UNITED STATES SENATE
Subcommittee on Security and International Trade and Finance
Committee on Banking, Housing, and Urban Affairs

Hearing on
Reforming Key International Financial Institutions for the 21st Century
August 2, 2007

Prepared Statement of
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Mr. Chairman, Senator Martinez, Members of the subcommittee, thank you for your invitation to testify this afternoon. I am a Professor of Law at Georgetown University Law Center and a non-resident senior fellow at the Center for American Progress. I testify today in my individual capacity as an academic, with no client interests or representation.

As the title of this hearing suggests, the international financial institutions created at the Bretton Woods conference in 1944 are showing their age. The world around them has changed dramatically: Capital now flows in amounts and at a pace undreamed of in the mid-twentieth century. The number of member countries has increased by a factor of greater than four, to the present level of 185 in both the International Monetary Fund and the World Bank. The world's economic weight is shifting toward Asia.

Over the years, the Fund and the Bank have made many policy mistakes of both commission and omission (though one hastens to add that these policies were usually agreed to, and often encouraged, by the institutions' largest members, beginning with the United States). And, like most organizations more than 60 years old, the Fund and the Bank have taken on certain internal features and practices that are not advantageous for responding to these new conditions.

Many commentators have concluded that, for both the external and internal reasons just mentioned, far-reaching changes are needed in both institutions. Indeed, in the past decade, some on both the left and right ends of the political spectrum have suggested that one or both institutions have outlived their usefulness. As my testimony this afternoon will demonstrate, I agree that extensive change is needed. However, my call for change rests squarely on the belief that it is very much in the interest of the United States that these two institutions successfully adapt so that they can more effectively confront the new challenges and take advantage of new opportunities. Thus, as we call for reform, it is important that these calls be cast less as threats to the Fund and the Bank than as the kinds of demands we would place on any organization that has a vital role to fill but is not currently up to the task.

In the balance of my statement I will try to place in context the current calls for reform by identifying both the similarities and the differences in the situations of the two institutions and thus the right agendas for reform. Though the two institutions are closely tied in many ways, they are faced with quite different challenges today. In some sense, the problems of the Bank are fundamentally management problems—extensive, to be sure, but largely within the capacity of the Bank's senior management to address, assuming even moderate levels of cooperation from major countries.

The Fund, on the other hand, truly faces an identity crisis. It has fallen rapidly from perhaps the most influential international institution (though not a beloved one) a decade ago to the point where its very relevance to contemporary problems has been called into question. Although not without its own shortcomings, the Fund management has tried to address this situation by proposing changes in Fund structure and practice. But management cannot on its own overcome the resistance and disagreement among some of its most important members.

In the last half of my statement, I will suggest some specific changes that could be part of, though by no means comprehensive, reform agendas for both institutions. The changes I identify are built on the different nature of the challenges confronting the two institutions.

The Context for Reform

Let me begin by making three points that provide some important context for crafting reform agendas for the Bretton Woods institutions.

First, beginning with their simultaneous creation towards the end of World War II, the IMF and the World Bank have been complementary parts of a single system. Their governance structures are similar. The physical proximity of their headquarters has facilitated considerable informal interaction among Fund and Bank staff.

More fundamentally, the missions of the two institutions are, to a considerable extent, dependent on the existence of the other. Although their missions are distinct, requiring different forms of expertise, the tasks of either become harder to perform if the other is ineffective. Thus, for example, development assistance to build needed infrastructure will yield a lower return in a country plagued by financial instability. Conversely, financial stability will not translate into sustained growth in a developing country lacking the most basic forms of physical and human capital.

This relationship between the two Bretton Woods institutions has important implications for shaping a sensible reform agenda. Most obviously, the mutual dependence means that the success of reforms in one organization depends, albeit indirectly, on the success of reforms in the other. Yet the very co-existence of the institutions means that each should be allowed to concentrate on its own missions, which require very different kinds of expertise.

In particular, we must resist the temptation to turn the IMF into a development institution. It is imperative that the Fund appropriately calibrate its conditionality and technical assistance policies to the differing circumstances of developing countries. There is no question but that the Fund has at times, including at some very important times, failed to do so. But making these important modifications to its policies in pursuit of financial stability is a very different matter than engaging in longer-term lending that is oriented more toward development than to financial stabilization. The Fund staff is, to be honest, not particularly well-suited to development lending. I wonder whether it might not be best to transfer any resources dedicated for long-term lending to the Bank.

