

MEMORANDUM:

TO: Rodrigo Rato,
IMF Managing Director

FROM: Jeffrey D. Sachs

RE: Running the Fund



You are taking over the International Monetary Fund (IMF) at a critical moment. A decade ago, globalization looked like a sure winner. Expanding world markets and global cooperation, many thought, would extend prosperity and foster peace. But today, the world is at war. The gap between the richest and poorest people is wider than ever. The vaunted capacity of economic integration to mitigate extreme poverty and environmental degradation looks illusory. The world needs effective international institutions more than ever, yet the legitimacy of the IMF is at a low ebb in many parts of the world.

From the start, the IMF has lived with a particular tension. It is an international organization with 184 member countries, and the IMF Articles of Agreement call on it to represent all of its constituent members. Yet the fund is governed by rich nations, foremost among them the United States. How you handle this tension will determine your own success or failure as the new managing director, as well as the continued relevance of the IMF at a time of enormous international strain. On key issues such as foreign aid, debt relief, and exchange-rate policy, you must learn to represent the entire world, not just the U.S. and European governments that put you into your job.

Money Talks (and Votes)

The way you arrived at the IMF speaks volumes about how the institution functions. Although your record as minister of economy in the last Spanish government is impressive, you were not an obvious candidate to lead a global financial institution with major operational responsibilities in the poorest countries. You were not a leading figure in the great debates of the past decade regarding the East Asian crisis, the initiative on highly indebted poor countries, capital market liberalization, African

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poverty, or other issues of central concern to the IMF. Indeed, you owe your job to a nontransparent process in which the richest countries dominate and most of humanity has little say. Still, given your professional skills and the respect you command among your peers, there is widespread hope and anticipation that you will rise to the occasion.

The fund's governance starts with some basic arithmetic. The IMF operates on a voting system based on each country's quota at the fund, rather than a system of one person, one vote (or one country, one vote). The United States, with 5 percent of the population of IMF member countries, controls 17 percent of the vote. Europe has a remarkable 40 percent of the IMF vote, with just 13 percent of the population. China and India comprise 38 percent of the world's population, and just 5 percent of the vote at the fund. Little surprise that the United States and Europe jealously guard their voting powers.

Nothing happens at the fund without the say-so of the United States and Europe. If decisions are by consensus, it is only because developing countries long ago learned not to lock horns with rich nations on matters of financial diplomacy. The IMF, after all, can do great financial damage to unruly countries, causing them to lose not only the resources of the fund, but also those of the World Bank, regional development banks, the Paris Club, the London Club, and private creditors, all of which are influenced by IMF judgments.

The institution prioritizes the interests of rich countries, and especially those of the United States, at every turn. When the United States wisely sought to forestall a Mexican default in early 1995, the IMF was induced to make an emergency loan of unprecedented size. When, on the other hand, the U.S. Treasury was wary of lending to Ecuador in late 1999 following that country's default to private creditors, the IMF withheld a pending loan. That decision helped topple the financially strapped government in Quito in early 2000. When ideologues in the Bush administration wanted to punish an allegedly left-wing government in Haiti, the IMF obligingly froze lending in 2001. Eventually, the Haitian economy crumbled and the elected government was ousted. Either through action or deliberate inaction, the IMF has repeatedly influenced politically charged issues of privatization, trade, and financial market policy in emerging markets at the behest of rich nations.

Countries siding with U.S. geopolitics have a much easier time getting IMF loans and debt relief. Countries labeled ideological opponents, by contrast, have had funding frozen at tremendous cost to their poor citizens. Most shocking, the IMF has asked the poorest of the poor for unconscionable belt-tightening and debt servicing since the early 1980s, because the United States, Japan, and most of the leading creditor countries in Europe showed little interest in extending debt relief or increasing development assistance. Debt relief for the poorest countries has been slow, grudging, and inadequate. The IMF has helped by dressing up fiscal austerity as a macroeconomic necessity.



Rato: The rich voted for you

The Lives in Your Hands

Your new job grants you daily and pervasive influence over billions of people, especially the world's poorest. African governments cannot take a financial step without the blessing of the IMF. If you make mistakes regarding Africa's finances, people don't just suffer, they die. That is not hypothetical. For the last 20 years, the IMF has been the chief enforcer of inhuman austerity conditions imposed on Africa, because the United States could not rouse itself to give Africa more help. The rich countries collect debts from impoverished nations, while pandemic diseases cut life expectancies to half of those in the rich world. Yet wealthy nations have pretended that there is no alternative to this state of affairs.

In recent months, the IMF Executive Board has approved lending programs to Burkina Faso, Democratic Republic of the Congo, Madagascar, Nicaragua, Tanzania, and Sierra Leone, among others. The board knows very little about these countries. Most of the information from the IMF staff that goes to the board is about budget deficits, domestic credit expansion, exchange rates, and inflation—not about AIDS, malaria, malnutrition, deforestation, and drought. A basic disconnect exists between the work of the fund, which obsesses over financial indicators, and reality in much of the world, especially where people live in extreme poverty.

