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An Empowered IMF Faces Pivotal Test

By BOB DAVIS

WASHINGTON -- The International Monetary Fund was widely dismissed as irrelevant just six months ago, an economic emergency room with nearly no patients.

Now, with the global crisis battering one nation after another, the ER is overflowing. The IMF has lent about $50 billion to needy countries to shore up their finances, with more countries lining up for help. At the same time, it's pressing rich ones to spur global growth through greater spending.

The IMF is about to gain more power. Thursday's summit of leaders of the Group of 20 industrialized and developing nations is poised to elevate the IMF by promising to pump more than $250 billion into the fund, and asking it to issue "early warnings" about countries in peril.

"Everyone sees the need for a rejuvenated IMF," says Egyptian Finance Minister Youssef Boutros-Ghali, who heads a policy-making group that oversees the IMF.

But questions are swirling about just how effective the new-look IMF will be in fighting the crisis. Where once it demanded that borrowers dramatically remake their economies, the IMF is now taking a softer stance, and attaching few restrictions to its massive loans.

"In most cases, the question for the IMF now isn't how to fundamentally change policies" of borrowing nations, says Marek Belka, a former Polish prime minister who is now the IMF's top official for Europe. "It's to help [weakened] countries get to the other side of the river."

There isn't a lot of evidence yet that the IMF loans are helping broadly in the short-term. Andrew Howell, a Citigroup emerging-market analyst, says that currencies in Ukraine and Belarus are plunging despite IMF loans, deepening the recessions there, although those in Serbia and Hungary seem to have stabilized. Also, big developing countries such as Brazil and South Korea have so far passed on a new IMF credit line, worried about both the stigma of borrowing and possible domestic backlashes.

In the long-term, the fund's unwillingness to press for fundamental reform may mean that borrowers miss opportunities to improve competitiveness, which could limit their growth after the global economy recovers. "The IMF retreat from conditions on structural changes for economies in crisis needs to be reversed," writes Susan Schadler, a former IMF official for Europe, in a report to the G-20 by the Atlantic Council and Chatham House think tanks.

The 185-member IMF was last at center of the action a decade ago when it put together multibillion-dollar packages to stem a financial crisis that started in Asia in 1997 and spread to Russia and Brazil. The fund insisted on tough changes in domestic economic policy as the price for loans, provoking deep resentment, and in some cases, bloody riots. Still, the nations under IMF care rebounded fairly quickly. The IMF prescription -- cut spending, devalue currencies, fix financial institutions, open markets -- helped many countries export more to the U.S. and Europe.

That approach won't work today because rich nations are cutting imports. Instead, the IMF is campaigning for wealthier countries to expand spending while keeping weaker countries afloat until the recovery takes hold. It's also asking China to boost spending and to make a big contribution to the IMF's loan kitty. In exchange, the IMF is searching for way to end a dispute over China's exchange-rate policy and give it greater voting rights at the fund.

The remaking of the IMF, which occurred largely out of public view, began during the global expansion of the middle of this decade when Brazil, Argentina, Russia and others repaid IMF loans early and few nations sought new ones. IMF economists began to prepare for what they viewed as an inevitable next crisis.

The revamp shifted into high gear with the arrival of the new IMF managing director, Dominique Strauss-Kahn, in late 2007. The 59-year-old former French finance minister took over an organization that was on its way to big losses because few countries were borrowing, and which was under orders from member-nations to make cutbacks. Mr. Strauss-Kahn used a spring 2008 town-hall meeting, held in an IMF reception hall decorated with a huge Persian rug, to encourage managers to take buyouts, say several IMF officials. It was the first significant round of layoffs since the IMF was founded in 1945.

At the January 2008 gathering of financial elites at Davos, Switzerland, Mr. Strauss-Kahn urged nations to spend more to fight a likely recession. That was such a departure from IMF orthodoxy that fellow panelist Lawrence Summers, now President Barack Obama's economic adviser, called it "a mildly historic event." But it spooked long-time IMF staffers, who argued with Mr. Strauss-Kahn not to press the idea further, warning it would be controversial in deficit-averse Germany and elsewhere. He did the opposite, making the recommendation more specific as global prospects darkened.

Mr. Strauss-Kahn's efforts nearly got derailed after an affair he had with a female staffer became public. But a review panel cleared him in October, and the downturn pushed the affair into the background. By November, he was urging countries that could afford it to boost emergency spending by at least 2% of gross domestic produce -- more than $1 trillion globally.

IMF economists acknowledge that the 2% number was as much a political call as an economic one: 1% seemed too little, while 3% could spook markets. "How do you convince governments to do things?" asked a senior IMF official. "You want to scare them, but not too much."

