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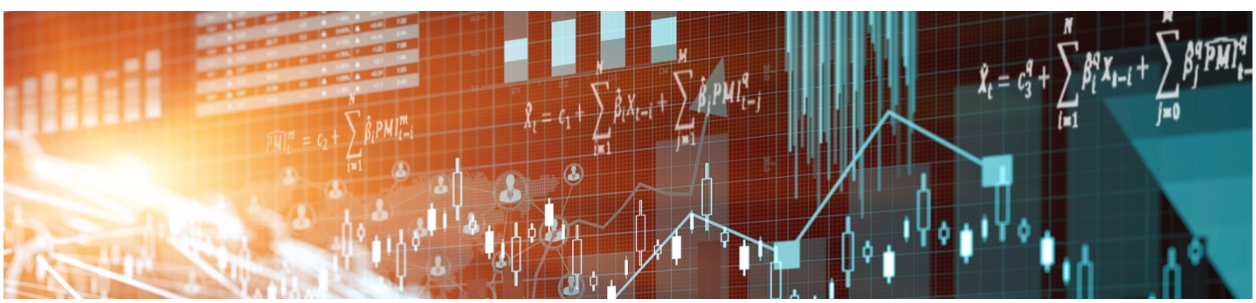

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The Role of the International Monetary Fund in the Post-Crisis World

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Abstract

The International Monetary Fund (IMF, or the Fund) has undergone a number of significant policy changes and reforms in the wake of the global financial crisis. Most notably, in December 2015, the United States approved long-delayed legislation to increase the representation of developing countries in the Fund's governance structure. The vital progress on quota shares has finally allowed for a resumption of wider and increasingly critical discussion of the strategic role of the IMF in the post-crisis world. This paper aims to relaunch the debate by assessing the recent reforms and changes, identifying areas where progress is still needed and proposing solutions. Our findings suggest that, while much has been accomplished by the Fund's management and staff since the global crisis, there is still a pressing need for member countries to push for further reforms if the IMF is to remain a relevant player in the rapidly evolving global economic and financial system. Emerging-market economies remain under-represented at the Fund and continue to perceive the IMF as biased against them, undermining the influence of its advice, despite the increase in their quota share and changes to improve the quality, efficiency and even-handedness of the IMF's surveillance and lending. In advanced economies, where the Fund has traditionally had little traction on national policies, the institution faces the challenge of managing and communicating its independence in programs involving large shareholders. We propose reforms aimed at improving country representation, granting the IMF real operational independence and enhancing its catalytic role.

JEL classification: F, F3, F33
Bank classification: International topics

Résumé

Le Fonds monétaire international (FMI ou Fonds) a connu une série de réformes et de changements d'orientation importants dans la foulée de la crise financière mondiale. Le fait le plus notable a été la ratification par les élus américains d'un amendement en décembre 2015, dont l'approbation avait été longtemps retardée et qui vise à renforcer la représentation des pays en développement au sein des organes de gouvernance du Fonds. La réforme essentielle des quotes-parts qui a été réalisée permet enfin de reprendre les discussions sur la question plus vaste et de plus en plus incontournable du rôle stratégique du FMI dans le monde d'après-crise. Notre étude se propose de relancer le débat en évaluant les récents changements et réformes, en circonscrivant les domaines où les progrès doivent se poursuivre et en soumettant des solutions. S'il est vrai que la direction du Fonds et le reste de son personnel ont accompli beaucoup depuis la crise financière mondiale, l'institution ne peut toutefois rester pertinente dans un système économique et financier en rapide évolution qu'au prix d'autres réformes portées par les États-membres.

Les pays émergents sont encore sous-représentés et continuent à soupçonner le FMI d'avoir un parti pris contre eux. Cette méfiance diminue la valeur accordée à ses conseils, malgré l'augmentation des quotes-parts de ces pays et les actions entreprises pour accroître la qualité, l'efficience et l'impartialité de la surveillance exercée par le FMI et de son activité de prêteur. Dans les économies avancées, où le Fonds a eu en général peu d'influence sur les politiques nationales, l'institution est confrontée à la double difficulté de gérer et de faire valoir son indépendance dans des programmes auxquels participent de grands actionnaires. Les réformes que nous proposons sont destinées à améliorer la représentation des États, à donner au FMI une véritable indépendance opérationnelle et à rehausser son rôle mobilisateur.

Classification JEL : F, F3, F33
Classification de la Banque : Questions internationales

1. Introduction

The global financial crisis (GFC) and the subsequent crisis in the euro area have necessitated far-reaching changes at the International Monetary Fund (IMF, or the Fund). The protracted period of turmoil highlighted weaknesses, some of which were already known, in the Fund's surveillance and lending frameworks, as well as in its financing mechanisms and governance set-up. It laid bare the extent to which the Fund was saddled with policies and structures of a bygone era, one in which emerging markets and developing countries (EMDCs) experienced crises; the IMF provided the financing and programs to restore stability; and advanced economies (AEs), as the main creditors, controlled the institution.

Since the crisis period began, the IMF and its members have had to adapt to new realities in almost all areas of the Fund's operations. AEs have become major debtors of the Fund and emerging-market economies are now significant creditors. The size of programs has ballooned, such that the Fund can no longer finance some of them independently. As part of the Troika (along with the European Commission and the European Central Bank), the IMF has found itself designing programs for advanced countries in a monetary union, where it is only a minority creditor and the major financial contributors (European governments) happen to also be the Fund's largest shareholder group. Even the Fund's channels of influence are evolving—the IMF's surveillance and advice, rather than its loan provision, have now become its principal means of influencing members' policies. Indeed, in today's highly interconnected world, where systemic crises seem more likely, the Fund's high-quality monitoring and risk analysis need to pack much more punch than its limited financing capacity.

The IMF and its country members have responded to the evolving paradigm by implementing a number of significant policy changes. For example, the Fund adjusted its lending policies to enable the extension of record-high loans to AEs in the euro area. It made very large sums available to emerging-market economies on a precautionary basis, with little or no conditionality (although with stringent qualification criteria). It espoused new surveillance guidelines that focus on inter-linkages, multilateral analysis, financial sector issues and risk assessment. Its resources have quadrupled and its governance has undergone review.

Most notably, in December 2015, the United States approved long-delayed legislation to increase the representation of developing countries in the Fund's governance structure. The vital progress on quota shares has finally allowed for a resumption of wider and increasingly critical discussion of the strategic role of the IMF in the post-crisis world.

The aim of this paper is to assess the recent changes, identify areas where progress is still needed, and propose solutions. In doing so, we hope to rekindle the debate about the reforms that are required to ensure that the IMF remains a relevant player in the rapidly evolving global economic and financial system.

Our findings suggest that, while much has been accomplished by the Fund's management and staff, there remains a pressing need for further reform. The most persistent problems relate to fair representation, the limited traction of IMF surveillance, and the adequacy of the Fund's finite resources. Notwithstanding the recent increase in their quota share, emerging-market economies continue to be under-represented at the Fund, an anomaly even apart from the fact that their policies have improved remarkably and it has been shown that crises in AEs have by far the most disruptive global effects. Despite the recent changes to improve the quality, efficiency and even-handedness of the IMF's surveillance and lending, it remains the case that many EMDCs continue to perceive the IMF as biased against them, undermining the influence of its advice. Related to this perceived bias is the governance structure itself, whereby periodic Executive Board approval is needed to reduce growing divergences between actual and calculated quota shares and one member alone (the United States) enjoys a veto right. In AEs, where the Fund has traditionally had little traction on national policies, the institution faces the challenge of managing and communicating its independence in programs involving large shareholders.

We propose a number of high-level reforms, focusing on a coherent set of principles rather than operational details. Our proposals aim to renew members' commitments to the Fund, improve representation, grant the IMF real operational independence, and enhance its catalytic role. These reforms are difficult and will have to involve members more closely than has been the case in the recent past. However, progress is necessary to ensure that the Fund is not eclipsed by other arrangements or regional institutions.

Indeed, alternatives to the IMF have been discussed and are being actively pursued. These include the creation of a credit reserve arrangement among the BRICS countries, enhanced regional financing arrangements (e.g., the Chiang Mai Initiative Multilateralisation), and a push among some emerging-market countries to develop a "global financial safety net" to include multilateral swap lines between central banks. Over the coming years, and perhaps sooner if frustration continues to grow and the momentum built up by the recent quota reforms is not capitalized on, the energy devoted to these alternatives will likely increase.

The paper is laid out as follows. In Section 2, we identify key trends that have challenged the IMF over the past decade. In Section 3, we discuss whether the recent changes made by the Fund are sufficient to deal with these trends and constitute a coherent and consistent crisis-prevention and management framework. Section 4 proposes a series of reforms that Fund members need to consider if the IMF is to remain a relevant player in the rapidly evolving global economic and financial system. Section 5 concludes.

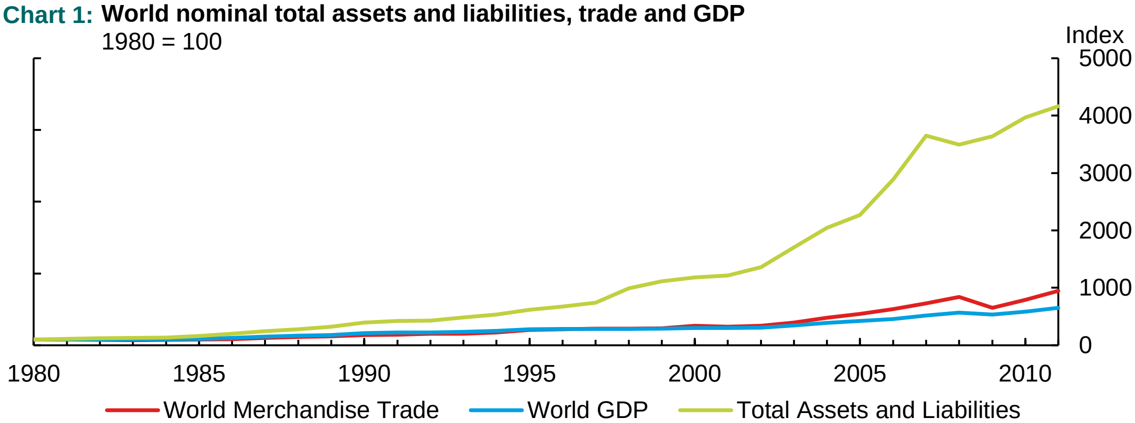
2. Changes in the Global Environment

To set the recent IMF reforms in their proper context, we briefly discuss three major shifts in the global economy and the particular challenges that they have posed to the Fund's operations.

