WebMemo
Published by The Heritage Foundation

No. 1675
October 23, 2007

The World Needs Less IMF, Not More

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The International Monetary Fund (IMF) and the World Bank concluded their annual meetings on October 22. Both institutions have new leadership and face serious questions about their role in an increasingly globalized world awash in private capital. The IMF today is an institution without a clear role. Its original mission ended with the expiration of the Bretton Woods system of fixed exchange rates in the early 1970s, and it has assumed several missions since, most recently the role of bailing out developing countries facing financial crises. The growth of global markets, however, makes this role increasingly untenable, and the moral hazard created by the implicit guarantee that the IMF will step in when needed casts doubt on the wisdom of this role, in any case. It is past time to fundamentally reevaluate the mission and structure of the IMF to make it better fit the modern world. The IMF can fill a useful role by providing sound economic and fiscal advice to governments. This role does not require its current resources, however, and new IMF managing director Dominique Strauss-Kahn should propose transforming the IMF into a leaner institution and returning the bulk of IMF resources to the member states.

The Increasing Irrelevance of the IMF. The IMF was created in the waning years of World War II as a key part of a strategy to prevent a recurrence of the economic recession and depression that preceded and contributed to World War II. Under the rules established for the Bretton Woods system,[1] each currency was assigned a value in gold that was to be maintained within a narrow range. The IMF was the mechanic that kept this system running smoothly.[2]

For the first quarter century of its existence, the IMF had a clear mandate, but in the late 1960s and early 1970s, the system of fixed exchange rates that the IMF was set up to oversee began to break down. The United States loosened the dollar peg to gold in 1968 and discarded it completely in August 1971. This rendered irrelevant the primary function of the IMF.

Instead of reducing its activities, the IMF sought out new missions to justify its continued existence. As successive crises erupted, the IMF reoriented its focus to deal with them. From the oil crises of the 1970s to the 1997 Asian financial crisis, the IMF moved from crisis to crisis to justify increased lending, arguing that each situation would be much worse absent IMF intervention. Throughout this process, the IMF doled out economic prescriptions along with financial assistance to many developing countries. Recipients often chaffed under the policy prescriptions of the IMF and increasingly sought to avoid IMF assistance and the accompanying restrictions. As noted by *The Washington Post*,

This paper, in its entirety, can be found at:
www.heritage.org/Research/InternationalOrganizations/wm1675.cfm

Produced by The Margaret Thatcher Center for Freedom

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
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> Just a decade ago, the fund, famous for its bailouts of troubled developing countries, was at the center of tumultuous financial events in Asia, Russia and Brazil. Those countries have recovered, paid back their emergency borrowings and gone on to pile up international reserves…. Asian resentment at the way Western-led institutions handled the 1997-98 Asian financial crisis has given rise to the Chiang Mai Initiative, a 13-nation accord to pool resources for the next crunch. It has far more money available than the IMF could muster.[3]

Simultaneously, other countries began seeking out less prescriptive sources of financing. Countries with access to international capital markets are tapping them rather than going to the IMF. In Latin America, finance ministries have expressed interest in creating a "Bank of the South" which could supplant many of the IMF's traditional functions in economic or balance-of-payments crises. Countries like Angola borrowed from China rather than bow to IMF demands for increased transparency that accompany its financing.[4] Today, the IMF finds itself a lender with few customers. According to *The Washington Post*, "The IMF has only $11 billion in credits outstanding; it is sitting on $252 billion in usable resources."[5]

What Role for the IMF? On November 1, 2007, Dominique Strauss-Kahn, a former French finance minister and presidential candidate, will begin his term as the new managing director of the IMF.[6] Mr. Strauss-Kahn should use his term to reshape the struggling international financial institution for the modern, rapidly changing global economic system. In his interview with the IMF Board of Governors, Mr. Strauss-Kahn vowed reform and acknowledged that "it will be a hard task for all of us to rebuild both the relevance and legitimacy of this organization. But I am prepared to do that and I ask you to be prepared as well."[7]

So what is Strauss-Kahn's vision for the "rebuilt" IMF? He acknowledged the need for the IMF to carefully examine its size and functions, reduce expenses, and develop a sound source of income. However, he also said, "We don't need less IMF, we need more IMF."[8] More IMF is needed, he said, "for the IMF to make financial stability serve the international community, while fostering growth and employment."[9] This plan ignores reality.

The IMF has become a marginal player in managing the global economy. Even if it could get nations to borrow, it is uncertain what purpose the loans would serve. As more countries eschew currency pegs and fixed exchange rates, there is less need for IMF lending to maintain currency values. Indeed, absent rock-solid fixed exchange rates

