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Reform of the Global Financial System and the Role of the IMF

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Reform of the Global Financial System and the Role of the International Monetary Fund

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This paper will focus primarily on the role of the International Monetary Fund, both in the current crisis and, subsequently, under reforms that must be made to the international financial system and within the IMF to better protect the global economy from this kind of crisis. Important lessons have already been learned from the events of the past year which have helped frame the discussions that took place among the G20 leaders at their meeting in Washington this past weekend. Those lessons point to serious weaknesses in the current financial architecture that need to be corrected and suggest some general principles which should help guide reform of the system. Those lessons and their implications are outlined briefly in the following section. The paper then concentrates on the reforms needed at the IMF within the context of broader changes to the global financial architecture.

I. Early Lessons from the Current Crisis and their Implications

Lessons from the Current Financial Turmoil:

- Globalization and the explosion in the size of international financial markets and private capital flows has dramatically increased the mutual dependence of economies around the world
- Large financial institutions are increasingly global in their operations and link together the fortunes of financial markets worldwide
- Financial instruments created in one country, subject to the supervisory and regulatory regime of that country, are bought and sold by institutions and individuals throughout the world
- Capital markets and capital flows now well exceed "conventional" commercial banking operations in their size and profitability as well as in their influence on the performance of overall financial markets
- Financial crises emerge with great regularity, but their origin and nature have been impossible to predict; increasingly such crises develop suddenly and quickly spill over beyond national boundaries, posing threats to the global system itself; their resolution now exceeds the capacity and resources of individual countries and institutions.

[1]This paper was prepared by Jack Boorman (Advisor to the Emerging Markets Forum, Washington, D.C. and Former Counselor and Director of the Policy Development and Review Department and Former Special Advisor to the Managing Director, International Monetary Fund) with inputs from Prabhakar Narvekar, Tomas Balino, Anupam Basu, Harinder Kohli, Claudio Loser and V. Sundararajan.

Key Weaknesses in the Current Financial Architecture:

- Both in its design and in its current capacities to deal with crises, the institutional architecture of the global financial system, as well as its governance structure, does not reflect the massive changes that have taken place in global financial markets and in the position of the most rapidly growing economies in that system
- The current system primarily relies on regulation and supervision at the national level, while many major financial institutions and the instruments created by those institutions are global in their reach and influence
- At the country level, there are important differences in the philosophy and approach to regulation and supervision; some of the most profitable and dynamic parts of the system remain virtually unregulated (hedge funds, private equity, derivatives, etc.)
- In some critical areas, including the analysis and oversight of capital markets and capital flows, no international body currently has a clear mandate
- There are serious gaps in the codes and standards that guide transparency in both national financial systems and in the global system
- Although a number of institutions and forums play a role, there is no effective "early warning system" regarding some of the risks that can develop at the global level
- There is an asymmetry in the willingness of some institutions, including the IMF, to comment candidly on the policy weaknesses and risks being taken by the largest countries and by those in the rest of the membership.

Principles for Reform

- The *current gaps,* disparities and fragmentation in the setting and monitoring of standards, and in the regulation and supervision of different parts of the financial system, *should be eliminated*
- Future responsibilities should be based on a *three-tier system: national, regional and global institutions*
- The setting of *standards and information reporting* should be coordinated and monitored at the global level
- While there is a need for some *regulations at the global level* applicable to institutions and financial instruments with global reach, these regulations should be the minimum possible and designed to facilitate (and not hinder) globalization. The *primary responsibility for regulation and supervision* should rest at the national level;
- An *"early warning system"* must be developed; it should consist of a three tier system, at the national, regional and global levels
- Periodic *discussions on the stability and vulnerabilities of national and regional financial systems and peer review of financial systems, and the sharing of experience* should rest at the *regional level,* perhaps through the creation of Regional Stability Forums
- *During financial crises,* the primary responsibility for the requisite *analysis and coordination of financial assistance would rest with the apex global institution,* the