My *second* contextual point is that this is not the first time these institutions needed to reorient their operations in quite basic ways. As the formal name of the World Bank—the International Bank for Reconstruction and Development—reminds us, the first anticipated order of business of that institution was reconstruction assistance in the theaters of the Second World War. The very first loan made by the Bank and, in real terms still one of its largest, was to France. The Netherlands, Denmark, Luxembourg, Belgium, Yugoslavia, Italy, and eventually Japan were also recipients of loans through the early 1950s. In the wake of the Marshall Plan and reconstruction, the Bank shifted the focus of its operations to development. Although it still lent money, often for some of the same immediate purposes as in its reconstruction efforts, doing so in developing countries required a focus quite unlike that needed where the emphasis was on rebuilding something that had recently existed.

The reorientation forced on the Fund was considerably more dramatic. The IMF began as guardian of a fixed exchange rate system, in which each member state's currency was set at a "par value," defined by reference either to gold or to the dollar. Although a country could change its par value in the face of a "fundamental disequilibrium" —and, in theory, even then only with the approval of the Fund—such changes were expected to be rare. And, in fact, they were exceptional, at least among developed countries, until the late 1960s. But then, for a complex set of reasons that I need not fully rehearse here, a combination of divergent inflation experiences, reluctance of surplus countries to revalue their currencies upwards, increased international capital flows, and the unsustainable guns *and* butter policy of the United States placed increasing stress on the system.

In 1971 President Nixon ended the convertibility of dollars into gold and thereby unilaterally abrogated the par value system that had been agreed at Bretton Woods. After an unsuccessful effort to restore a more or less fixed exchange rate system, the IMF Articles of Agreement were changed to permit countries to choose their own exchange rate arrangements. Yet the revised Article IV also created obligations in each IMF member, including one of special interest today—to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The Fund had a continuing role in achieving international financial stability, but now that role was to be played through its power of "surveillance" over its members' exchange rate policies, rather than through enforcement of specific par value obligations.

I will return later to the role the Fund has been and, more importantly, should be playing in overseeing the exchange rate obligations of its members. For now, I want simply to note that, with the end of the par value system, the IMF as an institution was forced to change its role in a fundamental way. As is well-known, much of its activity was redirected toward dealing with financial crises in developing and emerging market countries, many of which had not even existed as independent nations in 1944. Thus, like the Bank, during its lifetime the Fund has already had to make dramatic changes in its work. Today both institutions may face watershed moments, but not for the first time.

A *third* contextual point for considering reform of the Bretton Woods institutions is that their failure or, what is much the same thing, irrelevance, would have repercussions far beyond the potentially deleterious effect on international financial stability or development. These two institutions have been at the center of the multilateral economic system created sixty years ago. Their decline would both reflect and accelerate a basic change in how the rules and norms of the international economy are formed. Over time, the most likely direction of such change would be toward stronger regional arrangements—particularly, though not exclusively, in Asia. It is true that the long-predicted rise of regionalism has, at least outside Europe, not been realized. And it is also true that recent regionalist efforts in Asia have proceeded only in fits and starts. But I think it quite likely that a palpably weakened multilateral system would prod many of these efforts forward.

The erosion of a genuinely international economic system could well have a negative effect on world economic growth. It would surely reduce American influence over what would be a more fragmented global economy. It is only slightly melodramatic to say that the fate of the Bretton Woods institutions, particularly the Fund, will be a bellwether for the adaptability of the existing multilateral economic system to the new conditions of the 21st century.

One System, Two Institutions, Two Reform Agendas

The preceding three points make clear that the two Bretton Woods institutions are linked in important ways. They also share some basic problems. *First*, there is uncertainty and disagreement over how each institution should respond to the global economic changes mentioned earlier. At a high level of abstraction, there is general agreement on what each institution should do: The Bank should promote development, and the Fund should promote financial stability. Try to get much more specific, though, and consensus breaks down.

Second, both face challenges to the legitimacy of their governance structures. At the Fund these challenges go directly to the allocation of quotas and voting rights, with important emerging market countries understandably feeling that their growing economic importance is not reflected in their influence with the Fund. At the Bank, too, there are complaints about quota allocations and voting rights. But there the more immediate governance concern is the degree to which recipient countries are able to participate in the key discussions that shape Bank policies.

