

The IMF and the challenge of relevance in the international financial architecture

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This paper was prepared for the International Monetary Convention held in Madrid on 13-14 May 2003, organised by the Reinventing Bretton Woods Committee and the Spanish Ministry of Finance. The paper reviews the role of the IMF since its inception in 1944 and discusses some of the challenges for the IMF, and the international community more broadly, arising from recent developments in the world economy.

Introduction

The end of the 20th century, and beginning of the 21st, has proven to be something of a watershed period for the IMF. The string of major crises of the past decade, and the associated reassessment of how to maintain international financial stability, saw significant questioning of the role of the Fund.² The resulting soul searching — and the acknowledgment by the Fund and its shareholders of the need for change — has led to a substantial refocusing of its activities onto its core responsibilities in the last five years.

This change has not been without pain. But more change is needed still. The IMF must continue to evolve as the world changes in order to retain its relevance to the international financial system. But its evolution must be around its core responsibilities. It must avoid having its focus fragmented by straying into areas better dealt with by other parts of the international financial architecture.

This need for further change provides an opportune time to reconsider the evolution of the IMF's role since it was established in the 1940s and to ponder some of the challenges ahead. Despite criticism, the Fund retains a central role in today's international financial architecture, suggesting that the evolution to date has been broadly viewed as successful. However, the choices it makes

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2 See, for example, Feldstein (1998) and Meltzer (2000).

now in response to pressures for further change will help determine whether it remains equally relevant over the next half century.

While the actions of the Fund are important, the debate about its role is not simply about what the institution should, or should not, do. It is also about what the national government shareholders of the IMF expect from the Fund as an institution and their commitment to the role they bestow upon it. The appropriate role of, and the interactions among, the various institutions within the international financial architecture also bears on the debate. The shareholders of the Fund comprise virtually all countries in the world; its future effectiveness is, therefore, the responsibility of the international community writ large.

Original role of the IMF

The IMF was established in 1944 to promote international financial stability in the post World War II reconstruction period. The Fund's purpose, as set out in its Articles of Agreement (see Box 1), is to promote international monetary cooperation, financial stability and world economic growth. This purpose remains broadly relevant to the present day, although the means of achieving this purpose have clearly changed.

Box 1: Articles of Agreement of the IMF

Article I

Purposes

The purposes of the International Monetary Fund are:

- (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
- (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
- (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund shall be guided in all its policies and decisions by the purposes set forth in this Article.

At the time the IMF was established the experience of the 1930s remained fresh in many minds. Competitive devaluations associated with 'beggar-thy-neighbour' policies were seen as a key source of instability in the international financial system. A key part of the answer to this problem, as conceived by the architects of the Bretton Woods system, was to create a system of pegged exchange rates to counter such destabilising behaviour.³ The system provided for a set of exchange rate parities between members linked to gold or the US dollar, with the value of the dollar in turn linked to the price of gold at \$US35 to the ounce.

The Fund's primary function under this system was to support the maintenance of these exchange rate parities, including by lending to members facing short term balance of payments disequilibria. The Fund essentially acted as an international credit union. Members contributed to a pool of reserves from which countries facing balance of payments deficits could borrow to maintain their pegged exchange rate.⁴

The Articles of Agreement (Clause (V) of Article 1) arguably presume conditionality in referring to resources being made temporarily available 'under adequate safeguards'. But the nature of conditionality was not defined. Rather, it has emerged over time with the development and operation of Fund-supported programs of adjustment. The introduction of Stand By Arrangements in 1952 to provide medium term assistance saw the introduction of explicit conditionality, whereby countries were required to adopt policies to resolve balance of payments difficulties in exchange for Fund support.⁵ The introduction of the Extended Fund Facility in 1974 for longer term balance of payments difficulties saw the introduction of three year programs of conditionality covering structural, not just macroeconomic, policies relevant to the balance of payments⁶.

3 The response goes beyond the creation of exchange parities *per se* to include the other matters set out in Box 1 above.

4 For an interesting description how this lending occurred during the Fund's first major financial crisis, see Boughton (2000).

5 However, as noted by Boughton (2000), while the first SBA 'in which drawings were made conditional on the country adhering to specified policies was for Peru in 1954', this did not become standard practice until the 1960s.

6 See IMF Annual Report (2002).

Changing role of the IMF

The international financial system has seen many changes since 1944. Most notably, these include abandonment of the original Bretton Woods system of pegged exchange rates in the early 1970s and the emergence of capital account crises in the 1990s on the back of rapid growth in private capital flows.

Breakdown of the Bretton Woods System

A defining change was the breakdown of the Bretton Woods system of exchange rate parities between 1968 and 1971.⁷ While no consensus exists on the reasons for the breakdown, some common factors are generally put forward. Among these are the breaking of the link between the US dollar and the monetary gold stock, as the Vietnam War and the growth in world output and liquidity strained the convertibility of the US dollar into gold. Increasing capital mobility also put strains on the system through facilitating speculation against fixed parities. Finally, greater price instability in the US meant that the system of fixed exchange rates increasingly ran the risk of providing a transmission mechanism for higher world inflation, in turn placing pressure on parities.