IMF; in particularly acute cases, governments and central banks of large healthy economies could be called upon to contribute

- To ensure its legitimacy and credibility, the new global financial architecture, including the *governance of multilateral institutions,* should reflect the current economic realities and provide for a *larger role for the major emerging market economies*

- *Role of the IMF needs to be clarified and enhanced* to allow it to become more effective in providing more timely information on the health of and issues related to global financial markets and in coordinating global actions to forestall and manage future crises

- *The IMF must have the tools and authority to address weaknesses in the economic and financial policies of all its members, including those with the largest economies and the most important financial systems in the world, and must be proactive and independent in using that authority.*

II. The Role of the IMF

Introduction

The ongoing financial crisis has demonstrated serious weaknesses in the global financial system as well as in the national regulatory regimes that underlay that system. There exists a broad consensus on the need for macroeconomic stability as a prerequisite for growth and development. However, macroeconomic stability cannot be assured without stability in the financial system – both at the national level and, increasingly, at the global level. If this crisis has shown anything, it is that all markets and institutions are tightly connected and interdependent. Thus, the performance of any one economy is dependent on the actions taken by financial systems across the globe, and on the quality of regulation and supervision over those systems.

However, the architecture of the global financial system has proven itself inadequate to the needs of such a tightly integrated world. In the run-up to the current crisis, neither were the institutions within the system fully capable of identifying the risks that were building, nor did they prevent behavior on the part of some players in the system that put it at risk. Even the modifications to the system made in the wake of the crises of the 1990's and the early years of this decade have been found wanting. These included the push to establish and propagate standards and codes, the formation of the Financial Stability Forum, the calls for the IMF to better integrate financial risk analysis into its traditional macroeconomic surveillance, the expansion of the activities of the BIS, including the Basle Committees, and the like. Other initiatives, such as the attempt to give the IMF jurisdiction over capital account restrictions or to substantially modify its governance structure, were stillborn.

The efforts of individual countries, including many emerging market and developing countries, to protect themselves from instability elsewhere in the world, through improvements in their own policy making and through a (costly) build up of reserves, have failed to contain the contagion emanating from the United States and other developed economies. And the institution charged with being prepared to assist countries threatened by either contagion or their own policy failures – the IMF – has had to scramble to catch up with the needs of its members. [2] While the responses of many countries have been appropriate, the fact that those responses have been mostly ad hoc and less than adequately coordinated points to serious problems in the overall architecture of the system.

A major review of the architecture of the global financial system is urgently needed, and the G20 Summit held in Washington on November 15 has initiated such a review.

Modifications to the architecture will have to encompass changes to the governance, powers, and operations of numerous institutions at the global level and the design of mechanisms to assure better collaboration and integration in their work. Similarly, national institutions – particularly the financial supervisory and regulatory agencies – will need to be carefully scrutinized to correct the evident weaknesses that were

[2] The IMF has been distracted in its work over the past year by the substantial downsizing of its staff – an exercise that was conducted before the international community had come to agreement on the role to be played by the Fund in the new global financial system. In all likelihood, that downsizing will have to be reversed if the institution is to have the number of staff and the array of talents that will be needed to play its appropriate role.

permitted to infect the global system with the problems that created the current crisis.

The IMF will need to be given special attention in restructuring the global financial system. Recent efforts to update its governance structure have failed to fully recognize the realities of the global economic and financial system. Some of the weaknesses and missing elements in the global system will need to be corrected by increasing the Fund's financial capacity, its oversight responsibilities, and the nature of its interactions with other institutions and agencies – at the global, regional and national levels. Some of the changes should be made quickly to help deal with the current crisis; some will need to be aimed at strengthening the global system over time. Change is needed in many areas, but priority should be given to the following initiatives that require action by the Fund and/ or a reassessment of its mandate:

- Consideration should be given to an immediate, and large, allocation of SDRs.
- The financial resources available to the Fund should be increased on an emergency basis through borrowing, and its permanent financing through quotas should be dealt with more fundamentally as the crisis subsides.
- Important aspects of the Fund's governance need to be revisited. These include issues regarding the voice and vote of members, the size and structure of the executive board, the process of selecting the managing director, and the transformation of the International Monetary and Financial Committee (IMFC) into a Council, as anticipated in the Articles of Agreement. Management independence needs to be increased so as assure that the Fund can "speak truth to power" when assessing the policies of its largest members.
- The Fund's responsibilities regarding the policies adopted by member countries to foster capital account liberalization and to oversee their domestic financial systems need to be clarified and, expanded. In particular, the role the Fund is to play in overseeing the work of other institutions in the area of standard-setting and regulating and supervising financial markets and institutions needs to be agreed.

Each of these issues will be taken up in turn in what follows.

1) An SDR Allocation

An increasingly important feature of the current financial crisis is that it is worldwide in its scope and impact. It has disrupted normal capital flows and trade credits to countries heavily dependent on international capital markets and has triggered a worldwide recession which could be deep and long. Even countries with good policy track records – both emerging and developing economies – are being sucked into the web of this crisis. With a global contraction of liquidity and recessionary trends increasingly evident, there is an obvious need to provide immediate support to the affected countries.

Support is coming from a number of sources. However, the IMF – the one institution purposefully constructed to be the primary source of such support – has been halting in its efforts until the past few weeks. The heightened activity of the Fund is to be welcomed and the conditional resources of the Fund, as well as the resources that can be provided under its new credit line facility for countries with historically strong polices, will help. However, since a large number of countries do not have sufficient reserves, and cannot borrow them to meet their liquidity needs, a strong case can be made for a general allocation of SDRs:

- An SDR allocation can be decided quickly;
- The additional reserves provided to countries could help bolster market confidence and limit the disruption caused by the freezing up of the global financial markets;
- Additional reserves could help reduce the need for some countries – those with better policies and a less vulnerable position – to undertake a sharp adjustment to their domestic economies and to their external accounts at a time when the global economy is weakening;
- Additional reserves would also help limit the impact of the sharp decline in commodity prices on a large number of both emerging and developing economies; and
- An SDR allocation would help reduce the potential demands on the Fund's limited general resources (i.e., the resources available from countries quota subscriptions in the Fund).

Until a major realignment of quotas in the Fund is agreed (see below), only a very large SDR allocation would provide the needed volume of reserves to many of those countries most in need. However, an allocation of that size would most likely be unacceptable to some of the largest members of the Fund. Thus, a smaller allocation of SDRs, combined with a mechanism to transfer those SDRs on a voluntary basis from the major industrial countries - and from a few of those countries currently holding the largest stocks of reserves - should be urgently considered. Besides early action on a new decision to allocate additional SDRs, the United States should take urgent action to approve the pending Fourth Amendment to the Articles of Agreement to double currently outstanding SDRs to SDR 42.8 billion. This amendment has already been agreed to by a large majority of the member countries and agreement by the United States would bring it into effect.

2) The Fund's Financial Resources

The resources currently available to the Fund are clearly insufficient to deal with the problems emerging in the countries that may seek access to those resources in dealing with the current crisis. That crisis shows, once again, that the Fund will remain a lending institution for the foreseeable future and a substantial increase in quotas is needed to put the Fund in a position to respond appropriately when called upon.

Consider the current situation. The new facility just created by the Fund permits a member country with a track record of good policies to draw up to 500 percent of quota for up to nine months. To illustrate the issue:

(i) the quota resources currently available to the Fund (the forward commitment capacity) total just over $200 billion; an additional $50 billion is available through borrowing arrangements under the GAB/NAB;

(ii) the aggregate quotas of 44 emerging market countries that are members of the

Fund total over $91 billion; 500 percent of quota for these countries totals over $450 billion.

Thus, the resources available to the Fund fall far short of potential drawings by these countries under just this single facility. Moreover, this makes no allowance for drawings under the Fund's other facilities by these members or by other countries, including more developed economies that may be affected by the crisis.