Third, both institutions face medium-term funding difficulties with a common origin—the reduced demand for their resources. Both institutions derive a considerable portion of their operating revenues from the spread between the interest they charge on loans and what they pay for those funds—either to capital market actors for borrowed funds or to members as interest on their paid-in capital. The absence of financial crises has meant that few countries have drawn on Fund resources in the last five years. The Bank has lent progressively less to middle-income countries. Its lending to poorer countries takes place more through the IDA, whose concessional rates are insufficient to replenish available resources, much less provide operating expenses.

Despite these similarities, the problems faced by the two institutions differ in important ways. Consider the point about funding. In most respects, this is a good news story: The successful development of the middle-income countries and their concomitant access to global capital markets are reducing their need for Bank funding. Similarly, the absence of financial crises has meant that emerging market countries have not needed Fund assistance. While this trend creates a funding problem for the Bank, it hardly eliminates the need for the Bank's services—the challenge will be to come up with the resources to assist the poorer countries that pay lower interest on their loans.

At first glance, it looks as though the Fund faces a situation analogous to that at the Bank—the recent period of financial calm will eventually end, new kinds of crises will erupt, countries will once again be knocking at the Fund's door, and the task will be to intermediate the necessary resources.

This may yet be the next chapter in the Fund's history. But it might not, because something else has occurred during this period. Many of the emerging market countries that in the past would have been quick to approach the Fund at signs of a financial crisis have elected to self-insure through the accumulation of massive foreign exchange reserves. Ironically, then, the effort by these countries to avoid a position of dependence in the Fund's principal activity of the last thirty years—lending to developing countries in financial crisis—has contributed to the re-emergence of global imbalances and exchange rate friction. These new conditions require the Fund to revive its old role as overseer of foreign exchange policies, although in very different circumstances from the par value system established 60 years ago. To date, the Fund has been unable to do so.

Thus, while each institution is affected by the same transformations of the global economy, and while each is in need of far-reaching change, there are important distinctions in their situations. These differences have implications for the reform agendas that are indicated for each.

The Bank's policies are regularly attacked as ineffective, as insufficiently grounded in the needs and preferences of recipient countries, as wasted because misappropriated by corrupt officials of recipient governments, as burdening developing countries with more debt, and as anachronistic in light of the growing ability of emerging market countries to access capital markets. More fundamentally, there has been a long and vigorous debate among academics and policymakers over the theory of economic development and the assistance policies that will help achieve this goal. It is almost literally true that, no matter what the Bank does, *someone* will think it is misguided.

Sustained and, in some cases, fundamental disagreement among acknowledged experts over the core precepts for successful development assistance certainly complicates the task of the Bank's senior management. But these disagreements need not be resolved for the Bank to pursue its mission in a responsible way, because the Bank need not commit to a single strategy. In Fiscal Year 2006 the IBRD lent $14.1 billion for 112 projects in 33 countries. The International Development Association, the concessional financing arm of the World Bank Group, lent $9.5 billion for 167 projects in 59 countries of the world's poorest countries. The International Finance Corporation, the entity within the World Bank Group that invests in private sector activities, committed $6.7 billion in debt or equity to 284 projects in 66 countries. Among the three parts of the World Bank Group providing capital or assistance, that is a total of 563 different projects in a single year. Despite the separate identities of these entities, lending decisions in all three are made by essentially the same group of executive directors.

With this many operations, the Bank can simultaneously pursue multiple strategies. Indeed it should and has. Under these circumstances, though, it is imperative that the Bank maximize the effectiveness of its lending and assistance policies. A critical part of that task is that the Bank be organized to learn what policies succeed under what circumstances. Just as critically, the Bank must adjust its future activities to take account of what has been learned. As I will suggest in a moment, these observations provide a starting point for a reform program at the Bank.

The IMF confronts a more fundamental challenge to its position. While different strategies for development can be simultaneously pursued by the Bank, the Fund's mission of maintaining global financial stability requires a more cohesive approach. Yet there is no agreement on what the Fund's role should be in overseeing member countries' foreign exchange and macroeconomic policies in the face of large global current account imbalances. Indeed, there is not even a working consensus among Fund members as to how much of a threat these imbalances pose for financial stability.

Such norms of behavior as exist in Article IV have not been clearly elaborated by the Executive Board or Fund management. Indeed, since the demise of the Bretton Woods par value system, the Fund has not been consistent in its attention to exchange rate policies and problems. At times, as during the British and Italian currency difficulties in 1992, the Fund was quite active. At other times it has stayed in the background (or, perhaps, been confined there by some of its more influential members, who may have preferred handling the issue themselves in the G-7).