2.1 Increasing global financial integration

Financial innovation, European integration and technological advances have fuelled explosive growth in global finance since the 1990s. Growth in the stock of financial assets has well outstripped that of trade flows and global GDP (see Chart 1). As the volume of flows has increased, so has the potential for surges and abrupt changes in the size and direction of flows. The increased interconnectedness of national financial systems was made evident by the GFC, which underscored how significant financial spillovers from advanced economies were no longer solely a concern for vulnerable emerging-market and developing countries (EMDCs), but could shake the financial systems of advanced economies as well.

Chart 1: World nominal total assets and liabilities, trade and GDP
1980 = 100



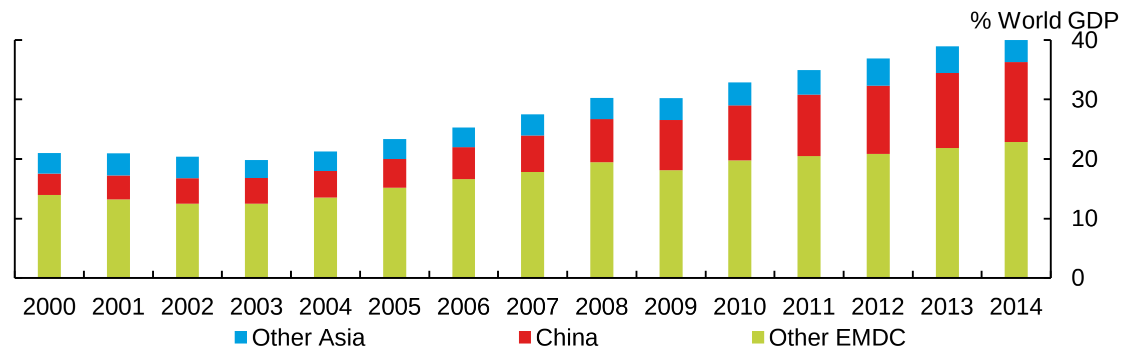
Sources: International Monetary Fund, Lane and Milesi-Ferretti (2011), and the World Bank Last observation: 2011

The increased financial integration has major implications for the IMF's operations. The Fund's surveillance and lending functions need to adjust to the heightened vulnerabilities stemming from increased cross-border spillovers from shocks and policy changes. The monitoring of financial markets and financial sectors has become essential, as has a sound understanding of real economy-financial sector linkages. Since the 1990s, the IMF had been trying to put more emphasis on the financial system, even though the oversight of financial sectors and markets has not traditionally been under the IMF's purview. It was challenging for the Fund to integrate financal system analysis into macroeconomic surveillance. Success requires that the Fund coordinate closely with the international bodies responsible for financial regulation and supervision, particularly the Financial Stability Board, to avoid inter-institutional tensions and duplication of work. In terms of IMF lending, large capital flows increase the magnitude of capital account crises and imply a need for larger lending packages, with a strong emphasis on restoring confidence in financial markets. Large packages, in turn, require that the IMF have sufficient resources.

2.2 The rising economic power of emerging-market economies

The rise of emerging-market and developing countries[1] has been one of the defining economic trends over the past decade or so. The EMDCs' share of world GDP[2] has almost doubled, from 20 percent in 2000 to nearly 40 percent in 2014 (Chart 2).

Chart 2: EMDC shares of GDP at market exchange rates



Source: International Monetary Fund

Last observation: 2014

EMDC growth has been both a product of and a contributor to increased globalization. Strong growth in advanced countries in the early part of the last decade encouraged export-led development in many EMDCs, especially China. New technologies permitted the development of just-in-time inventory management and global supply chains, which engaged countries at different levels of development, taking advantage of their comparative strengths. Increased demand for primary commodities benefited EMDC exporters of these goods, both through volume and price effects.

This growth was, in part, attributable to EMDC policies. Domestic macroeconomic policy management improved, especially in countries that had experienced crises in the 1980s and 1990s. National savings rose and external debt fell, reducing vulnerabilities.[3] More generally, the greater focus on inflation control and sound public finances has resulted in more stable economies in the emerging world.

This gradual strengthening of EMDCs carries important implications for the IMF, its operations and governance. For many years, the Fund could have been characterized

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[1] Countries in the group of "Emerging-market and developing countries," which is consistent with the IMF's definition, are listed in http://www.imf.org/external/pubs/ft/weo/2013/01/weodata/weoselagr.aspx#200.

[2] At market prices and exchange rates.

[3] The external debt of EMDCs fell from 37 to 24 percent of GDP during the first decade of the 2000s, while consolidated public debt declined from 50 to 36 percent of GDP.

as an institution dominated by AE creditors that conducted surveillance to assess which emerging-market economies (EMEs) might experience crises and designed adjustment programs for those it lent to. Now, the relationship has become more balanced, with some advanced countries in difficulty and EMEs providing a significant portion of the Fund's financing. EMDCs are asking for a level of representation within the Fund's governance structure consistent with their economic standing. Their rise has led to a clash of views on key policy frameworks, which in the past had been dominated by AE positions. Most notably, the two groups have differing views on the desirability of exchange rate flexibility and full capital mobility. This has put pressure on the Fund to adjust its advice in accordance with the now more-diverse views of its major shareholders. In addition, changes have been made to the IMF's lending tool kit to better accommodate EMDC concerns, including through the creation of readily available credit-line-type instruments to better manage capital flow volatility.

2.3 A Deepening Economic and Monetary Union in Europe

When the euro area formally came into being on 1 January 1999, it introduced a unique economic construct characterized by a new type of governance framework, with strong and multifarious interlinkages. Member countries are united in a policy and institutional framework, including a common currency and monetary policy, which supports integration and shapes economic and financial dynamics within the euro-area economy.

The euro-area economy is systemically important and, as such, it is also important for the IMF. With 12 percent of global GDP, it is the third-largest economy in the world. The euro is the second most important currency in the international monetary system, the stability of which the IMF is mandated to oversee. By way of illustration, the euro accounts for around one-quarter of global foreign exchange reserves;[4] it is one side of the most-traded currency pair (USD/EUR) and is involved in one-third of all foreign exchange transactions; and it plays a major role in the global financial system—e.g., it is the denomination of almost 40 percent of the outstanding amount of international debt securities (just below the U.S. dollar).[5]

[4] The total refers to those foreign exchange reserves for which holders disclosed the currency composition.
[5] ECB (2014), *International Role of the Euro*.

The global financial crisis exposed flaws in the euro-area policy framework. This framework, together with the dynamics of integration that increased mutual exposures, raised vulnerabilities within the euro area and called for vigilant monitoring. Yet the severity of these vulnerabilities was largely ignored, contributing to a crisis in some countries in the euro area. Fortunately, the crisis spurred a series of reforms to address these weaknesses. Now the euro area is emerging from the crisis with strengthened governance and oversight (especially fiscal and external balance), further centralization of policies (specifically banking supervision), and a crisis-management system (the European Stability Mechanism).

The challenges that the euro area poses for the IMF are fundamental. The IMF's model is one in which the Fund engages with sovereign states. However, in many instances, euro-area member countries have passed the responsibility for various economic policies—notably monetary and exchange rate policy—to the union level, while in other areas, policy is decided jointly (e.g., fiscal frameworks—the Stability and Growth Pact, trade, internal market).[6] The IMF's duty to oversee the stability of the international monetary system calls for an approach that takes account of the union as a whole. Surveillance needs to be particularly attuned to the euro-area framework and its unique internal dynamics.[7] IMF lending has to adapt to the union's institutions and policy framework. Finally, there is an unresolved tension regarding how the union itself should participate in IMF policy deliberations, an issue that is being rendered ever more acute by the greater centralization of policy-making.

3. Changes in the Fund's Activities

The three phenomena described above demand change from the IMF and, to its credit, the institution has undergone many reforms, often far-reaching, since 2008. However, there are questions about all of these changes—for example, their coherence, and whether they have gone far enough, or too far, in addressing these challenges. Here, we briefly take stock of reforms to surveillance, lending, resources and governance.

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[6] Individual euro-area members retain policy competency in the structural and fiscal areas.
[7] For more on this, see ECB (2015), "IMF surveillance of the euro area and its member countries," *Economic Bulletin*, April.

3.1 Changes in the focus and balance of IMF surveillance

As the GFC and the crisis in euro-area countries revealed, there were shortcomings in the way in which IMF surveillance had adapted to the trends discussed above. With the benefit of hindsight,[8] it is clear that the IMF had not sufficiently developed its analysis and understanding of financial sectors, macrofinancial linkages and related risks (of course, other institutions, including central banks, did not fare particularly well along these dimensions either). More work should have been done to better understand and monitor interconnectedness among countries, including policy spillovers and capital flows. Surveillance of external stability needed to be more broadly based and better embedded in a multilateral context. And communication of key policy messages needed sharpening.