Since the collapse of the Bretton Woods system, but especially since the Asian crisis of 1997-98, there has been growing acceptance of the benefits of more flexible exchange rates. Economic orthodoxy moved from regarding floating rates as a source of instability in the 1940s, to increasingly perceiving them as a means of absorbing the impact of international shocks (although acceptance of this argument is by no means universal).⁸

The 'shock absorber' role of floating rates became relatively more important with the increased output and price instability seen from the early 1970s onwards. It has become increasingly accepted that the trinity of a monetary policy directed at domestic balance, a fixed exchange rate and international capital mobility was not sustainable. That is, it was recognised that it was not

7 The abandonment of the pegged exchange rate system was, however, a symptom of a broader problem manifest in recurring current account crises among the developed economies and successively weakening political will in favour of seeking IMF support.

8 This view is perhaps more widely held in Australia than in some other countries given our experimentation in the period after World War II with a wide range of exchange rate regimes. The \$A was pegged to the pound sterling to November 1971, then to the \$US to September 1974. It was subsequently pegged to the trade weighted exchange rate — a basket peg — to November 1976, which became a crawling peg until December 1983, at which point the currency was allowed to float freely.

possible to pursue an independent monetary policy while defending a fixed exchange rate with mobile capital, and that this limited the flexibility of policy makers in addressing issues of price and output instability.

The fact that the end of the Bretton Woods system did not mean an end to the role of the IMF is itself informative of the way in which the IMF had evolved since its inception. While the system of pegged exchange rates had proved unsustainable, countries were not indifferent to exchange volatility. Exchange rates were free to move, but desirably in an 'orderly' fashion. So the need remained strong for an institution that would promote international financial stability, including through lending to countries requiring liquidity to correct for short term macroeconomic imbalances. However, the changing trends in the world economy clearly altered the way the Fund approached its role.

In particular, the beginning of the era of flexible exchange rates saw significant development in the concept of IMF surveillance. The Fund acquired a formal surveillance role following an amendment to its Articles of Agreement in 1978. Associated with this role, the IMF was charged with conducting surveillance over member policies. Equally, members were obliged to provide the information necessary for the conduct of that surveillance.

This reflected the broadening of the Fund's focus away from one of achieving balance of payments outcomes consistent with the relevant exchange rate towards considering issues of whether general macroeconomic policy settings were consistent with internal and external balance; identifying stresses before they had reached breaking point. This represented an evolution in the role for the Fund, but one which remains consistent with its overall purposes.

The introduction of the Extended Fund Facility in 1974, which focused on longer term policies affecting the balance of payments, is indicative of the associated broadening in scope of Fund programs. With the broader scope of programs came increasingly sophisticated conditionality addressing the longer term policy settings of member countries.

In retrospect, the IMF's role up to the end of the 1970's evolved in a broadly sensible fashion. The overarching purpose of ensuring international financial stability remained the same, but the assessment of the problem moved from one of exchange rate management, narrowly defined, to the compatibility of broader macroeconomic settings with orderly exchange rate behaviour, and the IMF's approach moved in step with this change.

More recent trends

More recently, an important development has been the rapid expansion of private capital flows between countries and closer integration of global capital markets. While potentially beneficial for the growth of recipient countries, these developments have had a number of less benign consequences.

First, countries have become more exposed to the risk of capital account crises. The presence of large amounts of mobile private capital has increased the risk of sharp market reactions in the face of emerging economic imbalances. This has meant that the loss of confidence in domestic policies can be quite sudden and can result in dramatic reversals in capital flows with consequent disorderly and damaging adjustment.

A second consequence has been that crises have increasingly been triggered by, and have exposed, serious structural policy weaknesses, particularly in relation to the financial sector. This has seen a distinction drawn between financial crises and 'traditional' balance of payments crises. While it would be overly simplistic to seek to draw a strict dichotomy between the two, it is clear that the strains on domestic financial systems posed by the increasing scale of capital flows have introduced a new element into modern crises. This has dragged the focus of Fund surveillance further beyond that of macroeconomic stabilisation and into areas of prudential and regulatory reform in the financial sector.

An additional feature of modern crises has been the presence of contagion effects arising from the closer integration of global capital flows. This has seen the loss of confidence in one country trigger similar losses of confidence in other countries. The transmission of crises from one country to another has posed new threats to the stability of the international financial system as a whole.

The changing nature and increased severity of crises has had a number of implications for the Fund's role. It has seen a further evolution in the role of Fund surveillance. The scope of surveillance has been broadened. First, to address structural issues which pose a threat to macroeconomic stability. Second, to better and earlier detect emerging vulnerabilities, which has led to a

focus on issues such as the size, maturity and currency composition of external debt.⁹ The widened scope of individual country monitoring has been complemented by an increased emphasis on multilateral and regional surveillance to identify interactions and linkages that might facilitate the spread of crises.

There has also been an increased focus on the stability of domestic financial systems, particularly following the Asian financial crisis of the late 1990s. This has seen the development and broadening of a role for bodies which complement the role of the Fund. Included amongst these is the Financial Stability Forum (FSF), which promotes discussion amongst members on appropriate regulatory and prudential practices. The FSF is not alone, however, with the work of the various standard setting bodies gaining greater attention in recent years.¹⁰

Increases in the size of private capital flows have also introduced a new element to crisis resolution. In 'traditional' current account crises, the challenge was to provide finance to support countries in making the appropriate domestic policy adjustments to correct the imbalance. While this role remains, the build up of large amounts of privately held debt has meant that IMF lending and domestic policy adjustment may not be sufficient to achieve macroeconomic stability. That is, countries increasingly appear to find themselves in situations where there may be no set of domestic policies that can place them onto a sustainable path without some restructuring of their debts. This has led to calls for mechanisms to better coordinate the restructuring of privately held sovereign debt in crisis situations.