Even if these resources were sufficient to finance all drawings permitted under the new facility as currently structured, those amounts are unlikely to meet the needs of these countries for support from the Fund during this crisis. Brazil, for example, can draw only about $22 billion under the new facility, far short of the needs it could face if the crisis continues and only a minor contribution to its reserve holdings of about $200 billion – severely limiting the confidence-building impact of such a drawing on the financial markets. By comparison, the US Federal Reserve has already entered into a swap arrangement with Brazil (as well as with South Korea, Mexico and Singapore) for $30 billion, almost 700 percent of Brazil's quota in the Fund. The lending by the Federal Reserve under these swaps to just these four countries amounts to almost one half of the total resources available to the Fund. It might be assumed that the Federal Reserve would provide additional resources to these four countries should they be requested, reducing the potential demand on the Fund. However, the aggregate quotas of the other 40 emerging market countries is such that potential drawings by those countries under the new facility would still far exceed the lending capacity of the Fund. Looking at this from a different perspective, the cross border claims of BIS banks on emerging market countries totals about $4.5 trillion. Even a limited deleveraging of these claims would create financing needs in the emerging market countries that dwarf the financing capacity of the Fund.

What steps should be taken? Quotas serve as the core source of resources to the Fund and its members. Quotas are also the fundamental determinant of the voice and vote of members in the Fund and, therefore, need urgent revision to correct the skewed power of members in the institution. However, reaching agreement on an increase in quotas takes a great deal of time and effort. It is not a solution to the Fund's current financing dilemma.

Therefore, in light of the immediate needs generated by the current crisis, urgent consideration should be given either (1) to permitting market borrowing by the Fund or (2) to establishing lines of credit for the Fund from the reserve-rich countries of the world.

However, borrowing from the markets is likely to be problematic in the current atmosphere:

- While permitted under the Articles, this is an untested and novel mechanism for the Fund, requiring a possible time-consuming elaboration of the institution's policy regarding such borrowings;

- It would also involve an approach to the markets at a particularly uncertain time, making it especially difficult to project the volume of borrowing that may be possible or to price that borrowing in advance with any confidence.

That leaves credit lines from member countries as the most desirable immediate approach in this crisis.

- The Fund has experience in these operations (e.g., the earlier borrowing from Saudi Arabia);
- Some countries have already indicated a willingness to consider such lending (e.g., Japan);
- Such lending protects the creditor country against loss and provides for condionality on the onlending of those resources to other Fund members; and
- This kind of operation could help foster a sense of solidarity among the membership at this moment of trial for the global economy.

While a quota increase will take time, a substantive review should begin immediately. The first act of that review should be to cancel the agreement on quotas and voting shares that was reached in April, 2008 and that is now out for ratification by the membership. That agreement fell far short of what was needed even then, before the current crisis – either in terms of the resources it would make available to the Fund or the changes it would bring about to the governance structure of the Fund:

- No global increase in quotas was recommended;
- The revised quota formula and the ad hoc changes to quotas – including the "compression factor", the "boosters" for selected countries, the "foregoing" of share increases by some of the largest countries – would result in only modest changes to shares and voting power.[3]

An ambitious effort is needed on both counts:

- There needs to be a large increase in quotas to make the Fund relevant in the modern global financial system. There has been no increase in quotas since 1998 (when they were increased by 45 percent) and they have only roughly doubled since the early 1980's. By all measures – whether relative to global trade or to capital flows – total Fund quotas have fallen woefully behind the changes in the international financial system. The proposition that the Fund did not need large resources because of the changes that had occurred in the availability of funds through the private markets has been shown by the current crisis to be seriously in error.
- In the same vein, the modifications to the Fund's governance structure brought about by the changes in quotas in the past 25 years, or by those implicit in the agreement reached in April 2008, have only served to further diminish the interest of many of the fastest growing economies of the world in the institution. The future of the Fund depends on realigning the power within the institution with the realities of the new order in the global economy. This process should begin with a commitment at the highest political level to fundamentally change the voice and vote of members in the Fund to accord with current economic and financial realities. An accelerated review process, with that commitment at its core, should begin immediately. Fortunately, in its communiqué from the meeting on November 15, the G20 "… underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy

[3] See Ralph C. Bryant, "Reform of IMF Quota Shares and Voting Shares: A Missed Opportunity", April 8, 2008 and "Reform of Quota and Voting Shares in The International Monetary Fund: "Nothing" is Temporarily Preferable to an Inadequate "Something", Brookings Institution, January 2008.

and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions." The needed change can be brought about only if a way is found to reduce substantially the current share of quotas of the European countries.[4]

3) Further Changes to Fund Governance

Beyond the governance changes that would be brought about through an increase and realignment of quotas, other changes are needed. These include changes to the size and structure of the executive board and consideration of the establishment of a Council. On the former, there are persuasive arguments for reducing the size of the board and powerful arguments to reduce the representation of European countries. Both of these issues should be part of the quota review. In making these changes, there should be a major effort to align the membership in the Fund executive board (and the IMFC and, prospectively, the Council) with the membership of the global agenda-setting bodies. This would require a simultaneous effort to replace the G7 with another, more representative body such as the G20, or some change in the composition of the current G20.[5]

On the latter issue of a Council, the following history is of relevance.[6]

- Article XII, Section 1, together with Schedule D of the amended Articles of Agreement, provide that the Fund shall have a Council if the Board of Governors so decide with an 85 percent majority. Councilors would be Governors or Ministers, or persons of comparable rank in the government.
- No council or any group of that nature was set up until 1974 when the Interim Committee was established. However, that committee, and its successor committee – the IMFC - was an advisory and not a decision-making body. While the work of these committees can be said to have enhanced policy formulation and decision making in the Executive Board of the Fund, they have not provided the kind of forceful leadership needed to deal with the issues of the day, such as the current crisis.
- An effort was made in the late 1990's to convert the Interim Committee into a decision making Council as foreseen in the Articles. One motivation for that proposal, as noted by Michel Camdessus, was "…to assure that the IMF is seen far more visibly to have legitimate political support of our shareholders."[7] However, the majority of Committee members were not convinced. In particular, many developing countries were averse, apparently fearing that ministers from industrial countries would not have the time or patience to build consensus among councilors in difficult cases and would rush to settle them by up or down votes.

[4] See "An Agenda for the Reform of the International Monetary Fund", Jack Boorman, The Emerging Markets Forum, November 8, 2007, p. 11.

[5] See in "Global Governance Reform" edited by Colin I. Bradford and Johannes F. Linn, Brookings Institution Press, Washington, D.C. the following articles: "IMF Reform: Congruence with Global Governance Reform" by Jack Boorman and "Summit Reform: Towards an L-20" by Linn and Bradford.

[6] See Leo Van Houtven: Governance of the IMF: Decision-making, Institutional Oversight, Transparency, and Accountability, Washington, D.C., International Monetary Fund, 2002 and Governance of the IMF, and Evaluation by the Fund's IEO, 2008.

[7] Said in a speech by Michel Camdessus in New York in February, 2000 to The Council on Foreign Relations

- In 1999, when the Interim Committee was transformed into the IMFC, it continued as an advisory body. In the same year, a new group was established outside the Fund: the Financial Stability Forum (FSF), with some functions overlapping those of the Fund. While cooperation between the FSF and the Fund has generally been good, the lack of clarity regarding the responsibilities between these bodies, and the very different nature of their operational mandates, appears to have contributed to the problems that arose in the lead up to the current crisis.