In particular, the Fund was insufficiently focused on the economic and financial risks in advanced countries. For example, the Vulnerability Exercise (established in 2001 with the aim of identifying major risks and vulnerabilities) focused on emerging-market countries and excluded advanced countries, despite the suggestions of some senior Fund staff and Executive Directors. Similarly, the Financial Sector Assessment Program (FSAP), introduced in 1999 in an effort to promote sound financial systems was voluntary, and the United States did not agree to undertake an FSAP until 2010. It is therefore not surprising that there is a general perception that the Fund's surveillance is not even-handed. In a survey for the pivotal 2011 Triennial Review of Surveillance, only 20 percent of the authorities from the G20 countries agreed with the statement "the IMF is even-handed." Indeed, many country authorities felt that the Fund was "too soft on large systemic countries."[9] Fund surveillance was, in part, coloured by the widely shared misperception that advanced economies were not crisis prone. Moreover, it was difficult for the Fund to demonstrate that it could add value to the extensive private sector analysis of these economies.

[8] There has been a thorough review of surveillance since the onset of the crisis. See, for example, lessons to be learned from the crisis (IMF, 2009); the review by the Independent Evaluation Office (2011) of "IMF performance in the run up to the crisis"; and the IMF's 2011 and 2014 Triennial Reviews of Surveillance. These have formed the basis for improvements in surveillance.

[9] See IMF, "2011 Triennial Surveillance Review – Health Check and Statistical Information," 26 August 2011.

It is useful at this stage to define what is meant by the term “even-handedness.” We consider it to be equal treatment for countries/economies in equal circumstances. This acknowledges that all economies are not equal and the major economies would warrant special scrutiny because of their systemic importance and the spillovers they may generate. Related, but distinct, are the *perceptions* of unequal treatment. The perception of bias in the Fund’s analysis and treatment of countries is detrimental for IMF governance, irrespective of the degree of actual uneven-handedness. We emphasize the importance of perception (as distinct from actual metrics of the IMF’s even-handed application of surveillance policies, which we note have generally improved over time), because it is the views or opinions of countries that count when it comes to fostering a co-operative environment in which IMF advice on national policies has traction.

Specifically regarding the euro area, while the IMF had drawn attention to weaknesses in the financial framework in Europe, it had not critically analyzed the policy and governance framework of the euro area nor had it fully appreciated the dynamics of inter-linkages and feedback loops at work.[10]

3.1.1 Reforming the surveillance framework

One of the most complete assessments of IMF surveillance around the time of the outbreak of the GFC was undertaken by the IMF’s Independent Evaluation Office (IEO, 2011). The IEO found that instead of highlighting the risks that eventually resulted in the crisis, the Fund focused on the possibility that a disorderly unwinding of global imbalances would trigger a rapid and sharp depreciation of the U.S.dollar.

This focus on external stability had been driven to a great extent by the recent decision to orient the Fund’s surveillance in that direction. Responding to criticisms that it had been “asleep at the wheel” on exchange rates[11] during the rise of global external imbalances, the IMF adopted, in 2007, a new Decision on Bilateral Surveillance Over Members’ Policies (the 2007 Surveillance Decision), which elevated the focus on exchange rates and made external stability the cornerstone of bilateral surveillance. The

[10] See, for example, Jean Pisani-Ferry, André Sapir and Guntram B. Wolff (2011), “An Evaluation of IMF Surveillance of the Euro Area.”
[11] See Brad Setser (2005), “Has the IMF been asleep at the wheel, and ignored surveillance of exchange rates?” at http://blogs.cfr.org/setser/2005/09/29/has-the-imf-been-asleep-at-the-wheel-and-ignored.

concern had been that the Fund was spreading itself too thinly in its surveillance: providing broad coverage of numerous, disparate topics, while failing to deliver clear commentary on the exchange rate, which was at the core of its mandate. However, the EMDCs did not fully endorse the 2007 Decision, particularly its mandate to identify currency manipulation and evaluate the extent of exchange rate misalignments. As a result, the Fund was not in a position to label any countries as being currency manipulators or even as having significantly misaligned currencies. China delayed its Article IV consultations for two years, largely because of a conflict of views with staff over the renminbi's valuation (Blustein 2012).

In light of the deficiencies revealed by the GFC and the lack of general acceptance of the 2007 Decision with its emphasis on exchange rates, a new surveillance Decision was agreed in early 2013. The new Decision on Bilateral and Multilateral Surveillance, otherwise known as the Integrated Surveillance Decision (ISD), broadens the focus of surveillance and breaks new ground in a number of ways. It encourages members to be mindful of the impact of their policies on the international monetary system, promotes the use of the Article IV consultations to discuss the impact of members' policies on global stability, and encourages the integration of bilateral and multilateral surveillance. It focuses on risks and emphasizes the consideration of financial linkages. It also advocates a more balanced treatment of domestic and exchange rate policies when considering internal and external balance.

However, some concerns remain. Firstly, with respect to the euro area, the ISD represents a missed opportunity to better come to grips with the unique features of monetary unions. The provision for the surveillance of monetary unions is largely unchanged compared with the 2007 Decision. Hence, the reference to monetary unions not only contains misattributions (holding members responsible for policies conducted at the union level by independent authorities), but also does not go far enough in acknowledging the additional surveillance challenges posed by monetary unions.[12] Indeed, these shortcomings undermined surveillance of the euro area prior to the crisis in

[12] These challenges include the need to evaluate the policy framework, consider the transmission channels of internal and external interconnectedness, acknowledge the respective responsibilities of the different policy-making authorities, and also evaluate members in terms of their sustainable functioning in a monetary union.

that region.[13] Fortunately, the IMF's 2012 Guidance Note on Article IV Surveillance went some way to addressing these elements. It spelled out more clearly that surveillance at the country level was to consider implications for the stability of the union as a whole, and that reports at the union level should refer to significant vulnerabilities in individual members. A second concern with the ISD was that by broadening out the focus of surveillance, it could de-emphasize the analysis of exchange rates, which was the focus of the 2007 Decision and should always be a prime component of the Fund's surveillance in view of Article IV of the IMF's Articles of Agreement. However, this concern was to a large extent assuaged through the introduction of the External Sector Report.

3.1.2 External Sector Report

In the past few years, the IMF has taken steps to integrate its mandate to exercise firm surveillance over members' exchange rates into part of a broader External Sector Report (ESR). The ESR, first published in 2012, aims to analyze external balances and the potential risks to international economic stability from a broader multilateral perspective. The ESR provides a multilaterally consistent snapshot of the external positions of 29 economies using a panel-based empirical methodology and integrates analysis from bilateral and multilateral surveillance to provide a coherent assessment of exchange rates, current accounts, reserves, capital flows, and external balance sheets. The reports are published and the methodology is open to scrutiny. Now in its fourth year, the exercise is overcoming its teething problems[14] and the conclusions of the ESR are starting to become translated into headline messages on global imbalances and risks. As such, it constitutes a clear step in the right direction.

[13] "TSR 2011 External Study – An Evaluation of IMF Surveillance of the Euro Area," Jean Pisani-Ferry, André Sapir, and Guntram B. Wolff, July 19, 2011.

[14] Notably, there was concern that applying the same empirical approach to all countries may not always be appropriate. Indeed, for many countries, the empirical "fit" for the ESR's explanation of exchange rates or current account balances was not particularly good. There was also a lack of transparency in how the overall assessment was compiled and policy guidance determined, which inevitably require a degree of judgment.

3.1.3 Financial sector surveillance

The global financial crisis was also a wake-up call for financial sector surveillance. While the Fund pointed to some of the key vulnerabilities in its Global Financial Stability Report, it failed to show how they would interact to cause a crisis. At the bilateral level, FSAPs suffered from being voluntary and resource intensive and had not been designed to flag risks. Not all countries underwent an FSAP, most notably the United States—the country with the most globally important financial sector—and even where FSAPs were undertaken, they failed to warn sufficiently of mounting vulnerabilities (e.g., the United Kingdom and Ireland were given a clean bill of financial health before the crisis). This inattention of the IMF towards the growing risks in advanced-economy financial sectors underscored EMDC concerns regarding the equality of treatment among IMF members.

The IMF responded in two ways. Firstly, FSAPs were revamped to include more risk assessment and greater focus on country concerns. They were also made compulsory for the largest financial centres. Since the start of the crisis, the United States, China and the European Union have all undergone their first FSAPs. Secondly, in 2012, the IMF began developing a Financial Surveillance Strategy designed to strengthen the analysis of macrofinancial linkages and risks, improve the instruments and products to foster an integrated policy response, and enhance traction. As part of this endeavour, the IMF is developing key aspects of macroprudential policy, which are to become an integral part of bilateral and multilateral surveillance. This approach requires close co-operation with the FSB and the BIS.

3.1.4 Spillovers

The crisis highlighted the need for a far better understanding of inter-linkages. As a result, IMF staff embarked on a pilot project in 2011 to study the policy spillovers of major systemic economies (China, the euro area, Japan, the United Kingdom and the United States) on the rest of the world. (In the 2015 report, spillovers are considered according to theme rather than region.) The spillover reports (now in their fifth year but expected to be subsumed into mainstream surveillance products in future), sensitize policy-makers to the potential impact of their policies on other countries. While policy-makers are under no obligation to alter their policies because of possible spillovers, this exercise is improving the quality of the global dialogue on inter-linkages and the transmission channels of shocks. The spillover analysis is supported by complementary studies on specific issues, such as the spillover effects of unconventional monetary policy.

3.1.5 New view on capital controls

In a related initiative, the IMF developed a new institutional view on the management of capital flows (IMF, 2012). This was one outcome of the IMF's attempt to expand its surveillance of the capital account, following instructions by the International Monetary and Financial Committee (IMFC) to review its mandate "to cover the full range of macroeconomic and financial sector policies that bear on global stability".[15] Indeed, greater focus on the capital account is a logical step in light of increased global financial integration. However, the IMF is restricted in how far it can go. The Integrated Surveillance Decision (2012) explicitly requires the Fund to consider capital account policies in the context of multilateral surveillance. At the same time, it does not change the nature of member countries' obligations under the Articles of Agreement, and the IMF does not have jurisdiction over the capital account.