In the last 30 years, most countries whose policies were in need of adjustment eventually faced pressures on their currencies that led them to the Fund for assistance.[1] Under those circumstances, the Fund had sufficient leverage through its conditionality policies to require changes in country policy in return for access to Fund resources. These conditionality policies were at times misguided and, even when not misguided, were generally unpopular—the routes out of a crisis are never pleasant. The point, though, is that the Fund had influence. Today, in contrast, the Fund has little or no more influence on China or any other emerging market country with large accumulated foreign exchange reserves than it has traditionally had on the United States—which is to say not much. Moreover, it is possible that the importance that those countries attach to the Fund could decline further.

Another concern—suppose the next global financial crisis arises not from unsustainably high exchange rates and excessive foreign currency debt in emerging markets, but from a meltdown in global derivatives markets. The former is obviously less likely in light of the aforementioned foreign exchange reserves. The latter looks a bit less far-fetched than it might have a couple of weeks ago. Should the Fund have a role to play in responding to such a crisis?

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[1] Not Britain and Italy, of course, which is why the 1992 ERM problems elicited a Fund response more directly address to exchange rate surveillance.

As we sit here today, it is clear that the Fund does not have the capacity to assume such a role. So if the answer to that question is yes, a lot of work will be required.

Yet another issue—those massive foreign exchange reserves to which I keep referring are no longer being held solely in the form of the government securities of the United States and other “hard currency” countries. The countries holding those reserves are creating so-called sovereign wealth funds, designed to invest in asset classes extending far beyond government securities. While the prospect of these government funds purchasing sensitive companies in other countries has garnered considerable publicity and elicited expressions of political concern from the likes of German Chancellor Angela Merkel, these funds could also inject a new element into the international financial system. The lack of transparency in the holdings and activities of those funds raises the danger not just—and perhaps not principally—of politically motivated decision-making in the investment and disinvestment of those funds, but also of a financial impact that could occur with the movement of large sums in and out of equities, bonds, and other financial instruments. To date, the Fund has done little more than express concern about this development. It has not, for example, attempted to incorporate sovereign wealth fund policies into its existing standards for economic transparency by its members.

It should by now be clear that internal institutional reforms initiated by Fund management will not be sufficient to cure what ails it. Ultimately, the fate of the Fund depends upon whether the world’s established economic powers can agree with the world’s rising economic powers on a reinvigorated role for that institution in the oversight of exchange rate policies and in responding to new forms of global financial dislocation. But internal reforms of the Fund, such as reallocation of quotas and voting power, will be an essential part of any such rapprochement. Moreover, even accounting for the admitted handicap of being caught between its disagreeing members, there are problems with the Fund’s senior management and staff that need to be addressed.

A Reform Agenda for the Bank

As I suggested earlier, I will not set forth here a comprehensive development strategy for the Bank to follow—in no small part because I have none to offer. But, as I also suggested earlier, one need not have such a singular strategy in order to better fulfill the Bank’s mission of promoting development. What is needed is an extensive overhaul in the Bank’s staffing and operations – all with the aim of maximizing the effectiveness of its lending and technical assistance. From among the many proposals for Bank reform advanced in recent years, here are some that could be pieces of a reform agenda directed to this goal:

Change the Size, Mix, and Incentives of the Bank Staff. I have been struck by the number of former Bank officials and staff—all committed to the Bank having a central role in promoting development—who believe that the Bank is too large to be effective. It has more than 10,000 employees, four times the number at the IMF. Despite some laudable recent steps to move more staff into the field, around 85% of these employees are based in Washington. The Bank has a lot of work, to be sure, but one invariably comes away with the impression that there are often just too many people in each meeting and on each project. While becoming more nimble should be sufficient motivation to pare the size of the staff in the coming years, financial constraints will eventually force this move in any case. As the Bank's lending to middle-income countries declines, the reduced lending yields less interest, which is a principal source of its administrative budget. Better to begin a gradual and orderly process of downsizing now, rather than to wait for the crunch.