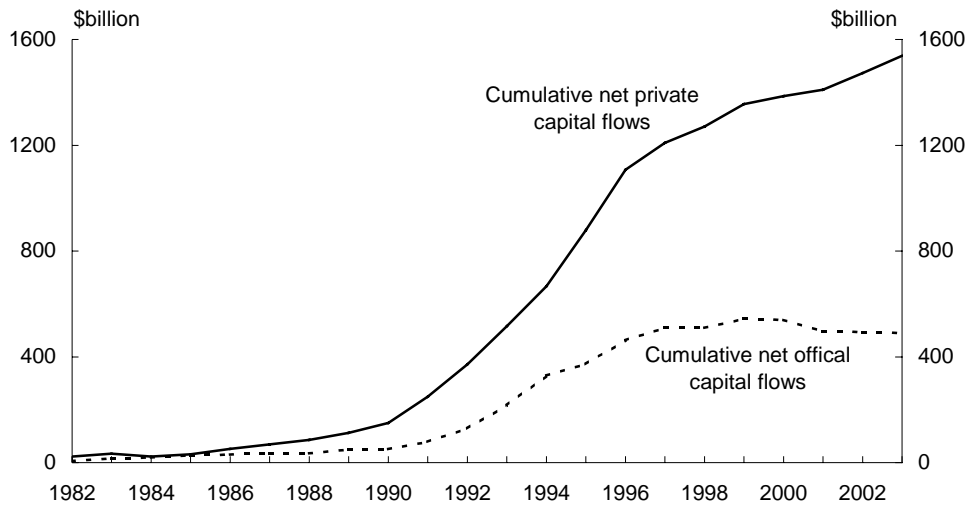
The relatively reduced importance of official sector capital flows has produced a situation in which the credibility and success of Fund-supported programs, Fund lending and conditionality are at a premium. In recent years the Fund has tried to stem crises with finance that is small relative to volatile private capital flows, notwithstanding a period in which the scale of Fund interventions has grown very large by its own historical benchmarks. Consensus also exists that, even were they large enough to do so, official sector resources cannot be used to 'bail-out' the private sector. The need for Fund

9 While the Fund's focus on structural issues expanded dramatically in the 1980s, it has been recognised that Fund conditionality with respect to structural issues may have 'overreached' in the 1990s. As a result, the Fund has recently emphasised that structural conditions should only be imposed in areas where an absence of structural reform will pose a threat to efforts to achieve macro stabilisation.

10 See, for example, <http://www.imf.org/external/standards/agency.htm>.

involvement in crisis prevention to be catalytic — to be confidence inspiring and to 'bail-in' the private sector — has therefore become all the more important.

**Chart 1: Emerging market economies —
cumulation of capital flows¹¹**



The recent period has also seen increased debate about the effectiveness of the Fund's policies in terms of crisis prevention and crisis resolution. Following the Asian financial crisis, some criticised the Fund for 'missing the signs' of the emerging crisis and for relying too much on 'old' solutions in seeking to resolve 'new' problems, for example through relying on macroeconomic stabilisation policies when many of the underlying problems were essentially structural in nature. Still others argued that the macroeconomic policy settings appropriate to the avoidance of a crisis were not those that should be pursued in the aftermath of a capital account crisis.¹² Some critics also argued that the pursuit of structural reforms as part of crisis management was inappropriate, while others believed the Fund had no role in structural issues at all. This debate has intensified with the emergence of crises in countries that have been subject to ongoing and extensive Fund support. This has reduced the

¹¹ Based on data from International Monetary Fund, World Economic Outlook, September 2002.

¹² See, for example, Stiglitz (2002). On whether the crises are really new, Boughton (2000) draws interesting parallels between the pressures on Sterling associated with the 1956 Suez crisis and the experiences in Asia in 1997-98.

credibility of the Fund in the eyes of some commentators and raised questions about its effectiveness in both preventing and resolving modern day crises.

Recent developments have also led to increased public scrutiny of the IMF's role and questions about its legitimacy. The Fund is considered to have experienced 'mission creep', moving into areas beyond its original mandate and areas of expertise.

At one level, these criticisms are unfair.

First, there is still no consensus on how best to identify, prevent, and resolve capital account crises. Even if such a consensus had by now emerged, hindsight is blessed with 20:20 vision — it may still be too much to expect the Fund to have known this in the mid-1990s.

Second, the Fund has experienced mission creep at the behest of its shareholders, and in response to broader international opinion (for example, as represented by some NGOs), who have demanded attention move to include structural policies in a wide range of areas only loosely related to the original purpose of the institution. These include military expenditures and environmental and gender issues. But mission creep has also arisen as the nature of the membership has changed. The membership of the transition economies in the early 1990s brought with it new sets of issues; different from those the Fund had previously to deal with, especially related to structural policy and its interaction with growth and macroeconomic stability.

Similarly, the increased emphasis placed on growth and poverty reduction — at the behest of the international community — has thrown up new and different issues upon which the Fund is expected to advise. Indeed, a checklist would indicate that Fund missions should now address perhaps as many as 40 separate issues in every Article IV surveillance report. The wider the range of responsibilities placed on the Fund, the greater the risk that its focus becomes fragmented, a risk that needs to be recognised explicitly by its shareholders.