The new view is striking in that it marks a substantial softening of the IMF's long-standing promotion of unrestricted capital flows by accepting the fact that countries may need to shield themselves from the negative consequences of volatile capital flows. The new view sought to secure the membership's backing for IMF monitoring and policy advice on capital flow management, which remains a controversial issue. Indeed, it is legitimate to ask whether this shift in the IMF's view represents a concession to countries that are inclined to use capital controls. Is it a "slippery slope" to condoning financial protectionism or a realistic approach to engaging, and improving traction, with those countries? Or is it simply a valid approach to solving a problem? Experience with developments in the recourse to such measures will be needed to evaluate these questions. At any rate, the new view does not speak to most advanced economies, which

[15] Independent Evaluation Office (2015), "The IMF's Approach to Capital Account Liberalization Revisiting the 2005 IEO Evaluation."

are typically characterized by liberalized capital accounts. (Some notable exceptions include Iceland, Cyprus and Greece.)

3.1.6 Traction and even-handedness

Whether all these initiatives go far enough in meeting the Fund's surveillance challenges depends on their implementation. The Global Policy Agenda—also a post-crisis innovation—helpfully draws the different surveillance strands together into a consolidated overview of risks and policy advice. Yet effective surveillance requires not only the right focus and objective analysis, but also traction. Enhancing traction—the extent to which a country's authorities take IMF advice on board—is a perennial challenge. The observation that only program conditionality, not surveillance per se, assures traction used to be a charge directed at advanced economies, but it is increasingly being applied to major EMEs. Indeed, many of the recent surveillance initiatives, such as the new view on capital flows or the analysis of spillovers, external stability and financial sectors (which increases the relative scrutiny of advanced economies) can be viewed as an attempt to re-engage EMEs with the IMF.

In sum, an excessive emphasis on exchange rates following the 2007 Decision and the Fund's failure to aggressively call out the weaknesses of advanced-country financial sectors fuelled the EMEs' perception that surveillance was not even-handed. To the extent that the enhanced surveillance framework addresses their perceptions, the IMF may become increasingly relevant for EMEs. However, the IMF cannot bend too far if it is to retain the trust of advanced economies in the process. It must be seen as neutral, which requires surveillance that is seen to be objective and dispassionate. We return to these themes in Section 4.

3.2 Changes in IMF lending

Just as with surveillance, the crisis exposed gaps in the IMF's lending framework. However, unlike surveillance—where the IMF could review the shortcomings and deliberate on improvements in a considered manner (notwithstanding the pressing need to improve risk monitoring)—lending had to adapt on the fly, under pressure of countries rapidly losing access to liquidity in a climate of contagion. The IMF showed itself to be flexible, pragmatic and swift, yet developments also revealed difficulties in meeting its members' needs. With the easing of the crisis, it is time to take stock of experiences and set a clear direction for lending. In what follows, we will consider, in turn, changes to EMDC loans, of which the main ones were primarily precautionary in nature, and loans to advanced countries, which included high-access programs.

3.2.1 Precautionary programs

Once the crisis broke, new precautionary facilities were created to both prevent the spread of contagion and re-engage EMEs.[16] Following a false start with the introduction of a Short-Term Liquidity Facility in October 2008,[17] the IMF subsequently created precautionary facilities suited to countries with differing degrees of macroeconomic stability. The Flexible Credit Line (FCL), created in 2009, targeted strong performers and is viewed as a "seal of approval" from the IMF.

The Precautionary and Liquidity Line (PLL), created subsequently, was aimed at countries with sound economic fundamentals but enough vulnerability to preclude them from using the FCL.[18] For both of these lines, approval is based on qualification criteria and, once approved, access is available immediately and could be large scale, with—crucially—no (or, in the case of the PLL, little) conditionality. Both the FCL and the PLL arrangement are limited in time (from six months to two years) and are reviewed regularly. To ensure their immediate accessibility, funds allocated to the precautionary lines are fully "scored," meaning they are counted on the IMF's balance sheet as an actual loan. The aim of these new types of lines was to align the Fund's messaging on surveillance and lending and help overcome the stigma of borrowing: countries deemed to be following sound policies would be backed by IMF support. Additionally, to the extent that some of the massive reserves being accumulated by EMEs were for

[16] An early (unsuccessful) attempt at a precautionary facility had given the IMF some experience in their design. In 1999, the Contingent Credit Line was established to offer precautionary assistance to economically sound countries that might be affected by contagion. Although it was discontinued in 2003, owing to lack of use from poor design, it introduced the concept of a precautionary facility, without specific conditionality, for countries with very strong macroeconomic fundamentals.

[17] The SLF was intended for countries with sound fundamentals but in need of short-term liquidity as a result of financial market strains. However, EMEs preferred to try for swap lines with the Federal Reserve, which could be set up for precautionary purposes and where the amount would be much larger than under an SLF (which was capped at 500 percent of quota).

[18] For EMEs whose performance precluded access to either the FCL or PLL, a high-access, precautionary version of the standard Standby Arrangement was introduced (a "HAPA").

precautionary reasons, it was hoped that the availability of the FCL/PLLs would reduce demand for reserves and thereby allow exchange rates to better reflect market forces.

Despite their conceptual attractiveness, there has been little demand for FCLs and PLLs. Only three countries have an FCL and one has a PLL, and they have not drawn upon them.[19] Part of the difficulty is the perceived "entry and exit" problem.[20] Countries are reluctant to ask for an FCL out of concern that it would send a signal to markets of some hidden vulnerability. There is also concern about the message received by markets should the Fund fail to approve or renew a country's FCL/PLL. To date, no country has exited an FCL arrangement: they have simply been renewed, with either increased or decreased access. This runs counter to the original purpose of the facilities. It is clear that once countries have overcome the initial stigma associated with acquiring a precautionary loan, there is little incentive to give up this "seal of approval" and relatively cheap source of external financing.

Notwithstanding the willingness of the IMF to make large sums available at short notice, EMEs do not yet appear ready to depend on the IMF for their safety net. Interest in regional or group financing arrangements (RFAs) has risen: East Asia's Chiang Mai Initiative has been multilateralized and expanded to US$240 billion (though it remains untested), and the BRICS countries have established a US$100 billion reserve pooling arrangement—the Contingent Reserve Arrangement. More recently, EMDC swap lines have proliferated, in particular with China on one side (though this has less to do with potential crisis financing than expanding the role of the renminbi). In 2010, Korea promoted the idea (unsuccessfully) of a "global safety net" that would bypass the IMF and rely directly on central bank swap lines. EMEs, it would seem, still have trust issues with the IMF, which can also be traced to concern about a lack of even-handed treatment.

3.2.2 Large-scale loans to euro-area countries

As the crisis spread to Europe, and euro-area members sought IMF assistance, lending moved into uncharted territory. At first, IMF loans were primarily provided to emerging

[19] Colombia, Mexico, and Poland have FCLs, and Morocco has a PLL. (For completeness, the Former Yugoslav Republic of Macedonia had a PLL between 2011 and 2013, on which it partially drew.)

[20] For further development of this idea, see the German Development Institute (DIE), "A Critical Review of the IMF's Tools for Crisis Prevention," http://www.die-gdi.de/uploads/media/DP_4.2012_.pdf.

Europe.[21] Once the sovereign debt crises in some euro-area countries erupted, however, the IMF found itself lending to advanced countries for the first time since the collapse of the Bretton Woods System and, for the first time ever, to members of a systemically important monetary union. It soon became clear that the design of a program for euro-area countries would be unlike those for standard IMF members.

- Large-scale financing was required for the programs for Greece, Portugal and Ireland (Chart 3). This reflected in part the high degree of financial integration with other euro-area members and the need to prevent contagion. The sheer size of the financing gap necessitated very high access to IMF resources as well as even larger co-lending from the rest of Europe.
- The program for Greece dramatically softened the Fund's exceptional access criteria. The trend towards increasing access began a decade ago, when the large programs for EMEs suffering capital account crises (most prominently Turkey, Brazil, and Argentina) dominated lending in the early 2000s. Recognizing a trend towards bigger financing packages, the IMF defined its exceptional access framework in 2002 by setting out four key criteria. A country could only receive exceptional access loans (over 300 percent of quota) if (i) the member is experiencing or has the potential to experience exceptional balance of payments pressures on the current or capital account, resulting in a need for Fund financing that cannot be met within the normal limits; (ii) its debt levels were sustainable over the medium term; (iii) it could hope to re-access private markets over the program period; and (iv) the program was likely to succeed. However, despite these criteria, loan sizes grew rapidly after 2002 (Chart 3), including loans to European countries where debt sustainability was a concern. The 2009 program for Greece led to an amendment to the exceptional access criteria such that, where there is a risk of systemic spillovers, a high probability of debt sustainability over the medium term is no longer a prerequisite for exceptional

[21] Programs to Eastern European countries (e.g., Ukraine, Hungary and Romania) were intended to deal with fairly typical EMDC external vulnerabilities, including large current account deficits, extensive unhedged cross-border loans, and overvalued currencies.

access.[22] Indeed, the systemic exception was introduced as a necessary part of the Greek program. Since then, the IMF has ceased lending to Greece on account of its concerns, although it remains involved at a technical level, and the systemic risk exemption clause has been repealed.

- Program conditionality focused on stringent fiscal and structural measures, reversing the trend up to 2009. Program design in euro-area countries faces unique constraints. For one, the ability of euro-area countries to adjust is limited by the preclusion of a large currency depreciation, which has been a cornerstone element of some IMF programs. More generally, looser monetary conditions to support program countries are not even conceivable unless they are consistent with the wider goals of the euro area. Financial sector conditionality must also be congruent with the EU supervisory framework. Moreover, debt-restructuring options need to be considered in light of the repercussions for financial stability within the union. As a result of these constraints, most of the adjustment in euro-area programs has to occur through fiscal austerity and structural reforms, which typically are contractionary in the short term and do not bear fruit until after several years of steadfast implementation. Moreover, real exchange rate adjustment has to come about through price-level changes, which is typically a drawn-out process.
- Loans will be outstanding longer. Recognizing that loans to euro-area countries would take many years to be repaid, the programs for Greece, Portugal and Ireland became Extended Fund Facilities, modalities that had been previously used only for emerging-market economies.