As the size of the staff must change, so must its composition. Too many Bank employees—although smart and dedicated—do not really have the kinds of background and training that are most important for a development institution. Generalizations on such matters risk misleading more than they elucidate. Still, some examples are important to put on the table. I would venture to say that there are still too many academically-oriented economists on the staff. The Bank needs to be a center of thinking about development, but its research staff should, as explained below, be more oriented towards program evaluation. It should draw more on the Bank's operational experience to develop and test hypotheses about development policy. That is where its comparative advantage almost surely lies, not in empirical studies that could be conducted by academic economists around the world.

Conversely, there are probably too few Bank employees who have relevant experience in health care, infrastructure operations, education, and the other areas in which the Bank concentrates its activities. It may be that people with such backgrounds are not so likely to apply for positions with the Bank. In that case, some proactive recruiting may be called for.

Finally, as has been noted by many others, the incentive structure for Bank employees still overvalues moving money (in the form of loans) out the door. If we want Bank staff to concentrate their energies on (a) what works and (b) the poorer countries with the greatest development needs, then they must be assured that their prospects for promotion will not be limited by spending time in a poor country carefully designing a project tailored to specific conditions in that country.

Design and Evaluation of Projects. If there is agreement that the goal of the World Bank is to maximize the effectiveness of its lending and technical assistance activities in promoting development, then those activities should presumably be designed to maximize desired outcomes. If a project is designed to increase the availability of potable water, for example, then its success should be judged by how many additional people gain access to drinking water. My understanding is that these performance measures are generally not central to the goals and assessment of IBRD and IDA lending.

Not all projects are susceptible to such readily quantified goals and, even where they are, the setting of reasonable baseline expectations may not be an easy task. But a concerted effort within the Bank to focus more on results would have several important advantages:

- It would make decisions on later lending for similar purposes to the same government more informed. When subsequent lending was reduced because of poor performance, it would advance the goal of maximizing the utility of available resources by channeling those resources to governments that use them most effectively. This impact on additional lending would also provide an indirect but effective check on the corruption or inefficiency of recipient governments.

- It would allow the Bank to reduce the use of conditionality in its lending activities, a practice that has managed to be both relatively ineffective and controversial at the same time.
- It could contribute to a reorientation of incentives for Bank staff by providing an additional set of measures for their performance.
- It would facilitate evaluation of Bank projects and, thereby, both further the goal of maximizing the effectiveness of Bank resources and provide important knowledge to other official development institutions, bilateral development agencies, and private foundations.

The importance of thorough evaluation of Bank (and, indeed, all development assistance) activities cannot be overstated. Without it, an essential tool for maximizing the effectiveness of those activities is lacking. As just suggested, incorporating more performance and outcome measures in projects at the design stage will effectively build evaluation into the project. But even a significant move in this direction will not obviate the need for judicious use of rigorous impact evaluations, which assess the difference a program actually makes by comparing outcomes to those observed in similar circumstances where the program is not operative. Increasingly sophisticated experimental and quasi-experimental tools have been refined by specialists in the field of program evaluation.

The Research Department of the Bank has undertaken a Development Impact Evaluation initiative (DIME), which began publishing evaluation reports last year. While this initiative is welcome, it is too early to tell if the research staff has the requisite program evaluation experience and independence to produce first-rate, objective impact evaluations. Of real concern in this regard is the recent report of an independent panel that examined World Bank research. The panel was critical of the research techniques used in many instances and, more disturbingly, found that the research was used "to proselytize on behalf of Bank policy, often without taking a balanced view of the evidence, and without expressing appropriate skepticism."[2]

Given the inevitable tension between program evaluations and the interests of any institution in showing itself in a favorable light, it may be necessary to take additional steps to assure genuinely independent, state-of-the-art impact evaluation. This might be done, as suggested by the Center for Global Development, through a consortium of official and private donors to sponsor and finance evaluations; through creation within the Bank of a program evaluation unit with institutional protections assuring its autonomy; through contracting out evaluations; or through some combination of these devices.

Reforming Governance. The subject of governance in international institutions seems to elicit a constant stream of discussion and proposals. There are many changes worth considering at the Bank. However, in keeping with my effort to present an illustrative rather than comprehensive list of reforms, I will limit myself to two ideas pertaining to the Executive Board

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[2] Abhijit Banerjee, Angus Deaton, Nora Lustig, and Ken Rogoff, An Evaluation of World Bank Research, 1998-2005 (2006), at 6.

that have particular relevance for the goal of increasing the effectiveness of the Bank's development activities.