That said, there is also a legitimate basis for criticism.

It is only in recent years that the Fund has begun to engage with its critics, and to become more transparent and accountable for its surveillance and policy advice. By exposing its judgements to public gaze, the Fund can help educate the broader community and make it easier for outsiders to see and assess the types of 'on balance' judgements it is required to make — this has been a good

discipline for national policymakers and there is no reason to believe it will not be equally valuable for the Fund.

The progressive redefinition of the problem of how to maintain international financial stability has taken the Fund into a widening range of structural, financial and institutional issues. Having embarked on this path the challenge is knowing when to stop, since virtually every aspect of an economy can be said to be macroeconomically relevant to at least some degree. Despite the success of recent efforts to refocus the Fund on its core responsibilities, the need to avoid excessive mission creep will remain an ongoing challenge.

Almost six years after the start of the Asian crisis, it needs to be recognised that there has been considerable evolution in the Fund's focus and *modus operandi*. This evolution must continue in response to the changing nature of the international economic and financial system. All institutions need to evolve if they are to remain effective. The question is how to get the right balance.

Future role

General considerations

Notwithstanding recent criticisms, the Fund has an on-going and important role to play in the international financial architecture. Its purposes as set out in its Articles of Agreement remain relevant to addressing the challenges confronting the global economy today and those likely to arise in the decades ahead. However, given the changes in the world economy of the last decade it is clear that there is a need to continue to re-evaluate the nature of its role going forward.

This is a critical point. As discussed above, the Fund's role is not, and has never been, static.

It was initially established to support a system of pegged exchange rates and had to adapt when this system broke down. It was established at a time of limited international capital mobility and has had to adapt to a world of large and rapid private capital flows.

While the trend toward increased capital market integration is unlikely to be reversed, appropriate exchange rate regimes have been a matter of debate for over a century. With proposals for target zones and currency unions continuing to be discussed as a means of promoting regional stability, it cannot be ruled out that fixed exchange rates will again become a more

important feature of the global financial system in the future. Further, it is unclear what additional pressures the forces of globalisation will place on domestic policy settings. The Fund needs to be flexible enough to continue to adapt to these, and other, trends as they develop.

The Fund's future role is, in many ways, endogenous. The role will evolve based on how it performs; specifically to how well it adapts to changes in the international environment. The Fund is likely to still exist in one form or another in the decades ahead, but whether it remains a relevant institution is a function of the decisions made now and in the future. It is one thing to survive as an institution — all national policy makers can attest to the difficulty of closing institutions and fora that have outlived their usefulness — but another to survive as a credible institution.

Credibility therefore emerges as a key issue that will shape the Fund's direction in the future. What do we mean by credibility? There are two key aspects to the concept. The first is the issue of effectiveness. Recent crises have highlighted the tension between providing funds to help 'bail-out' countries in crisis and encouraging countries, whether before, during or after a crisis, to make difficult, but necessary, domestic policy adjustments. The Fund has been seen in some quarters as too ready to dole out financial assistance without sufficient policy adjustment. Critics in the 'effectiveness camp' argue that the Fund is not doing enough to push the reforms necessary for domestic adjustment but is in some cases deferring (or even exacerbating) the necessary adjustment through its financing packages.¹³

In contrast, others argue that the Fund goes too far in seeking to impose changes to domestic policies and question the Fund's legitimacy in undertaking such a role. Critics in the 'legitimacy camp' argue that the Fund is not sufficiently accountable to its members and, as evidence, point to the lack of country ownership of the types of policies endorsed by the Fund. They would argue that a lack of legitimacy leads to an inability to achieve reform, in turn creating problems of low Fund credibility.

This would appear to place the Fund between the proverbial 'rock and a hard place'. For example, Feldstein (1998) has argued, 'A nation's desperate need for short-term financial help does not give the IMF the moral right to substitute its technical judgments for the outcomes of the nation's political process.' Equally, though, we would suggest that a nation has no automatic right to be bailed out

13 These criticisms have been made most recently in the case of the current IMF-supported program for Argentina.

by the rest of the international community if it persistently pursues inappropriate policies.

There are no easy answers to this dilemma, but it is clear that the Fund needs to address issues of both effectiveness and legitimacy if it is to have credibility. In fact, the two concepts can be mutually supporting — for example, greater country ownership and broader support for the Fund among the international community may increase country and communal support acceptance of programs that recommend difficult policy choices. A fundamental challenge for the international community moving forward is to find an appropriate balance between measures that increase the Fund's effectiveness and measures to address its legitimacy.

Streamlining conditionality and promoting country ownership

The task of promoting ownership of policy adjustments is often more difficult the greater is the needed adjustment, which may explain perceptions of low ownership of Fund-supported programs in recent crises. Often a lack of country ownership of policy *failures* makes ownership of policy *adjustments* difficult to achieve. Indeed, it is hard to recall any government saying that its policies led to crisis, although many are happy to attribute blame to the IMF for the failure to recover from crisis.¹⁴

Discontent with its policy advice has led to pressures for the Fund to adopt a role more like that of an international central bank, providing swift access to finance without applying excessive policy conditionality.¹⁵ The idea would be to play down the Fund's role of policy adviser in favour of its role as a provider of liquidity.

