The Orderly Resolution of Financial Crises – A G20-Led Initiative

How could a Leaders' Level G20 make a difference?

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BRIEFING NOTE

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The IMF lies at the centre of multilateral responses to financial crises. The Fund in 2005 requires political leaders to equip it to deal much better with crises. The proposed L20 could play a key role in this regard. They could start with four clear objectives set out below.

My starting presumptions are that the Fund is not a `fix-it-all'. It should not be engaged in replicating or substituting what private sector actors can or should do. It is a public, multilateral institution. Its core responsibilities are concerned with both efficiency and equity.

The IMF exists in part to ensure that markets can work efficiently. Equally vital is the Fund's role in ensuring equity, or to use words from Article 1 of the IMF's charter to ensure balanced growth, to promote high levels of employment and real income, and to shorten and lessen the impact of crises. Far too little attention has been paid to this latter duty in respect of the Fund's role in financial crises.

Let me provoke discussion by positing that the G7 countries have eroded the capacity of the IMF to fulfil its mandate in financial crises in at least four ways. Each of these signals a change the L20 could make.

1. The G7 have failed to direct the Fund to mitigate unemployment, poverty and inequality caused by financial crises.

For a brief moment in the aftermath of the East Asian crisis, the social effects of financial crises were considered (see World Bank's report on the Social Consequences of the East Asian Financial Crisis). Since that time, all too little follow-up attention has been paid. In the recent evaluation of the IMF's role in the financial crisis in Argentina, the first paragraph of the report notes that the incidence of poverty increased dramatically (IEO 2004, p.1). No further mention is made of poverty in the report. A much more serious evaluation of how the Fund can mitigate the harsh effects of crises – and the impact of the sequencing and scale of reforms in a crisis – is called for. Leaders are uniquely positioned to draw attention to this.

2. The G7 have weakened the Fund by demanding an ever-greater shares of remuneration to themselves from its resources.

The IMF expends a large portion of its resources remunerating its creditor members for the portions of quota they hold with the institution. This was not envisaged when the IMF was created. Indeed, it did not begin until 1968 when a small fixed rate of remuneration was fixed. However, pressure from the US in the 1980s resulted in a rapid escalation of the remuneration rate until it reached the full SDR interest rate. The result is that over the last couple of years the Fund is spending more than double its total administrative expenses on the remuneration of its creditors. To pay for these expenses borrowing charges have continued to increase so that in 2004 they stood at 154% of the SDR rate. Central banks and Finance Ministries in creditor countries need to have their own gains from remuneration placed into the larger political visio of an IMF which is a multilateral institution providing public goods to all its members, based on contributions by all its members.

3. The G7 have set borrowing charges (and conditionality) at a level which deters members from approaching the IMF in a timely way.

The failure of the CCL is but one example. Countries do use the Fund but as the absolute resort of desperation. The founders of the institution had envisaged low and stable borrowing rates for the institution which would encourage countries to approach the institution early on and enable larger deeper crises to be forestalled. Current arrangements neither provide an incentive to potential borrowers, nor confidence. Indeed some would argue that reserves being built up by Asian members outside of the Fund are a sign that the Fund is failing to give confidence to its members. The issue of charges and conditionality needs a political settlement, guided by expertise and much harder evidence as to the effects (including moral hazard) of current arrangements.

4. The G7 hold the institution tightly to account while giving borrowing members little if any incentive to participate in the governance of the institution.

At present the G7 needs hardly to consult with other members. Wielding 47.13% of the vote, it needs only persuade another Director in order to command a majority. Consider by contrast the position of Chile or Argentina. If they can persuade their own constituency of 6 countries, they will wield a total of 2% of the vote. Persuading the further 9 countries led by the Brazilian Chair in the Fund, will add another 2.47% of the vote. Further efforts might bring on board the 13 countries chaired by Malaysia, adding a further 3.18% of the vote. That's a lot of diplomatic activity in order to mobilize a voting power of less than 8%. They are still a long way from even being able to put something on the agenda.

Others advocate altering quotas or increasing basic votes. Yet neither of these measure is likely to produce the desired result – viz – creating a strong incentive for G7 members to consult more widely and build a broader coalition across the institution. Executive Directors widely bemoan a loss of the `consensual tone' of the Board. As I have argued elsewhere, this would be better recaptured by leaving voting powers as they are and simply extending the requirement for a double-majority already within the Fund's Articles (for amending them). This would require the G7 to muster a majority not just of voting power but also of members (Woods and Lombardi 2005, and Woods, forthcoming). Put simply, large shareholders would then face a powerful incentive to build a coalition across the institution. This is a simple straightforward measure which takes no voting power from any existing members. In a stroke it could deliver a measure of legitimacy to the organization, and a degree of participation which would help the other objectives laid out in this briefing.

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