To say the Bank's Executive Board is an unwieldy governance instrument is to understate the matter. Governing boards—whether in corporations or non-profits—are rarely in residence at the institution. Their purpose is to provide oversight of management in the interests of shareholders or the founding principles of an organization. It is expressly not supposed to substitute for management. Yet the Bank's resident Executive Board does just that, passing on every loan made by the institution. The purpose, presumably, is to ensure control by the countries that are the Bank's shareholders. But the result is an enormous expenditure of time and money. I have heard estimates that the resources required to support *each* executive director are in excess of $60 million per year. Bank staff spend a huge amount of time preparing for Board meetings. And yet, with rare exceptions, the Executive Directors—while often outstanding civil servants in their countries—are rarely influential enough to affect the policies of the country (or countries) they represent.

Abolition of the resident board is clearly not in the cards, and I am not even certain it would be desirable. But the Executive Board should not be involved in what is literally the day-to-day business of approving loans and projects at the IBRD, IDA, and the IFC. As a routine matter, the Bank management ought to be able to give final approval to individual projects, though obviously the President would have to exercise sound judgment in knowing when to consult with the Board. Instead, the Executive Board should be acting more like a normal board of directors—providing general oversight of management and strategic direction for the Bank.

It does not appear that an amendment to the Articles of Agreement would be necessary to make this change. The current Articles appear to grant the Board of Governors (consisting generally of finance ministers) sufficient authority to change the role of the Executive Board, although obviously the question would need a full legal analysis before proceeding. A second change would be to add 2-to-4 non-voting members to the Board in order to increase the involvement of smaller developing countries. If the Board gets itself out of the business of approving every loan and into the business of providing oversight and strategic direction, it will profit from additional recipient country voices on how to frame a set of effective policies and practices.

A Reform Agenda for the Fund

The starting point for considering reform for the Fund is the agenda laid out by Roderigo Rato, the recently departed Managing Director. In late 2005 and early 2006, he presented a program addressing many of the perceived problems in the IMF. Here are the elements of his program that, for present purposes, are most relevant, along with a report on the progress in implementing the proposals and my comments on the proposals:

Improvement in Article IV Surveillance of Member Country Policies. The principal means of Fund oversight of exchange rate policies since the demise of the par value system has been through its "surveillance" of country policies and member obligations regarding exchange arrangements under Article IV, including the obligation to "avoid manipulating exchange rate policies in order to prevent balance of payments adjustment or to gain an unfair competitive advantage over other members." Since, almost by definition, countries sitting on large reserves will not need Fund resources, its influence over them must rest principally in its clear, objective, and forthright identification of problems and of policies that depart from these obligations.

To be honest, the Fund's record on so-called "bilateral surveillance" has not been a very good one. Until the Managing Director's initiative, it had not revised its standards for surveillance of exchange rate policies since 1977 and, even within the terms of that rather dated document, it had not really applied those standards to Fund members in anything resembling a rigorous fashion. This, I should add, is not just a conclusion that many outside observers have reached, but one endorsed by the Independent Evaluation Office of the IMF itself in a recent evaluation of Fund exchange rate policy in the post-Asian crisis period of 1999 through 2005. Indeed, the Fund at times seemed interested principally in avoiding the issue since, I am told, it has turned down multiple requests for special consultations on China's policies in recent years.

Mr. Rato proposed, among other things, that bilateral surveillance focus more directly on county exchange rate policies and their effects on global financial stability. In June of this year, the Executive Board adopted a new decision on bilateral surveillance in which it incorporated the essence of the Rato proposals. Of most interest is the Board's addition to its list of "principles" for member exchange rate policies the point that a "member should avoid exchange rate policies that result in external instability."

At least on paper, then, the pieces are in place for a more pointed and relevant bilateral surveillance process. But the legacy of staff and managerial underperformance remains and, until we see a change in practice—especially where large and influential countries are involved—it is reasonable to retain a measure of skepticism. Moreover, it remains to be seen whether the countries whose policies might be critically reviewed will be moved to change those policies.

Creation of a Multilateral Surveillance Process. Rato rightly observed that even a well-functioning bilateral surveillance process is not optimal for dealing with global problems, including the current large global imbalances. He proposed a new multilateral surveillance process to complement traditional bilateral surveillance. In effect, the process would be a variation on the G-7 process, but with the involvement of financially important countries like China and Saudi Arabia that are not G-7 members. As you know, the G-7 operates strictly by consensus and has nothing approaching rules or an enforcement mechanism. The thought seems to be that, by holding these discussions under the IMF banner, there is an additional measure of pressure on participants.