Multi-party involvement has complicated program design. The need for co-lending, the setting within a multi-country economy, and the distribution of policy competencies across the euro-area governance framework meant that representatives of the union and other members of the euro area played a fundamental role in the design and monitoring of the programs. This was accommodated with the formation of the so-called Troika, comprising the IMF, the European Commission and the European Central Bank.

[22] See IMF 2013, p. 10, "Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-by Arrangement," IMF Country Report No. 13/156, June 2013. Available at (http://www.imf.org/external/pubs/ft/scr/2013/cr13156.pdf).

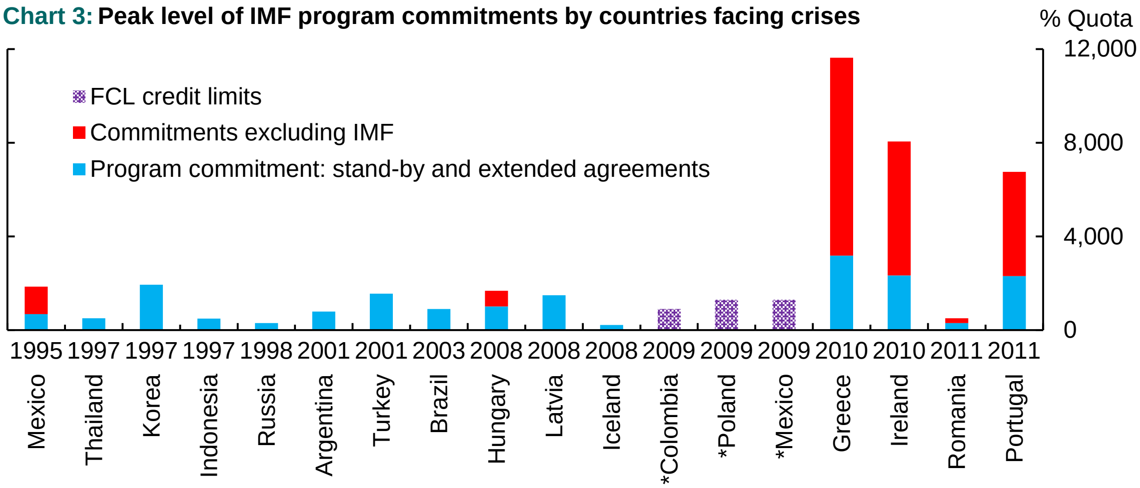
Yet the Troika arrangement poses a challenge to the IMF's independence. Since the national authorities within Europe collectively provided the majority of the financing to the program countries and were also, collectively, the Fund's largest shareholder, there were mixed perceptions regarding the extent to which the IMF maintained the ability to impose conditions as it saw fit. Some non-European members of the IMF's Executive Board were concerned that Europeans were sitting on both the debtor side (the afflicted sovereign) and the creditor side (ECB, EC) of the negotiating table (IEO, 2014). They felt this could conceivably lead to peripheral Europe being granted terms (e.g., on access size or in terms of conditionality) that would not have been available to the wider IMF membership.[23] In fact, some members questioned whether the exceptional access lending to Europe would be available for countries in other regions should the need arise (IEO, 2014). Public disputes between the Fund and its Troika partners have occurred on several aspects of program design, with differences in view being perhaps most acute regarding the need for debt restructuring.[24]

At the same time, it should also be noted that since program negotiations are conducted in a confidential setting—as is usual in an IMF program—the actual positions of each of the Troika partners on program components (including preferences regarding the strictness of conditionality) are often not known. Hence, it can be this need for confidentiality, which translates into a lack of transparency vis-à-vis the Executive Board, that is at the root of the discontent in the Executive Board. Also in terms of access, it should be remembered that the IMF was operating in a new environment where there were real market concerns of grave systemic spillovers that needed addressing.

[23] A lot of attention tends to be focused on the large amount of financing made available to euro-area members, but far less to the fact that euro-area countries, especially Greece and Portugal, were subjected to a far larger number of deep structural conditions than the IMF program average.

[24] See IMF, 2013, p.10, "Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-by Arrangement," IMF Country Report No. 13/156, June 2013. Available at http://www.imf.org/external/pubs/ft/scr/2013/cr13156.pdf.

Chart 3: Peak level of IMF program commitments by countries facing crises



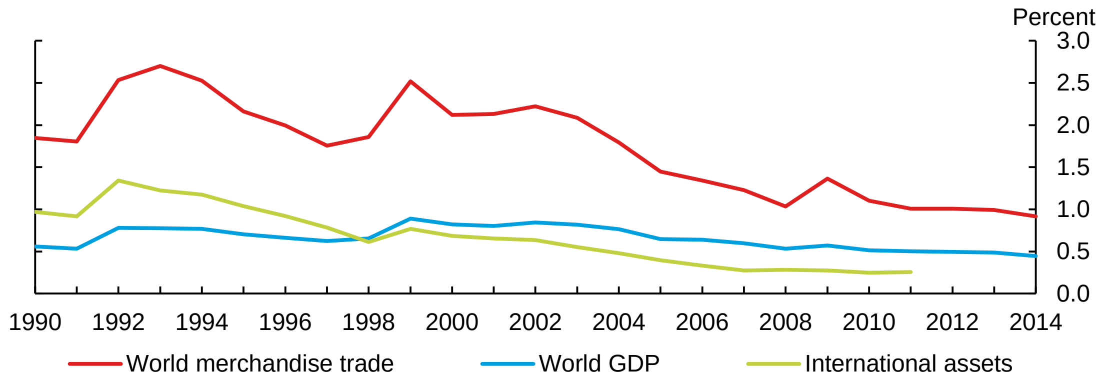
* Denotes the peak level of credit available under the Flexible Credit Line (FCL), including augmentations but ignoring reductions from the amount originally approved. The FCLs have not been drawn on.
Source: IMF International Financial Statistics

3.3 Changes in the IMF resource base

The global financial crisis revealed IMF resources to be woefully inadequate. The mainstay of IMF resources is its quota system, i.e., contributions from members. Quotas have been shrinking over the past two decades as a share of world GDP, but even more so when scaled by world merchandise trade and international assets (see Chart 4). The decline has occurred despite reviews of quotas every five years, which gave the opportunity for discrete increases (e.g., as occurred in 1998 when quotas were raised by 45 percent). The recently completed 14th General Review of Quota will reverse this trend. We estmate that the quota GDP ratio will rise to close to its 1999 level, while the ratios of quotas to trade and finanical assets will increase to the ratios seen in the early 2000s.

Following the Asian crisis, the IMF introduced the New Arrangements to Borrow (NAB), a set of credit arrangements through which the IMF can borrow from participating members in an effort to boost resources and make them available at short notice. However, these too shrank against key metrics over time. This inadequacy did not give cause for alarm before the crisis, as lending had all but dried up and the external environment appeared benign. Indeed, the IMF even began downsizing its staff before the crisis because it appeared that the reduced demand for its services was permanent.

Chart 4: Aggregate IMF quota as a share of world output, trade and assets



Sources: International Monetary Fund and Lane and Milessi-Ferreti (2011). Last observation: 2014

Beginning in 2008, the demand for lending soared and the Fund membership responded by raising IMF resources. Following the outbreak of the global financial crisis, G20 Leaders sought to ensure that the IMF had sufficient funds. At their April 2009 summit in London, the G20 Leaders announced that they would make an additional US$500 billion available, effectively tripling the Fund's resources from a pre-crisis level of US$250 billion. This would occur in a rather complex manner via bilateral loans,[25] an enlargement of the NAB, and an increase in quotas. Subsequently, in December 2010, an agreement was reached to double IMF quotas under the 14th General Review of Quotas. This first general increase in 12 years will raise quotas to around SDR476 billion. This increase will only take effect now, almost seven years after the London Summit. With the U.S. Congress approving the quota increase in December 2015, the rise in quotas finally has the support of three-fifths of the members having 85 percent of the total voting power (see discussion below).

The outbreak of the crisis in some euro-area countries led to a second round of bilateral loans and promissory note purchase arrangements (NPAs). In December 2011, euro-area member countries committed to providing up to 150 billion euros to the IMF. Subsequently, non-European countries also pledged support, bringing the total to

[25] A first round of bilateral loans and Note Purchase Agreements (NPAs) in 2009/2010 raised SDR180 billion. These were subsequently folded into the NAB, raising it to around SDR370 billion (from SDR34 billion previously) with the proviso that it would be scaled back to SDR182 billion once a quota increase was implemented.

SDR307 billion (US$456 billion). Many saw these funds as a second line of defence, to be drawn on only after a large drawdown of dedicated European resources and the NAB.[26]

As a sign of the changes, EMEs have made significant contributions to the Fund's resources. In return, they are seeking corresponding representation in the IMF governance structure. Three major EMEs pledged bilateral loans and NPAs as part of the first round of loans in 2009 (accounting for 26 percent of the total). Upon the enlargement of the NAB in 2011, the number of emerging-market participants increased and, as a group, they doubled their share of the NAB from 12 to 24 percent. However, as Brazil has made clear, willingness to contribute to the Fund's financing cannot be divorced from the EMEs' quest for fair representation.[27] Indeed, in the short run, the Fund's governance appeared to have deteriorated from the EMEs' viewpoint. This was because the NAB remained the mainstay of IMF resources, and NAB activation requires approval from participants representing 85 percent of aggregate credit, effectively giving some advanced countries a blocking minority. In contrast, the approval of quota-based loans only requires a simple majority of the memberships' votes.