1. The system was named after Bretton Woods, New Hampshire, where representatives from 44 nations negotiated the details of the new international financial institutions. The dollar was fixed to gold at $35 per ounce and backed by U.S. gold reserves, which led many countries to hold dollars as a reserve currency in place of gold.
2. For more information, see Brett D. Schaefer, "The Bretton Woods Institutions: History and Reform Proposals," Heritage Foundation *Economic Freedom Project Report* No. 00-01, April 1, 2000, at *www.heritage.org/Research/InternationalOrganizations/EFP001-01.cfm*.
3. "Crisis Comes to the IMF: The International Monetary Fund Needs Restructuring, and Maybe a Bailout," *The Washington Post*, October 19, 2007, p. A20, at *www.washingtonpost.com/wp-dyn/content/article/2007/10/18/AR2007101802012.html*.
4. James Traub, "China's African Adventure," *The New York Times*, November 19, 2006, at *www.nytimes.com/2006/11/19/magazine/19china.html*.
5. "Crisis Comes to the IMF," *The Washington Post*.
6. "IMF to Name New Leader Amid Questions About Its Future," Agence France–Presse, September 28, 2007, at *http://afp.google.com/article/ALeqM5h9AIeZ_bfOlGqPzd9B6tJY7drFkw*.
7. *Ibid.*
8. "Strauss-Kahn to Press Ahead on IMF Reform," *IMF Survey*, October 1, 2007, at *www.imf.org/external/pubs/ft/survey/so/2007/NEW101A.htm*.
9. Statement by Mr. Dominique Strauss-Kahn on His Selection as Managing Director of the IMF, International Monetary Fund, Press Release No. 07/213, September 28, 2007, at *www.imf.org/external/np/sec/pr/2007/pr07213.htm*.

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under a currency board or similar arrangement, efforts to mange or peg currency values simply invite currency speculation.

The days when an institution like the IMF can arrest serious global financial crises are waning or ended. It simply doesn't have enough money. Today's global markets facilitate the flow of trillions of dollars in private capital. In 2006, international net capital flows totaled more than $4 trillion, of which $650 billion went to developing countries.[10] Global trade of goods and commercial services exceeded $14 trillion in 2006.[11] The usable resources of the IMF, at less than $300 billion, are minimal in relation to international financial flows—certainly insufficient to counter private capital flows. Solving serious financial crises through IMF bailouts is simply no longer possible. Worse, attempts or implicit promises to perform such a role arguably increase market volatility and the likelihood of crisis by creating a moral hazard that encourages imprudent risk-taking by governments and investors.

In its search for a mission, the IMF has become increasingly involved in development. This blurs its mandate and treads on the mission of the World Bank. Unfortunately, Strauss-Kahn seems inclined to go further down this path based on his desire for the IMF to be active in "fostering growth and employment." Though the World Bank has seldom been successful in this mission, it does possess far more expertise and experience in these areas than the IMF. The IMF is unlikely to do a better job of achieving the Bank's mission than the Bank.

The one resource that the IMF possesses that remains relevant is its expertise and experience in providing governments with sound economic and financial advice. International markets and private capital flows react to policies: Prudent polices are rewarded with investment and access to capital, and poor policies are punished as investment flees and credit is frozen. Governments should use the IMF as an impartial consultant and advisor on economic policy. Specifically, the IMF should seek to advise governments on how to transition toward greater economic freedom.

Enhancing economic freedom is crucial to economic development and sustained prosperity in an increasingly integrated global market. Economic growth and prosperity depend on maintaining and improving an environment in which entrepreneurial activities and innovation can flourish. Countries with higher degrees of openness and flexibility benefit from the free exchange of commerce and thereby enjoy sustainable economic growth and prosperity. This relationship is documented in the *Index of Economic Freedom*, published annually by The Heritage Foundation and *The Wall Street Journal*, which measures economic freedom around the globe.[12] The empirical findings of the *Index* confirm that countries with greater economic freedom are more prosperous than are those with less economic freedom. In other words, economies built on greater economic freedom are inherently and fundamentally stronger.

Mr. Strauss-Kahn should pursue reforms to focus the IMF on promoting economic freedom. While not as dramatic as organizing bailouts or crisis management, this role would make a big contribution to the IMF's historical mission of promoting stability in international financial markets and its stated desire to promote economic growth and development. A leaner, more focused IMF could also return most of its current reserves to member states, retaining only a small portion sufficient to fund expenses through returns on investment.

10. Global Development Finance 2007: The Globalization of Corporate Finance in Developing Countries (Washington, D.C.: World Bank, 2007), at http://go.worldbank.org/A6NOL5UPY0, and International Monetary Fund, "Global Stability Report: Financial Market Turbulence: Causes, Consequences, and Policies," September 2007, at *www.imf.org/external/pubs/ft/gfsr/2007/02/index.htm.* In 2006, worldwide FDI inflows were about $1.2 trillion. Other capital flows include portfolio equity investment, which is more liquid and volatile.

11. World Trade Organization, "Risks Lie Ahead Following Stronger Trade in 2006, WTO reports," Press Release, April 12, 2007, at *www.wto.org/english/news_e/pres07_e/pr472_e.htm.*

12. Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, 2007 Index of Economic Freedom (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/research/features/index.*

Conclusion. To a great extent, Mr. Strauss-Kahn's success depends on how seriously he implements real changes in close coordination with reform-minded member states. Reformers should urge Mr. Strauss-Kahn to overcome institutional inertia and transform the IMF into an institution better suited to the modern world and able to provide useful services to member governments. Specifically, Strauss-Kahn should eschew the temptation to maintain the IMF's futile mission to counter private financial markets and manage financial crises. Nor should he attempt to infringe on the mission of the World Bank. Instead, he should seek to make the IMF a leaner institution focused on using its expertise and experience to provide sound economic and financial advice to countries seeking to adjust to a global economy that rewards entrepreneurship and economic freedom.

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