In April 2006 the Fund's ministerial-level International Monetary and Financial Committee agreed to this extension of surveillance arrangements. The first such consultation was subsequently held, involving the United States, the Euro area, Japan, China, and Saudi

Arabia. In something resembling G-7 communiqué fashion, the shared understandings and policy commitments of the participants were reported in April of this year.

To be honest, the results were underwhelming. There was little, if anything, new in the statements and commitments of the participants. This was only a first effort, of course, so it is fair to give the process more time to develop. But there are some grounds for concern in the statements of some Fund officials—in private as well as in public—that tout these results as significant. If this is the Fund's idea of significant, the aspirations for the process are clearly not high enough.

Quota Reallocation. As Dick Cooper and Ted Truman of the Peterson Institute of International Economics have convincingly argued, changes in the IMF allocation of quotas and voting power may be the linchpin in efforts to reform the Fund. Quotas determine both the amount of capital that a member must pay in to the Fund and the voting rights that it will have in Fund decision-making. As Cooper and Truman also point out, quotas are symbolically important as an expression of a country's economic standing and therefore, in their words, a "realignment of voting shares is central to preserving support of the Fund by all of its members and thereby to the Fund's relevance and legitimacy in promoting global growth and economic and financial stability."[3]

The formula that is used in allocating quotas is thus critical to the Fund's character and operations. GDP is a key part of the formula, but other economic measures such as reserves and current international payments are also factored in to the current formula. There is obviously no single "right" formula to weight the various economic indicia. While the Articles of Agreement of the Fund require a review of quotas every five years, there has been a predictable conservatism in reallocations in the past, since countries whose quotas would fall under a new or updated formula will usually resist change. The result is that the quota system today looks demonstrably out of line with trends in the global economy. As you would expect, China and other emerging countries hold quotas less than their growing importance would suggest. As you might also guess, the countries whose quotas are arguably the most inflated are many of the smaller European countries.

Roderigo Rato proposed a two-step process for reforming the quota system. In the first step—which has since been completed—China, South Korea, Mexico, and Turkey received small increases in their quotas. His second, much more controversial step, was that the Fund adopt a new formula and enact another round of quota increases in 2008, when the next five-year review of quotas is supposed to be completed. He did not have the temerity to propose his own formula, and wisely so, I would think.

I will not engage here in a technical discussion of formulas that might, or should, be adopted. I would just say two things. First, it is essential that, for both substantive and symbolic reasons, the formula be changed to give larger quotas to the fast-growing emerging market countries. Second, and related to the first point, this can be accomplished through giving greater weight to GDP than in the current formula, but to cap its impact on the quota shares of the older,

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[3] Richard N. Cooper and Edwin M. Truman, The IMF Quota Formula: Linchpin of Fund Reform, Peterson Institute of International Economics Policy Brief Number PB07-1 (February 2007).

slower-growing industrialized countries (as, de facto, the current U.S. quota is capped). Obviously other factors should and will be included, but the basic changes in the world economy are most directly reflected in the shift in the share of output towards those emerging market countries.

Under virtually any formula that might be imagined, the United States will retain a quota over the 15 percent level necessary to block major changes in Fund policies. This, I am pleased to say, is not a case where U.S. interests clash with those of new economic powers. The problem, as I earlier mentioned, really lies with the European countries—both the quota shares allocated to the smaller countries and the fact that three members of the European Union have their own executive director position on the Board.

Financing Fund Activities and Lending: As earlier mentioned, the decline in Fund income generated through lending to member countries is creating a budgetary problem. At the same time, with the size of existing Fund resources dwarfed by international capital flows, the capacity of the Fund to respond effectively to a financial crisis has been in doubt since at least 1997. Rato, apparently wanting company before going hat in hand to ask members for additional resources, appointed an Eminent Persons Group (which, unlike so many groups given that title, really was eminent) to consider a new income model for the Fund. In January of this year, the Group reported its recommendation that Fund income be supplemented from three sources: investment of its reserves and current quota resources in a broader range of assets; creating an "endowment" from the proceeds of limited sales of its gold holdings; and charging for services to member countries. I note in passing that the proposal for gold sales could require Congressional approval.