- In 2008, the Fund's Independent Evaluation Office (IEO), in its report on the Fund's governance, recommended that a Ministerial Council, as envisaged in the Articles of Agreement, be activated, making it a formal decision-making body with a legal status. As was argued by earlier proponents of the creation of a Council, it was suggested that the political visibility of such a body would enhance the legitimacy of actions taken by the Fund. When an institution is seen to be led by senior political authorities with decision making powers in countries around the world, its views and actions are likely to carry much greater weight. Some have also seen a Council as a stepping stone to better aligning the country composition of the decision-making bodies in the Fund with those of the evolving economic and financial agenda-setting bodies of the global community – such as the G20.[8]

The responsibilities of the proposed Council would include setting the strategic goals of the Fund; taking those decisions that require support at the highest political level, e.g., appointment of a managing director; and exercising effective supervision over the institution, including the executive board. As in the Council visualized in the Articles, councilors would be permitted to split the vote in their constituencies so that all countries would see themselves as participating in major decisions.

There remains a lack of support for the creation of a Council in a number of quarters and the perceived benefits of such a Council need to be better argued. For example:

- The possibility of splitting votes in multiple country constituencies may help win over some of the resistant developing and emerging market countries.

- A clear understanding should be established that the Council would operate as much as possible on the basis of consensus and that voting should take place only in extraordinary circumstances.

- In elaborating on the decisions to be taken by the Council, clear understandings regarding the continuing responsibilities and authority of the executive board would need to be sought.

Ultimately, a reform of the governance of the Fund – and of the global agenda-setting bodies - that gives greater voice to those now under-represented in the Fund relative to their place in the global economic and financial system may be needed to advance the idea of a Council. Thus, the proposals made above regarding quotas and representation should probably be taken up before considering the creation of the Council.

[8] Michel Camdessus: "The Council would be the ideal place to discuss the policies needed to address global systemic issues with a global membership, and thus to take the place also of the G10, G20, and other Gs", Per Jacobson Lecture, September, 2005

4) Capital Flows and Financial Markets: The Fund's Role

If it was not well understood how inter-connected the world's financial system has become, the current financial crisis has made that perfectly clear. It is now also all too evident that not only does capital flow across borders, but so does risk. And the extent of that risk is determined by the web of institutions that create the instruments that are bought and sold across borders. The regulatory and supervisory systems that oversee capital markets and those that oversee the financial institutions that comprise those markets are highly interdependent. As those markets and institutions operate across borders, the national agencies that form the supervisory and regulatory systems within countries have become increasingly interdependent. Thus, the regulation of capital flows and the regulation of the institutions that manage those flows are two sides of the same coin.

There are a number of international institutions and agencies that have some role in this system. These include the IMF, the BIS, the OECD, the FSF and, increasingly, the central banks of the larger countries and currency areas. While coordination among these agencies is reasonably well established, there are gaps in the responsibilities with which each is charged, and there is a lack of clarity regarding some of those responsibilities. Unlike as in the area of trade, where the WTO has clear oversight responsibility, and in the realm of current account restrictions, where the IMF has clear jurisdiction, international capital flows, and the coordination and monitoring of banking and other financial supervision across borders, lack both a comprehensive coordinating mechanism and an institution with clear oversight responsibility. The communiqué of the G20 recognizes that these gaps and uncertain mandates contributed to the current crisis. It is time to consider ways in which the global system needs to be reformed and what the role of the IMF should be in that system. It is useful to consider these two aspects of reform separately.

(i) The Fund's Role in Fostering an Orderly Liberalization of Member Countries' Capital Accounts

The global financial system has changed dramatically since the establishment of the IMF. At that time, most countries had extensive capital control systems and the attention of the founders was on promoting trade by opening the current accounts and dismantling the tangle of exchange restrictions that had been put in place during the great depression. That agenda was highly successful. Gradually over this period, more and more countries also liberalized their capital accounts, and the volume of capital flows exploded – far exceeding the value of trade-related flows. Moreover, most of the serious balance of payments crises that have struck countries in recent decades have had their origin in disruptions to capital flows.