Against this background, the Fund has taken a number of steps to streamline conditionality and promote better ownership of Fund-supported programs. Following reviews of conditionality beginning in 2000, revised conditionality guidelines were agreed in 2002. The revised guidelines aim to ensure that policy conditions in IMF programs enhance the prospects of program success by including only those conditions that are 'critical' or 'relevant' to achieving

14 This is particularly the case in the Asian crisis where, as noted in Parkinson et al (2002), legitimate criticisms of the Fund's actions have not been matched by a willingness to acknowledge that some crisis affected countries rejected warnings and refused repeated offers of assistance from the IMF until the crisis was in full flight.

15 This is by no means a new development. The IMF envisaged by Keynes was more along the lines of a global central bank, as are the lender of last resort models put forward since by Fischer (1999) and others.

the goals of the program. The guidelines also aim to provide greater emphasis on national ownership of IMF-supported programs.

These efforts are to be welcomed, but they are unlikely to be sufficient.

We would venture that they need to be married to a focussed and effective communication strategy within countries with Fund-supported programs if support for IMF policy advice is to be maximised.

But is this the role of the Fund?

Governments adopt Fund-supported programs, meaning that governments should be the ones to engage with their citizens on these issues. This highlights an intractable dilemma — the very existence of the Fund may provide 'cover' for governments to pursue policies that are necessary but for which support is lacking. While we believe that governments ultimately expend scarce political capital whether they educate their populace on the need for given policies or argue 'the Fund made us do it', it has to be conceded the IMF may be a convenient whipping boy at times. If this is the case, perhaps a lack of 'in-country' legitimacy is to be expected.

But if this is the case, it makes it even more imperative that the Fund have 'global' legitimacy. That is, when it provides policy advice it does so from a position of strength — with a good track record of effective advice and with the clearly recognised support of its membership behind the policy recommendations being made. That is, the 'they' in 'they made us do it' becomes the international community and not the Fund in isolation.

This suggests two critical issues. First, that the advice must be recognised as of high quality and appropriate for the country. Second, that the Fund be seen to receive 'direction' and 'guidance' on its policies from a broadly representative group of members. If it is seen to dance to the tune of a small group of like-minded countries to the exclusion of others this global 'legitimacy' will always be under threat.

Improved surveillance

We argue that the role of the Fund revolves around providing sound policy advice to members to promote macroeconomic stability and prevent the emergence of crises. Macroeconomic stability is crucial as it is a pre-requisite for ensuring the effective operation of the international financial and trading systems and meeting the ultimate goals of economic growth and development. Consistent with this, the IMF should also only provide members with access

to its resources where demonstrably necessary, and likely, to assist in achieving stability.

Central to the effectiveness of the Fund's policy advice is the strength of its surveillance, where surveillance encompasses both the identification of necessary policy adjustments and, equally importantly, the effective implementation of policy advice by member countries.

The current and future shape of Fund surveillance is a topic that merits detailed consideration in its own right and we will not cover it here. The important point to note is that as the nature of problems facing countries has evolved, so has Fund surveillance. Indeed, a commentator from 1993 would be astounded by the change in surveillance over the last decade. We hope to be equally astounded by the change in the shape of surveillance between now and 2013.

The formal surveillance function was introduced when the move away from the pegged exchange rate system saw more of a focus on broader macroeconomic stabilisation policies. With more recent crises raising issues of longer term solvency, this has created a need to extend surveillance to examine underlying structural problems, particularly in the financial sector. This has stretched the Fund's traditional areas of expertise and made the task of surveillance more challenging.

Since the Asian financial crisis the Fund has introduced a range of measures to strengthen its surveillance function. These include measures to increase transparency and accountability through the voluntary publication of Article IV staff reports and program documentation, and through the publication of all policy papers. The promulgation of standards and codes has helped promote sound policies in member countries, particularly in the critical area of financial sector stability. The rapid development of the Reports on the Observance of Standards and Codes (ROSCs) and the Financial Sector Assessment Program (FSAP) — both introduced at the end of the 1990s — has been impressive. Enhanced data dissemination standards have improved the consistency and comparability of data available to the Fund while supporting the monitoring of developments within member countries. Improvements to debt sustainability assessment methodologies and to multilateral and regional surveillance, including monitoring of capital market developments, and the development of early warning systems, are all designed to assist the Fund to

identify vulnerabilities in the international financial system at an earlier stage.¹⁶

The list of measures adopted by the Fund is long and represents a constructive response to the changing international landscape¹⁷. While it might be desirable for all the new initiatives to be a mandatory part of surveillance, the Fund has made a pragmatic decision to move slowly to overcome opposition among some members to the broadened scope of surveillance. It is evident that the Fund is continuing to evolve to the changing circumstances of the world economy, just as it did in the 1970s following the breakdown of the Bretton Woods system of pegged exchange rates. That said, there is more that needs to be done to enhance the Fund's surveillance function.

The relationship between the Fund's surveillance function and its role in providing policy advice is central to the effectiveness of the Fund in preventing crises. Unfortunately, poor surveillance appears to have resulted in an excessive level of optimism by the Fund in relation to many members, particularly program countries. While a reluctance to make candid and critical assessments of economies may be understandable — perhaps in the hope of engendering confidence in the policies of the program country — such an approach is short-sighted and ultimately damaging to both the Fund and the member.

It is for this reason that we have championed the application of a 'fresh pair of eyes' to surveillance in program countries. The introduction of a fresh perspective will in many cases be necessary to ensure that surveillance remains objective and supports robust policy advice.