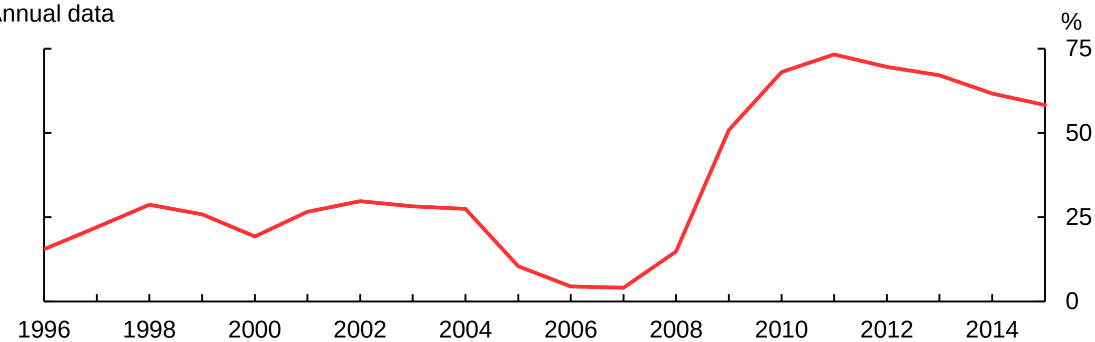
The pertinent question is whether the amount of IMF resources is now sufficient. Despite the headline figure for IMF resources of over one trillion U.S. dollars, the forward commitment capacity (i.e., the amount available to lend) is only US$420 billion (June 2015). While the recent quota increase will arrest the rise in loan commitments (disbursed and promised) relative to (permanent) quota resources (Chart 5) and address concerns regarding funding risk (IEO 2014), it will not help improve the forward commitment capacity. Following the recent quota increase, it is not clear if there is an appetite for devoting additonal quota resources to the IMF. Advanced countries in the euro area, having made bilateral loans to the IMF and contributed to the European Stability Mechanism, would currently have difficulty contributing more to the IMF.

[26] See IMF, "IMF Managing Director Christine Lagarde Welcomes Additional Pledges to Increase IMF Resources, Bringing Total Commitments to US$456 billion," 19 June 2012. Available at http://www.imf.org/external/np/sec/pr/2012/pr12231.htm.

[27] "BRICS members have agreed to inject resources into the IMF but this is conditioned to the continuation of the Fund's reforms; that the Fund makes effective the quota reforms that were accepted in 2009 and 2010," comment by Brazil's Finance Minister, Mantega, *MercoPress*: 2 December 2011, "Brazil ready to support IMF but demands greater power for BRIC countries."

EMEs caught in the current global turmoil may lack the motivation to devote their reserves to financing further quota increases.

Chart 5: IMF program commitments relative to quota
Annual data



Note: Values as of December 31 of each year.
IMF program commitments is defined as the total amount the Fund agreed to lend a nation, not necessarily the amount borrowed.
Once a nation's program matures it is no longer included in the lending arrangements data, even though loans are outstanding.
Hungary's loans have been included for 2010, 2011, and 2012. Ukraine's loans have been included for 2012 and 2013. Ireland's loan has been included for 2013
Source: IMF Lending Arrangements

How large future demands are likely to be hinges on a variety of assumptions, as well as on future developments in global capital flows, EMEs and the euro area. Increasingly, groups of countries are developing their own liquidity sources. The euro area has set up its own financing pool: the European Stability Mechanism. The Chiang Mai Initiative Multilateralisation for a group of East Asian countries has been enlarged and the international network of swap lines has been expanded. Moreover, the BRICS now have the contingent reserve arrangement, a framework for the provision of support through liquidity and precautionary instruments in response to actual or potential short-term balance of payments pressures. The demands made on IMF resources can be expected to remain within limits in the absence of new large programs. The future of precautionary loans and their take-up is a key factor, given that FCLs are not subject to access caps. It is not at all certain what dimensions the future demand for IMF lending will take.

3.4 Changes in IMF governance

During the decade before the global financial crisis, IMF governance changed little, leading to frustration among the major EMEs (Malkin and Momani, 2011). A country's voting share in the IMF is determined by its quota, for which there is a formula. The quota formula is composed of four variables that seek to reflect the IMF's mandate.[28] Reviews of quotas take place every five years, but ad hoc changes to quotas are also possible. Since 2000, two rounds of ad hoc increases in quotas have been implemented to benefit under-represented countries.[29] Still, on the basis of economic weight alone, the change in the distribution of quotas has not kept up with developments. In 2000, the four BRIC countries accounted for around 8 percent of both world GDP and IMF quota share, but by 2012, their share of world GDP was double their quota share. While GDP is not the sole basis for a relationship between a country and the IMF, the fact that the two are so far out of kilter increases the pressure for quota reform. The inability of the Fund's voting structure to reflect the growing economic power of emerging-market countries is seen as damaging the Fund's legitimacy (Seabrooke, 2007).

The global financial crisis provided the impetus for governance reform in favour of EMEs, but negotiations on quota shares have been difficult, owing to the multiple roles that quotas play in the Fund and also because the shifting of voting power is a zero sum game. Countries will always favour formulae that maximize their relative positions.

Following the G20 Leaders' Pittsburgh statement, which called for quotas to better reflect the relative weights of its members in the world economy, the 14th General Review of Quota was agreed to in 2010. This Review doubles quota resources and accords dynamic EMDCs a 6 percentage point increase in their quota share. China will have the third-largest quota share, while the BRIC countries will all be among the Fund's 10 largest quota holders. The long delay in implementing the 14th Review frustrated EMEs. Moreover, the upward adjustment of the BRIC countries' quotas still leaves them below what their quotas would be under the current formula ("calculated quota"). For example, under the 14th Review, the BRIC countries' current quota share is set to rise from 11 percent to 14 percent. However, their calculated quota share is 18 percent (Chart 6).

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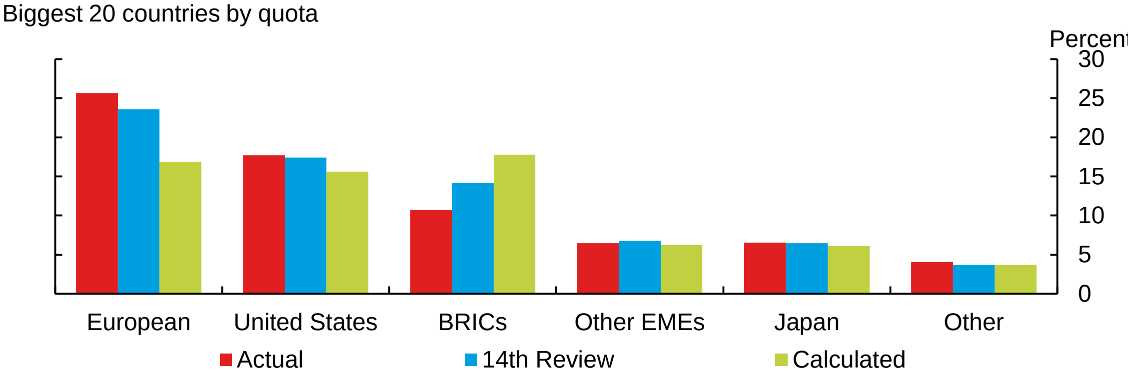
[28] The current quota formula is based on a weighted average of four variables: GDP, current payments and receipts; the variability of current receipts and net capital flows; and official foreign exchange reserves.
[29] The first round in 2006 (increasing quotas by 1.8 percent, SDR3.8 billion) lifted the quota shares of four countries (China, Korea, Mexico, and Turkey), while the 2008 round (increasing quotas by 9.7 percent, SDR20.5 billion), which also included a change in the quota formula, benefited 135 under-represented countries. See IMF, "The IMF's 2008 Quota and Voice Reforms Take Effect," 3 March 2011. Available at http://www.imf.org/external/np/sec/pr/2011/pr1161.htm.

Despite the reform having been accepted in most other countries, the United States was unable to get the quota reform passed through Congress for six years. Its ratification in December 2015, as part of an omnibus budget law aimed at avoiding a government shutdown, is a crucial step towards re-enfranchising EMDCs and, for the first time in years, opens up the possibility of a real discussion of much needed reforms beyond quotas. Still, more progress on quotas is required. New data are becoming available, which means that the quota formula will deliver a further shift of quotas in favour of EMEs. Some agreed means of automatically approving mechanical quota increases by all countries would be a firm step forward.

Chart 6: IMF quota shares
Biggest 20 countries by quota



Source: International Monetary Fund

Last observation: 2012

The package of reforms being considered along with the 14th quota review also included a rebalancing of the seats on the IMF's Executive Board to reflect the change in quotas. Two seats are to be transferred from advanced European countries to EMEs. In addition, all Executive Directors will be elected, enabling formerly appointed single seat members (the United States, Japan, Germany, France and the United Kingdom) to form their own constituencies with other members.

EMEs will feel disenfranchised until they are appropriately represented at the IMF. Indeed, the 2010 refroms are already a compromise, and there may be a need to go further. Should these countries decide to concentrate their efforts in parallel institutions, it could be difficult for the Fund to recover its role as a global institution. It is the task of the IMF to ensure fair country representation and a governance structure that is not out of kilter with any group.

4. Challenges Ahead

After reviewing the main changes at the IMF in light of the major trends in the global economy, it is apparent that key issues still remain. These can be distilled into essentially three challenges for the IMF: improving the traction of its advice (including addressing even-handedness); enhancing legitimacy and engagement through reform of membership representation; and overcoming the constraints of its balance sheet. These remaining challenges each call for their own solutions, but effective solutions will be mutually reinforcing.

4.1 Strengthening analytical independence for greater traction

Concerns over unequal treatment have not been laid to rest by recent far-reaching reforms to surveillance and lending discussed in Section 3. Indeed, developing countries have been disillusioned by the apparent susceptibility of the IMF's advice and programs to political pressure. There are, in fact, several cases in which IMF lending and surveillance decisions appear to reflect political pressures from dominant shareholders.[30] These episodes feed EMDC perceptions of a lack of even-handedness, which breeds an atmosphere of mistrust and undermines confidence in the advice of the IMF Board, management and staff.

