fund members are more concerned with their share of power within the organization, most generally in the number of votes they can cast. Under the leadership of Rodrigo de Rato, the IMF's managing director, the Fund is now proposing a reform in the voting system over the next two years. The reform entails increasing quotas for members that look underrepresented—most immediately for China, South Korea, Mexico and Turkey. It also will look at broadening the allocation of votes and designing a new formula to calculate voting rights.

Giving greater voting power to members who have a strong role in the world economy and politics makes sense, and the Bush Administration should support that reform. However, it is important that the United States, since it has the biggest financial stake in the organization, retain its veto power to changes to the Articles of Agreements.

The World Bank's Dilemma

The World Bank faces the question of how to make aid more effective. The most difficult challenge for the Bank is the issue of corruption, the main reason that aid money never reaches the poor.

Corruption is sometimes a moral problem, but more often, particularly when it takes the form of bribery, it is the response to high taxes, cumbersome regulations, unpredictable changes in business rules, and lack of rule of law. Corruption is especially prevalent in poor countries, where most people cannot afford to abide by the rules and the political leadership squanders funds regularly without punishment.

Foreign assistance has the potential to help poor countries achieve specific goals, but it cannot replace the political will to implement policy change. Developing countries must make their own internal reforms. However, the World Bank can place incentives for the governments of poor countries to adopt policies that promote economic freedom and strengthen the rule of law. It could emulate the Millennium Challenge Account (MCA), a new U.S. government approach that makes assistance available only to countries that govern justly, invest in their people, and encourage economic freedom. In other words, only countries with relatively good policies receive aid.

The Bush Administration should work with the U.S. representatives to the World Bank to propose a reform of its programs so that aid is delivered to countries with sound policies in place and a record of good governance.

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1. The full International Financial Institutions Advisory Commission (IFIAC) report is available in English at *http://www.house.gov/jec/imf/meltzer.htm*, and in Spanish at *http://www.heritage.org/library/efp/efp00-04.html*.