That said, we would not go as far as advocating a strict separation of surveillance from the Fund's program function. Put simply, the creation of parallel institutional edifices comprising something called 'surveillance' and something called 'programs' would, in our view, be a retrograde step. This

16 While not established for the direct purpose of improving surveillance, the existence of the new Independent Evaluation Office is a critical step in creating a culture which learns from experience and, as such, is likely to enhance the effectiveness of surveillance, albeit indirectly. As evidence of this, the IEO is soon to produce an evaluation of the Fund's actions during some of the early capital account crises. Not only should this help to throw some light on the validity of the 'old solutions for new problems' claim cited earlier, it may provide pointers to early signs of crisis and hence contribute to better surveillance.

17 It is somewhat ironic that the scope of surveillance — the keystone of crisis prevention — has been broadened at the same time that conditionality — the foundation of crisis resolution — has been narrowed.

would be more so the more 'surveillance' looked like the activities of rating agencies.

The Fund's judgements carry weight because they are, in principle, the voice of the international community, placing it in a powerful position as policy adviser. To be effective, it is important that the Fund engage in open and honest dialogue with its members. If the Fund fragments its focus by attempting to become both an entirely independent and open observer and a candid and confidential policy adviser, then it risks the breakdown of its relationship with its members.

Instead, we would argue that the 'fresh pair of eyes' should be approached pragmatically. We could support the development of a specialist 'programs department' if that would more effectively bring cross-country experience to bear on emerging problems. But the IMF would need to establish internal arrangements to effectively ensure the advice of that department, the relevant area department and the Fund's surveillance watchdog — the Policy Development and Review Department — were confronted. A simpler model still would see management facilitate the development of an evaluation culture in the organisation by periodically augmenting country teams with 'outsiders' tasked with reviewing and evaluating the approaches being pursued.

The need for a 'fresh pair of eyes' highlights what is the single most striking problem in the operation of the IMF — the capacity of the Executive Board and Management to take hard decisions.

Clearly, the IMF must respect national sovereignty and it is recognised that there can be legitimate differences in approach to addressing particular economic problems. However, it is incumbent on the Board and Management to tell governments when risks are emerging¹⁸, to be rigorous in assessing requests for assistance and to refuse requests for assistance when they do not believe that the policies being pursued will contribute to achieving macroeconomic stability. Major shareholders should encourage the Board to make such clear-eyed assessments and should support hard decisions rather than pursue short-term political objectives. This issue is taken up further below.

18 While there is much to be gained from making such assessments public, this needs to be balanced against the likelihood of the Fund precipitating the very crisis it is attempting to prevent.

Another challenge thrown up by the evolution of surveillance is how to improve the 'traction' of policy advice. In short, how can Fund advice be made more compelling to national governments?

It is striking that the Fund has singularly failed over the last decade to encourage faster corporate and financial restructuring in Japan, to move Europe to address persistent constraints to product and labour market flexibility and, more recently, to address emerging financial sector weakness, or to convince the United States of the dangers of disorderly current account adjustment. These failures constitute a set of serious structural weaknesses that now constrain global growth, yet they have been apparent for five, and in some cases, 10 or more years. This raises a question — has the failure been with the message, or simply that countries that believe they will never be borrowers feel comfortable in ignoring advice? While the Fund may have had no discernible impact on economic management in the major advanced economies, it is hard to believe that developing economies would have been able to avoid responding to Fund advice for anything like this length of time.

If Fund advice is to be legitimate, there needs to be a presumption that it will be given *appropriate* consideration by developed, emerging market, and developing economies. What constitutes 'appropriate' may differ among countries and may require the Fund to develop a better appreciation of the political constraints operating in member countries at any point in time. At the least, the Fund may need to begin to think about how it can best help governments persuade their citizens of the desirability of particular policy reforms.

Financial support

While the Fund's approach to surveillance has evolved since the Asian crisis, its lending activities have changed in a more radical fashion.

The Fund currently has resources outstanding on the General Resources Account of around SDR 65 billion. However, a substantial proportion of this amount — SDR 45 billion — is accounted for by just three countries, Argentina, Brazil and Turkey. Moreover, Brazil has the capacity to draw down a further SDR 15 billion.

In contrast to the way in which it would caution financial supervisors to avoid concentrated lending, the IMF has more of its resources concentrated in a small group of countries than at any time in its history. This concentration of risk is striking. In the event that the Fund were to find itself faced with substantial

arrears this could constitute a true watershed, with profound consequences for the operation of the institution.

This concentration of resources is a consequence of the way in which the Fund has responded to capital account crises — through large packages involving exceptional access. But exceptional access carries with it risks that magnify the risks inherent in these types of crises. While such an approach may be inevitable given the changing nature of crises, it again places a premium on rigorous assessment of the likelihood of success, and the capacity to take, and stick to, hard decisions — to learn how to 'just say no'.

Governance issues

As noted earlier, bolstering the IMF's role as a policy adviser is not only about the advice and actions of its Executive Board, Management or staff. The IMF is a creature of its member governments. It is difficult, if not impossible, for the Fund to make hard decisions with respect to individual member countries without the backing of its other members. This suggests that the responsibility for ensuring that Fund surveillance and programs are effective is shared by all member countries.