While the IMF supported that opening of capital accounts, the OECD was more active than the Fund in championing that move, especially among the industrial countries that were members of that body. Much of the impetus for liberalization beyond the members of the OECD came from the countries themselves. While the Fund was supportive of moves toward liberalization and provided technical assistance to members that requested it, its role was limited. As the Independent Evaluation Office (IEO) of the Fund has said in its 2005 Report on the Evaluation of the IMF's Approach to Capital

Account liberalization: “During the 1990’s, the IMF clearly encouraged capital account liberalization, but the evaluation suggests that, in all the countries that liberalized the capital account, partially or almost fully, the process was for the most part driven by the country authorities’ own economic and political agendas. In none of the program cases examined did the IMF require capital account liberalization as formal conditionality. This is consistent with the interpretation of the Articles of Agreement, which states that the IMF, as a condition for the use of its resources, cannot require a member to remove controls on capital movements.”

An effort was made in the mid-1990’s to amend the Articles of Agreement to give the Fund jurisdiction over capital controls by member countries. The proposal was motivated by a perceived need to close the gap in the architecture of the international financial system and the Fund, with its universal membership, was seen as well placed to assist in the establishment of a multilateral and non-discriminatory system to promote an orderly liberalization of capital movements. However, that effort was distracted by the Asian crisis, in particular, but also by the opposition that arose to giving such power to the Fund. The concern among many seemed to be that the IMF – or some of the larger members of the Fund - would use its new authority to push a more ambitious agenda of liberalization on emerging market and developing countries. However, the intent was, instead, to help foster orderly liberalization and to insure that the experience of other countries and the expertise of the Fund would be available to members embarking on liberalization programs. Moreover, clear safeguard provisions were to be included in the amendment to give confidence to members that retained or modified restrictions. These safeguards were to be similar to those that had been successfully employed by the Fund when encouraging member countries to remove restrictions on current account transactions – a process that took several decades The safeguards would consist of transitional arrangements to ensure that liberalization would be not be premature, that there would be appropriately flexible approval polices for the maintenance of restrictions, and that financial support would be available to members undertaking liberalization programs. Notwithstanding the request of the Interim Committee to the executive board to continue discussions toward the formulation of an amendment, the initiative faltered during the course of 1998.

In addition to the intent to give the Fund jurisdiction over capital account restrictions and to close the gap in the international financial architecture, some believed that formalizing the Fund’s role in this area would encourage greater attention to these issues within the institution and in the global financial community more generally. It had become increasingly obvious that the traditional surveillance by the Fund over countries’ macroeconomic policies and prospects needed to be intimately wedded to surveillance over countries’ financial systems and the risks that could develop from integration into rapidly changing and potentially volatile international financial markets. A second leg of the efforts to encourage this work in the Fund involved the creation of new departments and the reorganization of others. While these administrative changes have produced some positive results in the quality and breadth of the Fund’s work in these areas, the Fund has not established itself as the central institution in the system. Thus, important gaps remain.

A renewed effort should be made to provide the Fund with a clear mandate in this area. It would need to be decided whether that effort should be focused, in the first instance, on an amendment to give the Fund jurisdiction over capital account restrictions or rather, that the Fund should be asked to review its role in this area, and make recommendations as to the authority and resources that it would need to conduct the enhanced surveillance and provide the technical assistance that is needed to effectively play this role. If the latter route was chosen, formal jurisdictional authority through an amendment to the Articles could be considered after more experience with this expanded mandate is gained.

(ii) The Fund's Role in Fostering Stability through Better Financial Regulation and Supervision

A case can be made that capital controls can serve as a temporary substitute for prudential supervision while capacity in that area is being built. This is correct, but it should not delay or forestall the work needed to build the institutions in each country that can provide effective supervision. Similarly, there is a need, on an ongoing basis, to monitor the policies and practices of supervisory agencies to assure that best practices guide those agencies. This is needed in all countries, whether in the most sophisticated economies that are home to the largest financial centers, or in countries just beginning the process of integration into the global financial markets. Unfortunately, a fully comprehensive and well coordinated system for such monitoring and assessment does not yet exist. Nor is it clear where responsibility for this task should reside. As noted, there are a host of agencies and institutions that play some role in this area, but no one institution has oversight authority, nor do the coordination mechanisms that have been developed for such oversight appear to be up to the task.