These recommendations were presented against the backdrop of Rato's prior call for a general quota increase, but the Group indicated that it was addressing the issue of income for Fund activities, rather than resources available for lending as such. Whether a quota increase would be sufficient to provide the Fund with the resources it might need in a future financial crisis is of course unknown. But there is a good enough chance that it would be insufficient to explore other potential sources of crisis resources. One possibility would be an agreement with some of the countries holding large foreign reserves, along the lines of existing arrangements with the United States and other countries that allow the Fund to supplement its resources by borrowing specified amounts from those countries under certain crisis circumstances.[4]

Of course, the receptivity of Congress, or anyone else, to these proposals must rest on an assessment of the Fund's relevance and capacity for effectiveness in assuring international financial stability. It would be counter-productive to starve the IMF for resources and then demand it shape up. But it seems to me that the processes of IMF reform and additional funding are, and ought to be linked. It makes little sense to proceed with one unless the other is also proceeding forward.

New Selection Process for Managing Director. In his list of reforms, Rato repeated the calls of others for a new method of selecting a Managing Director. As you know, since the

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[4] These are known as the "General Arrangements to Borrow" and the "New Arrangements to Borrow." Each was last activated in 1998 as the Asian financial crisis spread to other parts of the world.

founding of the Bretton Woods institutions, convention has been for an American to head the Bank and a European to head the Fund. Neither the United States nor Europe has shown great interest in changing this convention, despite the growing resentment of the rest of the world. Of course, Rato did not stay long enough to give substance to this proposal. Indeed, his unexpected and premature departure virtually assured that the old convention would prevail, as it seems to be doing.

Just having inserted an American as president of the World Bank, the United States was hardly in a position to challenge the convention. Indeed, the United States has duly endorsed Dominique Strauss-Kahn, who was identified for the job by President Sarkozy of France and endorsed by the European Union. Let me be clear: he is a very credible candidate. But some questions to him are in order.

We should at least know if he will commit to stay for a full five-year term, barring some obvious extraordinary circumstance. We have now had two consecutive European managing directors who have left the position early. The first returned to Germany explicitly to re-enter German electoral politics. Rato said he was leaving early because of his children's educational expenses, but rumors abound that he too will soon reenter domestic politics. Even if he does not, the leadership of the Fund at this most delicate of times is suffering by these frequent turnovers. Since both French and American media speculated that President Sarkozy was nominating a prominent Socialist in order to *remove* him from French politics, we should assure ourselves that M. Strauss-Kahn will not leave the Fund early if a political opening presents itself at home.

It is also important to elicit M. Strauss-Kahn's views on other issues, such as the Fund's surveillance activities to date. While he will not be able to force members to change their policies, he would as Managing Director have the authority to instruct Fund staff to present rigorous and forthright reports on how Fund members are complying with their Article IV obligations.

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To sum up, it is no exaggeration to say that the continued relevance of the Fund may be determined in the next few years. Fund management has taken certain steps to respond to the new challenges. While immediate past performance in surveillance is not particularly encouraging, we can for the present adopt a wait-and-see approach to the revised bilateral and new multilateral surveillance methods. As to changing attitudes of the Fund's members, essential to any real progress, I am afraid that skepticism is warranted here as well. China, like other surplus countries in the past, is disinclined to adjust its policies to help deficit countries. The United States, for its part, cannot seem to decide if it wants to address this issue bilaterally or multilaterally.

Finally, I note that I have concentrated here on the key issues that will determine whether the Fund is relevant to the international financial circumstances of the 21st century. There are other elements of the Rato reform agenda that I have omitted, such as a proposal for a new lending facility. Similarly, I have omitted mention of some of the Fund's secondary missions, such as providing technical assistance. These are important functions and, by and large, ones that are being well-performed by the Fund. Their omission from my discussion is really a compliment to the Fund staff engaged in those activities.

Conclusion

The agendas I have sketched out today are obviously quite different. The agenda for the Bank is more micro- and management-oriented, as befits that institution's situation. The agenda for the Fund is really about its basic role in the world today. As you and other Members of Congress consider these institutions and appropriate reform agendas, I would like to make one suggestion.

Neither institution has ever been as diligent as it should be in communicating with Congress. Their primary U.S. interlocutors should be Treasury Department officials, of course, but it hardly needs saying that you must approve quota increases. More generally, you probably shape public attitudes towards the institutions more effectively than the Treasury can. I hope that officials of the Bank and Fund will contact you more regularly. But, if they do not, I hope you and your staffs will take the initiative.

Thank you for your attention. I would be pleased to answer any questions you might have.