The backing of national governments is key to ensuring the legitimacy of the Fund. Unless the Fund's membership has collective ownership of the types of policies it pursues, the legitimacy of these policies will always be questioned. But this need not involve the Fund stepping back from its role of policy adviser. Rather, it involves national governments, through their representation on the IMF Board, supporting the Fund in giving robust policy advice and making rigorous assessments of requests for resources by the Fund. Importantly, it means governments accepting some ownership of that advice. It means not pursuing short term 'fixes' for individual countries that undermine the future and effectiveness of the Fund. It also means being willing to operate bilaterally to reinforce Fund advice to other members.

This is admittedly not easy to achieve in practice. The desire of individual governments to use the Fund to achieve such short-term political aims is a sign of the relevance of the institution. There will always be political pressures on the Board to provide assistance to countries in crisis and there is the risk of these immediate pressures forcing decisions that go against the aim of implementing sound policies in the medium term. This is a difficult tension for the Board to address, but it is important that member countries avoid sacrificing Fund credibility in pursuit of short-term goals.

In this light, it is also important for the Fund to address voice and representation issues. While this means different things to different players, we believe that Fund representation should better reflect developments in global economic weight, subject to some minimum and effective representation of all members. In the current economic environment, this requires greater representation for some Asian economies, especially Korea, at the expense of reduced representation of older developed economies.

In the interest of operational effectiveness, it would be undesirable to further increase the size of the Executive Board although a strong case can be made for measures to assist the capacity of smaller, multi-country or constituency, based chairs, and especially those representing developing countries predominantly or wholly. Our own experience points to the benefit of mixed constituencies — comprising both developed and developing economies — for reasons of voice, representation and importantly, enhanced recognition of different perspectives. It is recognised, though, that this experience will not be compelling for others.

The IMF's role in the overall financial architecture

The legitimacy of the Fund depends not only on its internal governance and the support provided by its members, but also on 'external governance' arrangements i.e. where it is seen to sit in the overall financial architecture. Many of the challenges it faces raise issues not just of how the IMF operates but are equally relevant for the other fora and institutions that provide direction and/or assistance to the Fund.

Our premise is that the IMF should retain a central role in the international financial architecture. It should fill this role, first, because it has near universal representation.¹⁹ Second, the IMF's mandate to promote international financial stability forms a foundation stone for the work of the other international financial institutions, and has done so since the Bretton Woods institutions were established.

¹⁹ That said, it is worth noting that the IMF (with 184 members), and the United Nations (191), are both less representative than FIFA — the International Federation of Football Associations — which has 204 members!

In addition, the IMF also has the resources to back up its decisions, which sets it apart from other, more consultative, forums such as the G-7, G-20, G-24, FSF, the standard setting bodies, and so on. However, an effective relationship with these representative fora is critical in maintaining and enhancing the IMF's effectiveness and legitimacy.

Groups such as the G-20 will not replace the Fund — they are fora, not institutions, and lack a mandate or the resources to intervene in the international financial system in the manner of the IMF. However, they can play an important role in bringing together IMF member countries to consult on issues that are both relevant for, and go beyond, the IMF.

Notwithstanding the Fund's advantages, it cannot always easily play a consultative role, in part because issues fall outside its mandate but also because its membership is large and its processes for coordinating the views of such a broad membership are inherently unwieldy. The Fund should not expect, or try, to be expert on all issues or represent all the needs of regional groups. The emergence of bodies such as the G-20 and FSF reflect an understanding in the international community that the Fund cannot do all these things and that its governance mechanisms are relatively unwieldy and unrepresentative. Pressures for regional bodies have arisen for similar reasons. A key challenge for the Fund moving forward is to ensure that these bodies help to reinforce its role rather than seek to supplant it.

Groups such as the G-20 and the OECD would appear better suited to facilitating the exchange of views between member countries than the IMF with its diffuse membership and rigid institutional structures. Similarly, the FSF and other specialist bodies are able to harness technical expertise on a range of issues outside the Fund's traditional areas of expertise. In recent times, such bodies have made an important contribution to developing accepted practices for strengthening domestic financial systems. The presence of such consultative and technical support mechanisms can reinforce the IMF's role by shoring up support for, promoting ownership of, and enhancing the technical basis of, the types of policies it pursues. They can also help constrain the development of 'mission creep', whereby the Fund's resources are continually stretched outside its traditional areas of expertise and ensure that issues do not

'fall between the cracks' of the mandates of the Fund and other international financial institutions.²⁰

But to maximise the benefits of a larger and more diverse group of players in the international financial architecture, these other fora need the support, not hostility, of the IMF. With respect to the relationship among the G-20, IMF and the World Bank, it would seem that the Bank has been the quicker of the two institutions to recognise the potential synergies and influence to be gained from extensive interaction with the G-20.

Despite this, as Germain (2003) has noted, the current international architecture is perhaps more consensual than previously, in part because of this specialised division of labour (see Chart 2). There is also arguably greater public and academic appreciation of the issues confronting the international financial system than a decade ago. This enhanced appreciation has led to a more sophisticated dialogue regarding IMF policies — that is, the IMF's own enhanced transparency is leading to more widely shared expertise and resulting in strengthened accountability.

The issue is how to 'optimise' the guidance provided to the Fund by other groupings while ensuring appropriate accountability for all.