The Fund, being a creation of sovereign governments, is naturally subject to political forces. That the IMF should respond to and be held accountable to its membership through formal governance channels is both desirable and democratic. However, if the IMF is to fulfill its mandate of promoting a stable and functional international monetary system, its economic analysis and advice should be insulated from political pressures, remaining frank, competent and unbiased. Leading members have to buy into the benefits of an independent view, which may sometimes differ from their

[30] For instance, the Fund's influence on Russia in its 1998 program was weakened by the political interests of some advanced countries. Many Fund staff would have preferred to insist on more ambitious policies before agreeing to lend (Odling-Smee, 2004). In its review of the capital account crises in Indonesia, Korea and Brazil, the Fund's Independent Evaluation Office (IEO) found that Fund staff was "unnecessarily subjected to micromanagement and political pressure, contributing to a blurring of technical and political judgments" (IEO, 2003). More recently, the IEO found that some Fund staff and management considered that "the views of influential shareholders regarding the IMF's inability to influence China's exchange rate policy in the last decade were an important factor explaining why concerns about the stability of the international monetary system were expressed in terms of excessive reserve accumulation," (IEO, 2012).

own. This can be a challenge for some advanced economies as well as some emerging-market countries. Reforms to bolster the Fund's "operational" or "analytical" independence—meaning measures to ensure that its surveillance, loans and conditionality are based on objective analysis and are not unduly influenced by the interests of one or several members—are critical to preserving the Fund's credibility and traction on national policies in AEs and EMEs alike.

We suggest two ways to bolster the Fund's analytical independence: (i) governance reforms to solidify the independence of the Fund's surveillance and lending; and (ii) increasing the transparency of the Executive Board.

(i) Governance reforms

The IMF's current governance structure for internal decision making does not support the management/staff's analytical independence. Indeed, the Executive Board, dominated by large members, discusses and approves all IMF decisions. As it stands, the Board's daily involvement in the Fund's operations blurs the responsibilities of the staff and the Board and produces ambiguous lines of accountability (Santor, 2006). It is currently difficult to hold the Managing Director (MD) or staff accountable for their decisions because MD/staff decisions are not always readily differentiable from those of the Board.[31] Nor can the Board assess the behaviour of the MD/staff without also evaluating itself.[32] It seems clear that if the institution is to be seen as an objective, high-quality source of policy advice, it will need to be accorded a sufficient degree of independence from the Executive Board.More than a political commitment will be required—analytical independence needs to be supported by improvements to the institution's accountability framework aimed at protecting the staff's capacity to carry out its regular surveillance and lending in an objective manner. Greater accountability lies at the heart of the recommendations of numerous independent evaluations, such as the IEO (2008) and Manuel (2009). In general, they recommend clarifying the roles and responsibilities of

[31] The push to publish staff reports goes some way to help distinguish the staff view.
[32] This current governance set-up has additional drawbacks. Because the Board is always "in the weeds" of daily decision making, it does not have the time or the capacity to focus on setting the strategic direction of the Fund. This has led to concerns regarding the Fund's lack of vision in the face of a rapidly evolving global economy.

management and the Board to develop an accountability framework in which the Fund, rather than being controlled by the Board, is now held responsible to it for the implementation of its mandate. Such a system will require a shift of the Board away from daily involvement in the staff's surveillance and lending towards a more supervisory role.

These changes are critical to enhancing the operational independence of IMF staff and management. They would enable the staff to conduct its analysis in a neutral manner, and the MD to make lending calls in accordance with the IMF's mandate. This does not mean that the MD/staff would be given a free rein. Indeed, a more independent IMF would need to report regularly to the Board, which would be in charge of assessing the staff's performance from an arm's-length position.[33] Importantly, this formal accountability to the Board could be used as a counterweight to help the MD resist direct pressure from particular members.[34]

(ii) Increasing the transparency of the Executive Board

In recent years, the Fund has become a much more transparent institution. Ninety percent of Fund members publish their Article IV consultation staff reports, including one hundred percent of those members whose Article IVs were combined with an assessment of a Fund-supported program. Members' requests for the use of Fund resources are routinely published, and the Fund's Independent Evaluation Office's reports are available to the public. However, the operations of the Fund's Executive Board remain largely private. Since the Board is the vehicle through which national governments oversee the Fund's work, publishing Executive Directors' written and oral statements would make latent political pressures more evident. By making their views public, Executive Directors, and their national governments, would be held accountable. Public debate on controversial policy advice could feed back to national policy-makers and ultimately lead

[33] An analogy can be made with national central banks, which are ultimately accountable to legislatures for meeting their economic objectives (which are set by the government), but maintain the freedom to implement monetary policy to achieve their goals.

[34] In this framework, the MD would need to assume a more assertive position, one akin to central bankers explaining how they have carried out their mandate to Parliament or Congress. This will be a departure from the current consensus-based decision-making process, but the proposed corporate governance framework would provide some support to an MD trying to defend the staff's objective analysis and policy decisions.

to better Executive Board decisions. Thus, greater transparency could promote decisions that are consistent with the Fund's best long-term interests. One legitimate concern with this proposal is that greater transparency could lead to decreased candour in the country statements. Another is that the process might become even more political, since Executive Directors would have to tailor their messages to their domestic consituencies.

4.2 The need for fair and effective representation

The IMF's relevance and legitimacy require not only trust in the independence of the institution, but also fair representation in its decision-making bodies. It is hard to expect rapidly growing EMEs to be full participants in the Fund if they cannot get fair representation, and failure to address this is likely to encourage the further development of regional financing arrangements in competition with the IMF. Consequently, the IMF's legitimacy depends on a rational governance structure. Several important reforms should be considered by members.

Quota reform. Representation needs to be consistent with an economy's stake in the stability of the global economic and financial system and with the relevant policy authorities. To ensure that the shares in IMF quota reflect global economic importance, now that the 14th Review has been completed, it is critical that negotiations for the 15th round be initiated as soon as possible. Moreover, there should be a commitment to complete quota reviews on an ongoing basis so that the gap between economic importance and quota share never becomes too big. Along with quotas, seats on the IMF Executive Board need to be adjusted accordingly.

Enhancing ministerial-level involvement. To increase the legitimacy of the IMF, as well as to bolster country ownership, members may want to consider raising the degree of ministerial-level involvement in the institution. The most obvious way of doing so would be to give the International Monetary and Financial Committee (IMFC) formal decision-making powers. According ministers and governors a formal decision-making role at the Fund via the IMFC would increase the legitimacy of the institution by directly involving national policy-makers in setting the strategic policies and priorities of the institution. The profile and the influence of the institution would be enhanced, as would the opportunities for candid policy-maker discussions. EMDCs would also be better represented than in the G20, thanks to the IMFC's constituency system. Founded in an international treaty, the IMFC would also be more permanent than the G20 and could serve as a regular meeting place for policy-makers that need not be dependent on an imminent need for policy coordination.

Members would need to decide on the scope of the IMFC's powers, which could range from being executive in nature to taking on a supervisory role. A more executive role would enable the IMFC to set policy for the IMF, and powers would need to be taken from the Executive Board—the creation of a Council of Ministers would be a possibility.[35] A more supervisory role could involve monitoring and evaluating the performance of the Board more proactively in the enhanced accountability framework outlined above.

Representation needs to be aligned with policy competency. Proper governance of the IMF requires that the pertinent authorities are officially party to relevant discussions and decisions, commensurate with their competence. For economic and monetary unions such as the euro area, this implies some modification to IMF governance.[36] Following logic and abstracting from the obstacles (legal and otherwise) that may stand in the way, a number of options are conceivable. For example, membership of the IMF could be based on policy authority, rather than on country, to reflect the realities of governance of and within economic and monetary unions. Alternatively, the IMF could develop a new type of formal relationship specifically with monetary unions—their policy authorities and members—leaving the country-based approach of the remaining IMF membership intact.

A more systemic approach to the euro area. Reflecting the above approach, the IMF could take a more systemic approach to the euro area as a whole. The Fund's mandate to

[35] The activation of a Council would have effects that extend beyond accountability. By enabling stronger and more direct ministerial involvement, a Council of Ministers and Governors would promote coordination and strategic decision-making critical to global stability. It would also increase the legitimacy of the institution. For further discussion, see IEO (2008).

[36] It is out of touch with reality to hold the members of an economic and monetary union responsible for policy powers that they have placed beyond their influence.

oversee the stability of the international monetary system is the proper context for examining euro-area policies. Historically, the IMF's country-based membership model has led the Fund to pursue a strong country focus and, only through that, a concern for the stability of the euro area. Yet this approach produced clear gaps in euro-area surveillance. A more thorough analysis of the euro area requires a greater top-down focus and putting in perspective the narrower policy competency of national authorities. Thus, the Fund should strengthen its focus on the entire monetary union, and assessments of individual members would examine how they fare in the union and affect the stability within and of the union as whole. That being said, the IMF should not lose sight of the country dimension, as this remains a critical source of information. A natural consequence of this shift of emphasis would be to produce a single Article IV-type report for the euro area as a whole.[37] To be clear, there is currently no "euro-area Article IV report." The euro area is not an IMF member and, hence, is not subject to Article IV. At present, although a report on the euro area *is* produced, its focus is on area-wide policies because its purpose is to better inform Article IV consultations with euro-area members. This is also why the report is officially called "Euro Area Policies," not a euro-area Article IV report. By contrast, a comprehensive perspective on the euro area would naturally highlight inter-linkages and spillovers, more clearly address the different layers of policy competency, and better promote the stability of the euro area. It would promote the flow of information both ways, enabling country-based analysis to feed into an assessment of the entire euro area.