At the Obama White House, the IMF number reinforced the preexisting conviction to do a large-scale stimulus, said a senior administration official. Germany, France and others resisted. Overall, the G-20 nations approved fiscal packages worth 1.8% of their combined GDP this year, the IMF estimates.

The IMF's efforts to aid poorer nations have also required political calculations, particularly convincing countries that had sworn off IMF aid that the fund had changed. Pakistan, whose prime minister declared the country had smashed its "begging bowl" when it paid off the IMF in 2004, decided it needed IMF help in late 2008 after foreign capital flows and exports dried up. The move was so unpopular that Mohsin Khan, then the IMF's top Asian official, says he met with a group of generals to get their backing.

Unlike past loan discussions, the IMF didn't press Pakistan to revamp its tax system, or make other fundamental changes. When the IMF wanted the central bank to raise its discount rate, then 13%, to battle inflation that at the time was around 25%, Mr. Strauss-Kahn refereed a debate at headquarters in late October. IMF hardliners insisted on a 10-percentage point rise, says Mr. Khan, though others say now that wasn't a serious option.

The fund settled on 3.5 percentage points, which Mr. Khan said was enough to signal markets that inflation would be addressed. The IMF loaned Pakistan $7.6 billion, though the country never raised the discount rate more than two percentage points. Inflation has dropped, but only slightly, to 20%.

In Eastern Europe, the IMF generally limited its requirements for loans to cuts in spending. In Serbia, IMF economists criticized the country for failing to privatize state industries and neglecting exports, but they didn't insist on a privatization program, as they had in Asia and Latin America. Serbia is in line to receive $4 billion in loans.

When Latvia requested loans, IMF economists considered stipulating that the country devalue its currency, the lats, and end its peg to the euro. That would have made imports less affordable, but could have made the country's exporters more competitive.

But after the European Union and European Central Bank pressed the IMF to keep the currency peg to make it easier for Latvia to pay debts to Western European banks, the IMF relented, say European and IMF officials. Instead of devaluation, the IMF settled for a steep cut in government salaries, which the Latvian government backed anyway.

Critics say the IMF has overdone its charm offensive and is wasting a chance to press for needed changes.

Peter Holtzer, a Hungarian pension-reform expert, said he was disappointed that the IMF hadn't demanded that the Hungarian government revamp its too-generous pension system and inequitable tax system when it loaned the country $15.7 billion last October. "It would have been easy for the government to use external help, point to the IMF and say, 'Sorry, the IMF is forcing us to do it,'" says Mr. Holtzer.

IMF officials say they no longer want to play the fall guy. Indeed, for countries like Brazil, South Korea and Mexico, whose policies the IMF judges to be sound, but which are in danger of falling into recession, the fund recently began to offer condition-free credit lines.

It's far from clear the new credit line will be enough to induce Asian or Latin American nations to borrow. An earlier version of the credit facility didn't attract a single borrower and no country has signed up for the new one either. To make the new credit line more palatable Mr. Strauss-Kahn considered removing the name IMF from the loan.

When South Korea said no to the IMF credit line, Lee Hyoung-ryoul, a Korean Finance Ministry official explained: "South Koreans tremble and financial markets turn sensitive whenever they hear the word 'IMF.'"

IMF officials are also wooing China, whose relations with the fund have been icy. Since 2007, China has blocked IMF reviews of its economy because it knows its exchange-rate policy is bound to come up. To avoid singling out China in meetings about currency, Mr. Strauss-Kahn decided to invite another country to the table. He looked at tiny countries which the IMF also believed to have over- or undervalued currencies. One candidate, the Maldives, was rejected, says Eswar Prasad, a former IMF official who oversaw China, because it seemed "too ludicrous." Instead, the IMF chose Latvia, with a population of two million. But the "ad-hoc consultation" with both countries was called off when Latvia's economy tanked in late 2008.

China recently said it would loan the IMF money, though it hasn't said how much, if its voting rights are increased at the fund, a change the IMF favors and which the G-20 is likely to order. That will require another round of tough negotiations to get smaller European nations, whose voting rights at the IMF are in outsized proportion to their share of the global economy, to agree to a reduced vote.

As for the currency question, IMF officials say the global recession might make a difference. If China shifts its policies to promote domestic industries rather than exporters, Beijing would have good reason to let the renminbi appreciate, argues IMF chief economist Olivier Blanchard. "But it is better to avoid labeling" countries for misbehavior, he says. "That's proven incredibly counterproductive."

—Andrew Higgins contributed to this article.

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