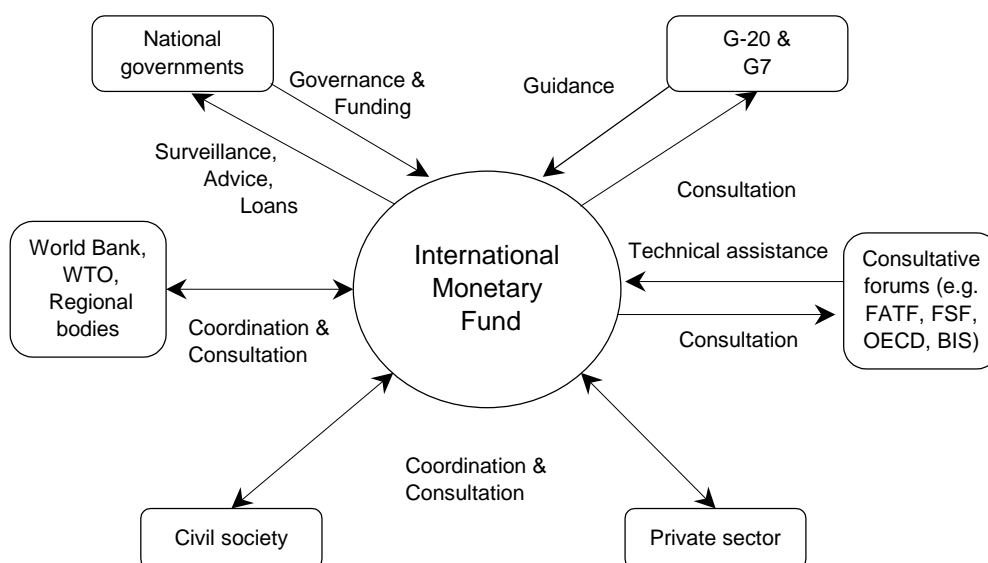
The G-7 has played the most important 'guidance' role for the Fund to date. However, the G-7 cannot provide the Fund with great legitimacy as it only represents the interests of larger developed economies. In fact, it has been argued that guidance from the G-7 has detracted from the Fund's legitimacy as its members have been seen to be pursuing their own agendas through the Fund (Meltzer, 2000). Downplaying the G-7 role in favour of a more representative grouping could, therefore, be an important step towards ensuring greater legitimacy and enhanced effectiveness of the IMF.

²⁰ There has also been pressure in recent years for the development of regional institutions, particularly in the Asia-Pacific region. The appeal of such institutions is that they provide the scope to give regions a greater sense of ownership of outcomes in international crisis management and to fill gaps in the representativeness of the Fund, which may not be well placed to handle region-specific issues. Consequently, a regional body that plays a complementary role to the IMF can improve the credibility of the overall financial architecture and thus help reinforce the Fund's role. However, there is a danger that the development of regional institutions — particularly regional monetary funds — may have the opposite effect. If they lead to a situation of competing crisis managers or are seen as a soft alternative to the IMF, they risk undermining the credibility of the international financial architecture. (see Parkinson et al, 2002). The extent to which regional funds seek to replace, rather than complement the Fund, will reflect perceptions of the Fund's effectiveness and legitimacy.

The G-20 may be an effective consultative grouping able to offer valuable guidance to the Fund. G-20 members account for around 2/3 of the world's population, nearly 90 per cent of world GDP and almost 60 per cent of the world's poor (Martin, 2001). The G-20 therefore represents a reasonable approximation of the IMF's membership, bringing in both developed and emerging market views and capturing well the growing influence of the fast-developing economies. As such, is a potentially powerful tool for facilitating a dialogue between a representative group of member governments, for achieving agreement among key economies on issues of common interest, and for getting emerging concerns of these key economies (especially the non G-7 members) onto the IMF's radar. This has been shown by the G-20's work in recent years identifying policy lessons for member countries in the areas of globalisation, economic growth and poverty, much of which has the potential to be directly relevant to the activities of the Fund.²¹

Consequently, guidance from the G-20 can support the legitimacy of Fund policies.

Chart 2: The IMF and the international financial architecture



²¹ See, for example, the results of the workshop on Globalisation, Living Standards and Inequality held in Sydney in May 2002. A series of case studies on members experiences with globalisation are currently in preparation, while Mexico, the current G-20 chair, is coordinating further work on globalisation and the role of institution building in the financial sector, to be discussed by G-20 Finance Ministers later in the year.

Conclusion

It is a major achievement of the IMF, and the architects of the Bretton Woods system, that the Fund remains relevant today despite the momentous changes in the global economy since it was first established in 1944. The challenge for the Fund moving forward is to maintain that relevance in the face of significant changes to the underlying 'problems' which the institution was established to address.

There are, today, important tensions underlying the IMF's role. How does the Fund maximise its effectiveness in crisis prevention and resolution? How can it continue to improve its surveillance when so many of the recent initiatives are voluntary? Is there a case for a 'fresh pair of eyes'? How does it best catalyse the actions of debtor countries and their creditors through sound policy advice? Does it have a role in helping members better communicate the desirability of particular policy choices? Is it possible to strengthen the capacity of the Executive Board to make hard decisions? Is it excessively exposed to individual countries? How can the right balance be struck between ensuring legitimacy (through measures to improve the overall architecture and governance) and improving effectiveness (through stronger surveillance and programs)? How can it ensure appropriate voice and effective representation of all members? What role can other groups, such as the G-20, play in helping the Fund confront these issues?

The Fund's role has evolved. The challenges it faces going forward call for further evolution. The question is whether the international community — the Fund's shareholders — is up to the challenge.

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