Poor countries need massive investment in the building blocks of economic growth—including physical infrastructure, health systems, and education systems. The IMF should help establish the financial and macroeconomic framework for these investments. I am arguing not for inflationary finance and macroeconomically irresponsible policies, but for sound strategies in which the rich countries contribute much more development assistance to poor and vulnerable nations. The IMF must appreciate that its policymaking is part of a larger reality and that its programs should be judged against a standard higher than whether they produce price stability or a balanced budget. They must be judged on how they support the escape from extreme poverty, the control of pandemic disease, and the positive evolution of the global economic and political system. On all of these counts, the United States and the other leading economic powers have failed, and they have used the IMF as a key instrument in that failure.

Debt of Gratitude

The financial interests of rich and poor countries are likely to be at odds in at least four areas during your tenure. The most urgent involves the poorest countries in the world, especially in sub-Saharan Africa. The rich countries signed international



They have a point, you know

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treaties—including the Millennium Declaration of 2000 and the Monterrey Consensus and Johannesburg Plan of Action in 2002—committing more financial help to developing countries trying to cut extreme poverty and disease sharply by 2015, as embodied in the Millennium Development Goals (MDGs). Without deeper debt cancellation and much greater development aid, especially from the United States, these goals will not be met.

Under your leadership, will the IMF continue to enforce unconscionable austerity, or will it fulfill its pledge to support the MDGs by telling the truth about the need for much greater aid from the United States and other rich countries? The key step will be for the IMF, in conjunction with the World Bank, the U.N. agencies, and the governments of the poor countries to insist that the richest nations finally move toward 0.7 percent of gross national product (GNP) in development aid and support well-governed poor countries trying to achieve the MDGs. For the dozens of impoverished states within the IMF, your support for these goals will signal the institution's willingness to confront the greatest economic challenge of our time: the dramatic reduction of extreme poverty.

The debt of emerging-market economies will be your second test. In 2002, IMF management considered a valuable proposal for a new system known as the Sovereign Debt Restructuring Mechanism. This plan would have finally brought to cases of sovereign debt some of the worthy principles of bankruptcy settlements—including easing the collective action problems that arise when multiple creditors confront an insolvent debtor. When U.S. financial interests balked, however, the U.S. Treasury pulled the plug on the IMF's draft proposals. It behooves you to reopen this discussion and bring it to a more satisfactory conclusion.

Your third area of concern will be the IMF's position on the exchange-rate systems in developing countries. The United States has often politicized exchange-rate questions on mercantilist grounds by calling on other countries to appreciate their currencies vis-à-vis the dollar in order to reduce foreign exports to U.S. markets. For example, Washington pushed Japan away from a much-needed depreciation of the yen during the 1990s, and it is now pressuring China to appreciate the yuan. You should discount the fevered political advice you will get from Capitol Hill and focus on how exchange-rate changes will affect the country in question.

Taming the United States

Potentially the most dangerous problem you will face is the financial instability that will soon result from irresponsible U.S. macroeconomic policies. The Bush administration has nearly done the impossible, converting a budget surplus of more than 2 percent of GNP in 2000 to a budget deficit of 5 percent of GNP this year—a swing of \$700 billion in just four years. This transformation occurred through the combination of irresponsible tax cuts, massive increases in military

spending, and even a surprising splurge on some domestic social programs.

U.S. fiscal and monetary imbalances could eventually threaten global financial stability. To keep their currencies from appreciating against the dollar, Asian central banks have been accumulating massive foreign exchange reserves. Around \$2 trillion now sits in the bulging central banks of China, Japan, Taiwan, South Korea, Hong Kong, Singapore, and India. Meanwhile, the U.S. Federal Reserve continues to run an irresponsibly loose monetary policy, seemingly politicking on behalf of the Bush administration in the run-up to the November elections. The United States is playing with fire: A sharp rise in long-term interest rates, higher inflation, or a plummeting dollar may result.

You must push the United States to quickly improve its fiscal situation. Realistically, Washington must raise taxes, since there is no public support for broad-based spending cuts. Another key step will be for the rest of the world to move progressively and smoothly to a multicurrency reserve system in which the U.S. dollar is no longer the single reserve currency or unit of account. The IMF can play an important advocacy role in this transition. The euro will come into its own as a major global reserve currency. East Asian countries as well will need to diversify their units of account into a more appropriate East Asian basket. South American countries should think more seriously about much closer monetary cooperation and perhaps eventual monetary union within Mercosur, the economic cooperation organization that includes Argentina, Brazil, Paraguay, and Uruguay.

I also urge you to take advantage of the IMF's superb professional staff by fostering internal debate, as well as more symposia, conferences, and outreach. You should support the work of the Independent Evaluation Office, a valuable recent addition to the fund's institutional design that objectively assesses IMF operations. You should also encourage your staff to forge closer relationships with the World Bank and with U.N. agencies such as the United Nations Development Programme, the World Health Organization, and the Food and Agriculture Organization. These organizations know vastly more about economic development and poverty alleviation than does the IMF staff. Finally, it is critical that you increase transparency of the organization, in part by opening board meetings to more scrutiny and public participation. The board is seen as a mysterious cabal—an image that is both unnecessary and debilitating.

The fund has urgent global fiscal and financial responsibilities at a time when globalization itself remains under extreme threat. More than 80 percent of humanity lives in the developing world, and half of the world's population lives on less than two dollars per day. The world wants to know whether globalization works for all or only for the most powerful nations. Representing global interests with professionalism and goodwill will be an enormously tall order. On this task you have my best wishes and strongest hopes for your success. **FP**