This focus on the euro area as a whole would presumably also lead to greater convergence in setting conditionality for euro-area members when designing programs, in conjunction with euro-area authorities. With this approach, the interests of the union and the Fund would be more closely aligned and more consistent with the IMF's mandate to oversee the stability of the global monetary system. It would be clear that the package of official finance, country adjustment, and private sector involvement necessary for restoring a crisis country to a sustainable debt position should not destabilize other parts of the union or the union as a whole. Moreover, explaining this to stakeholders and the

[37] This idea was also floated by J. Pisani-Ferry et al. (2011).

public would help promote understanding of the genuinely different needs of countries belonging to an economic and monetary union of advanced countries.

Management and staff should be selected on merit and be representative of the nations the IMF serves, and they must be so perceived. Although the selection procedure for the MD has been competitive for the last two appointments, it is not widely perceived as such. The long-standing tradition of appointing a European Managing Director appears unbroken to outsiders as long as a European heads the institution. The selection procedure for the MD and, above all, its transparency need to change to dispel the entrenched perception of reservation for a European. In turn, the seats of the Deputy Managing Directors, which are also currently reserved for specific countries or regions, should be subject to transparent and competitive processes.[38] Likewise, management and staff—while of the highest calibre obtainable—should reflect the diversity among members.

4.3 IMF balance-sheet constraints: the need to improve lending efficiency

Large capital flows, heightened vulnerability to shocks, and large precautionary facilities potentially imply bigger IMF packages. Since its resources are finite, it is imperative that the Fund improve the efficiency of its lending. This means ensuring a good balance among official financing, adjustment and private sector involvement. Three areas for improvement suggest themselves.

First, the IMF must strengthen its catalytic role. The Fund needs to combine limited financial support with high-quality advice and conditionality so as to attract official co-lending as necessary and encourage the private sector to maintain its exposures. This could be done, for example, by clarifying lending guidelines and revisiting exceptional access rules.

To the extent that moral hazard is considered a key factor behind large lending demands, one possibility would be to impose a hard cap on IMF lending, including precautionary credit lines, in terms of maximum amount of quota.[39] By making this upper

[38] The same should apply at all Bretton Woods institutions and multilateral development banks.
[39] Indeed, it can be argued whether quota is still a relevant basis for lending access.

limit clear to all, the cap might limit moral hazard behaviour by debtors and creditors, thereby helping to avoid the situations of overinvestment and overindebtedness that are at the root of many crises. Indeed, by clearly stating the limits to its lending, the IMF would underscore how it has neither the intention nor the resources to be a global lender of last resort. Moreover, a hard cap would clarify, ex ante, the situations in which a debt restructuring is necessary. By limiting the scope for political pressure and eliminating the possibility for “gaming” the IMF for ever-larger bailouts, a lending limit would align the incentives of creditors and debtors towards a timely resolution. Arguments against a hard cap are that it may be insufficiently reassuring to markets, and that unforeseen developments may make a breach of the ceiling unavoidable, thereby undermining its credibility. The challenge would be to set the cap sufficiently high to reasonably meet most liquidity-driven demands for loans but to restrict lending in the most egregious cases, when countries are possibly insolvent. One option might be a limit of 1,000 percent of quota, as in the current PLL. Even if there is a need to exceed the cap in highly exceptional and rare circumstances, this may arguably be less problematic in terms of debtor and creditor moral hazard than the current situation in which there are no credible limits to IMF bail-outs.

The catalytic role could also be enhanced by refining approaches to deal with sovereign debt. Recent proposals for debt reprofiling go in this direction. Changes to sovereign debt contracts offer another avenue, for example, sovereign debt contracts that include clauses automatically extending the debt’s maturity once the country receives official assistance. Proposals for sovereign contingent convertible debt—CoCos—suggest that these instruments could have a number of benefits.[40] They would reduce the size of official sector assistance, as amortization payments would not need to be covered. They would also ensure that the private sector participates equitably in writedowns. Finally, they would enhance market discipline by eliminating the presumption of a bailout by the official sector.

Improving the Fund’s advice on structural policies could also serve to enhance the IMF’s catalytic role. Indeed, this issue has arisen at the current juncture, when global

[40] See Brooke, Mendes, Pienkowski and Santor (2013).

growth remains below potential, and particularly concerns advanced economies. Given that the scope for further macroeconomic stimulus remains extremely limited, for IMF advice to remain relevant, it must wade deeper into structural policy matters. This is not easy. Structural policies are highly diverse and, by their nature, structural reforms have specific rather than blanket effects. The IMF seeks to focus on macro-critical structural issues only, yet the threshold is blurred. The criticism directed at the Fund for its approach to dealing with structural reform in the 1990s underscores the need to engage closely with those institutions whose focus is mainly structural. This is a pertinent current challenge in promoting the traction of its advice.

Second, changes to the precautionary instruments (FCLs and PLLs) are necessary in view of their impact on the IMF's forward commitment capacity. Useful areas on which to focus efforts would be size and exit. The size of access should be based on a more transparent assessment of potential needs, taking into account other sources of liquidity, such as own reserves and access to swap lines and RFAs. Additionally, exits should be built in. For example, there could be a gradual reduction in access over the second half of the access period, possibly combined with rising commitment fees, in order to wean the recipient and market expectations off the arrangement, rather than testing both with a "cliff." Renewals would not be ruled out, but would be subject to a transparent assessment of initial versus current risks facing a country and the appropriate amount of precautionary financing required.

Third, the IMF could clarify its approach to joint programs. This conclusion was also reached by the IEO (2014). Because the IMF will likely continue to engage with bilateral creditors or RFAs in the future, it would be helpful to spell out, in advance, the role that the IMF would be willing to play. It should be clear about any limits to its lending and the procedure to follow in the event of disagreements on program content. These terms should be clear to all parties beforehand, perhaps even via a formal agreement with joint lenders on handling program design conflicts in co-lending programs.[41] This would help preserve IMF credibility and independence in programs

[41] A template for such an agreement could be the current Concordat between the IMF and the World Bank. This specifies each institution's area of responsibility and, in the event of disagreement on conditionality in

where it contributes the smaller amount. For such independence to be meaningful in a euro-area program, it would be vital that the Fund fully appreciates the dynamics of the union's policy-making process, respects the mandates of the various actors, and is mindful of the systemic consequences of program design and lending decisions. This implies that the IMF would need to formalize and internalize its understanding of the euro area (see above). This is not, however, to underestimate the drawbacks of such an approach. Clearly, there are issues with drawing up such an agreement, given the special circumstances of each case, the degree of financial involvement of the IMF relative to other lenders, and the difficulty in seeking to provide in advance for particular challenges that may arise. It would also have to be decided on what basis agreements were drawn up, e.g., with each RFA, for different types of programs, or with all partners per program. One of the strengths of the Troika has been that it has fostered an exchange of views based on differing expertise—benefiting from the principle that three heads are better than one. The key is to find the right balance of transparency and predictability to satisfy decision-makers in the IMF, while ensuring that the proposed program is the best for the country concerned and also taking into account spillovers to others.

5. Conclusion

Global financial integration, the rise of EMDCs and the emergence of the euro area have posed major challenges for the IMF. The Fund has responded by revamping its surveillance, adjusting its lending policies, augmenting its available resources, and (with some delay) working towards the correction of EMDC under-representation. However, the reform process is incomplete, and the remaining steps are quite steep. They require members' political engagement and will affect the fundamental role of the institution. Broad-consensus reforms, such as revisiting surveillance or adjusting the types of lending instruments, have already been implemented. If the IMF is to truly transform itself to meet the needs of the global economy, it must reach higher and aspire to fundamental lending and governance reforms.

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a particular area, the view of the institution with primary responsibility for that area prevails. For instance, in the case of short-term balance of payment issues, the IMF would have final say on program measures.

The reforms discussed in this paper aim to address the challenges that the Fund still faces with respect to its credibility, resources and legitimacy. These fundamental reforms are intended to bolster the IMF's analytical independence and its lending efficiency, and encourage fair and effective member representation. Our proposals are mutually reinforcing, creating a coherent framework that will better enable the IMF to fulfill its mandate of preserving the stability and efficiency of the international financial system.

An important aim of these proposals is to increase the Fund's analytical independence and more clearly separate the analysis from the decision-making process, thereby reinforcing its objectivity and credibility. Fundamental changes to the Fund's accountability and decision-making structures are needed so that the Fund can acquire the objectivity needed to regain the trust of both the EMDCs and AEs, and encourage them to engage with the IMF's advice constructively. Such reforms are essential if the Fund is to augment its traction over member policies in a world where its resources are limited but systemic vulnerabilities have increased dramatically.

A core component of increased credibility is a firm understanding of members' economic and policy-making environments. Notably, if the Fund is to gain traction and credibility with euro-area members, it must ensure that its surveillance and program design are properly geared to monetary unions. It needs to consider the region as a whole, using bilateral surveillance to feed into and enhance euro-area surveillance, rather than euro-area policy surveillance enhancing country analysis, as is presently the case.

The proposals are also aimed at ensuring that the Fund gets more out of its scarce resources in a world where the demand for its loans could become very acute in the event of a systemic crisis. Firmer ex ante caps on lending are one option to curb creditor and debtor moral hazard behaviour, minimize the scope for judgment and political pressure, as well as help coordinate creditor and debtor actions in the event of a debt restructuring. Clarifying the IMF's role in joint lending programs will help the Fund preserve its integrity in the face of large shareholders or in programs in which it is a minor creditor.

Finally, the proposals aim to boost the IMF's legitimacy through accelerated quota reform and a better alignment of country responsibilities with IMF representation. Both the IMF and the euro area, in particular, could benefit from a better alignment of policy competence with voice at the Fund. Also, only through fair EMDC representation and deliberate efforts to counter the perception of a lack of even-handedness can the Fund effectively fulfill its global role.

The proposals offered in this paper will not be easy to implement, in part, because there is unlikely to be consensus on their desirablility. Yet they do present a coherent framework for creating a stronger, more effective Fund. Bold changes and strong member commitments are needed to keep the IMF, and with it, broad multilateralism, at the centre of the global economic and financial system—enhanced rather than emasculated by the rise of alternative arrangements.

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