Here, too, there is a need for a far-reaching review of the weaknesses in this system and an assessment of the role that should be played by the IMF. That role should be complementary to its role – to be decided – in promoting orderly liberalization of capital controls. The reality is that there needs to be an integration of the capital account regime in countries with the domestic financial supervisory framework. And there needs to be, at the global level, an institution that can, at minimum, monitor the strength of those systems. That is a natural role for the IMF under its mandate to foster global economic and financial stability.

The Fund already plays an important role in assessing the quality of countries' financial systems. This includes, in the context of its bilateral and multilateral surveillance responsibilities, an assessment of the risks that countries, regions and the entire system may face from financial sector developments. The Fund's work in this area was greatly expanded by the role it was given in the context of discussions of the global financial architecture that followed the Mexican and Asian crises of the mid to late 1990's. Most important was the push to improve the various standards and codes that must guide the operations of both supervisory authorities and financial institutions and the establishment of the process of assessing the application of such standards through the Financial Sector Assessment Program (FSAP). In all of this work, the Fund has worked closely with the relevant standard setting bodies as well as with the World Bank and others in the establishment of appropriate standards and codes and in conducting of the FSAP exercises in individual countries. This was, and remains, an appropriate way to tap the expertise of the various standard-setting bodies. It was also aided by the establishment of the Financial Stability Forum (FSF) which, for the first time, provided a forum for regulators and supervisors to meet with those responsible for macroeconomic policy. While only a limited number of countries have been represented in the FSF, unlike the universal representation within the Fund, the G20 has called for "…a broader membership of emerging economies, and other major standard setting bodies". The G20 communiqué also calls upon "The IMF, in collaboration with the expanded FSF and other bodies, (to) work to better identify vulnerabilities, anticipate potential stresses, and act swiftly to play a key role in crisis response."

The Fund's role should be to provide incentives, both to individual countries as well as to regional and international groupings, for good and timely regulatory actions, and appropriate macro-prudential surveillance and stability assessments through a strengthened and more robust surveillance process. Such a process should include:

- Making the FSAP a compulsory component of IMF surveillance;
- A closer involvement of the Fund in the formulation of regulatory standards established by the relevant standard setting bodies;
- Coordination by the Fund of a system of regional financial stability forums, with the Fund becoming a global financial stability forum playing off its strength as a universal institution with a global focus;
- Consideration could also be given to the establishment of an independent peer review process to assess a country's compliance with relevant standards, informed, inter alia, by the FSAP process. The World Bank and other agencies as appropriate should continue to partner with the Fund in the conduct of FSAPs.

The Fund would seem the natural institution in which to lodge these coordinating and assessment responsibilities.

- It already is the premier agency for macroeconomic surveillance over both country and system wide policies and prospects.
- In cooperation with others, the Fund has developed the methodology and the staff to conduct financial sector assessments.
- The Fund has already been given the mandate to better marry its macro assessments with the financial sector risk assessments it already conducts.
- As a universal institution, it is in a position to help reduce the fragmentation of responsibility that has existed across a multitude of forums and agencies with more limited memberships.
- Nationally focused supervision and regulation has been shown to leave important gaps and inconsistencies; only an institution like the IMF could have the capacity to hold national regulatory authorities accountable for adherence to internationally accepted standards.

Reform is needed in all these areas, and the current crisis provides the appropriate incentive and backdrop to deal with that reform on an urgent basis. The G20 has taken up that challenge. However, major work lies ahead to give specificity to the broad set of reforms suggested by the G20. In formulating more specific proposals, much greater clarity will need to be given to the role of the International Monetary Fund as the institution at the apex of a reformed global financial system.

Emerging Markets Forum

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