Chapter – II

CHANGING ROLE OF THE IMF IN THE INTERNATIONAL MONETARY SYSTEM

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CHAPTER-II

2.1 Introduction

This chapter is about with the study of the international monetary system. Here an attempt is made to trace the evolution of the international monetary system. The changing role of the IMF is also explained during this evolution. The current structure of the international monetary system and the role of the IMF in the current structure are explained. An attempt has also been made to study the problems with the current monetary system. The reforms the IMF should go through to reach a more efficient monetary system have also been mentioned in this chapter. This chapter also deals with the surveillance aspect of the IMF in the international monetary system, its deficiencies and possible future reforms to reach better surveillance through IMF.

The methodology used in this chapter is both analytical and descriptive. The chapter tries to study different aspects of the international monetary system and different aspects of IMF operations in the international monetary system. The database in this chapter is secondary data through available working papers and reports from the IMF website and other available sources and journals.

This chapter is divided into 3 sections. Section 1 of this chapter deals with the definition of the international monetary system and the existing role of the IMF in the current monetary system. Section 2 deals explaining the changing role of the IMF in the international monetary system and the factors involved in the change. It also deals with the problems with the current running monetary system. Section 3 deals with the reforms the IMF should go through to benefit the international monetary system and stay legitimate in the eyes of all its member countries.
SECTION- I

2.2 The International Monetary System

The international monetary system is defined as a set of rules, policy instruments and conventions as well as the institutional, political and economic environment which delivers two fundamental global public goods, namely: an international currency and external stability. Rules, conventions and policy instruments, among other things, bring about the rules and conventions that govern the supply of international liquidity and the adjustment of external imbalances; regional, bilateral and global surveillance arrangements; exchange rate and capital flow regimes; and crisis prevention and resolution instruments. The environment of the international monetary system encompasses a free trade environment, with one or more countries with higher degree of economic dominance at the centre of the system. The countries with different degrees of economic development are interconnected. There is some combination of rules versus discretion and of supra-national institutions versus intergovernmental arrangements in the management of the system; and a given mix of cooperation and conflict in the broader political environment.

The first public goods in this system- an international currency or currencies- allows private and public sector agents of different countries with each other as a means of payment in an international economic and financial activity. External stability, the second global public good, refers to a global constellation of cross-country real and financial linkages (e.g. current account and asset/liability positions) which is sustainable, i.e. does not, and is not likely to, give rise to disruptive and painful adjustments such as disorderly exchange rate and asset price swings or contractions in real output and employment.

The four major elements in an international monetary regime are:

- The Exchange-rate regimes;
- The system of capital flows and currency convertibility;
- Institutions to provide liquidity in case of emergency;
- Monetary surveillance and cooperation.
Any international monetary system is considered effective when it is able to deliver sufficient nominal stability in exchange rates as well as the domestic prices, plus a timely adjustment to shocks and structural changes. Achieving all this can be very difficult. Dynamic changes in the geographic distribution of economic and political power, inconsistent monetary and fiscal policies, wars, and the global integration of goods and asset markets are all threats to an effective monetary system. Previous monetary system could not incent systemically important countries to adjust policies in a timely manner. The question is whether the current system is sufficient enough to do so. If not, further reforms are necessary to achieve a stable monetary system that promotes economic growth.

2.3 The Evolution of the International Monetary System

The international monetary system has gone through major changes over the years according to respond to the needs and preferences of the member countries. Different aspects of the monetary system have changed in each of the phases of the running monetary system. Each of these phases has been studied and the role of the IMF has been explained in each phase.

2.3.1 The Gold Standard

From 1870 to 1914, the gold standard was the monetary system and it was a largely decentralized and market-based system. Apart from the commitment from major economies to maintain the gold price of their currencies, there was seen minimal institutional support. The adjustment to external imbalances was also not very problem-free as the surplus countries frustrated the adjustment process by sterilizing gold inflows and did not abide by the conventions of the system. On the other hand, the adjustment process was very difficult for deficit countries due to downward wage and price stickiness.

The gold standard did not survive World War I. high spread of inflation caused by was expenditures and further shifts in the global economic power composition were very high for the pre-war gold parities to handle. The system had no clear mechanism to coordinate an orderly return to inflation-adjusted exchange rates. Some countries such as the United Kingdom, however tried to return to the gold standard at overvalued parities. The country was forced to undergo painful wage deflation and prices to restore its competitiveness in the system.
The circumstances became tougher during the Great Depression, when with an open capital account and a commitment to the gold exchange standard, the United States could not offset the existing economic contractions by using monetary policy. Deflationary pressures from the United States spread very quickly to all the countries in the system and weakened the global economy further. First, the deficit countries experienced the crisis, but the crisis spread very quickly to all other countries and caused the collapse of the system eventually.

2.3.2 Bretton Woods

As a response to all the instabilities of the interwar period, the Bretton Woods system was created, a system of pegged, but adjustable exchange rates. The new monetary system was more administered than market-based; the International Monetary Fund was responsible for coordination among the countries with clearer rules and conventions, and capital controls were widespread.

Although there were institutional changes in the new system, surplus countries still did not abide by the adjustments. Foreshadowing present problems, countries often sterilized the impact of surpluses on domestic money supply and prices. The interventions were skipped arguing that the imbalances were temporary, and surpluses were evidence more of virtue than disequilibria. In contrast, the zero bound on reserves remained a binding constraint for deficit countries, which eventually ran out of time.

The Bretton Woods system also collapsed in the early 1970s after the United States took very expansionary monetary policies, held very unsustainable trade deficits, and the loosening of capital controls began to put pressure on fixed exchange rates. The aftershocks of these changes, once again affected the member countries in the monetary system.

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38 As the Federal Reserve pursued tight monetary policy in the aftermath of the crash of 1929, it simultaneously sterilized the resulting large gold inflows. In 1931, to counteract the outflow of gold (due to the U.K.’s decision to leave gold), the Fed sharply raised its rediscount rate. This effort to maintain confidence in convertibility resulted in considerable monetary tightening and, consequently, a further wave of bank failures in the ensuing six months.

39 IMF Articles of Agreement, Article IV, Section 3. “members should avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members....”
2.4 Structure of the Current Monetary System

To reflect the ongoing changes in global economic realities, the international monetary system has evolved continuously over the last century. Not adapting the changes in the global economy was the reason previous systems failed.

2.4.1 The Evolution of the Global Economic Power

In the last two decades, the world economy has expanded and there are changes with respect to its size and complexity. The regions like the Asia, the European Union member states and the United States are more interdependent. Although the US and EU are still dominant in the system economically, their dominance is relative rather than absolute these days. The two still account for almost half of the world’s GDP. Their share, however, has gone down by 10 percent in last 15 years. On the other hand, China’s share has grown five times, making it the second largest world economy with an 11 percent share of world GDP at market exchange rates. (Figure 2.1)

**Figure-2.1**

Share of World GDP (%, 1995 and 2012 at market exchange rates)

![Figure-2.1](image)

Source: IMF, World Economic Outlook April 2012

Recent rise of China in the world economy, and more shift towards the developing countries in the distribution of world GDP, implies a risk that the US and the EU may lose their economic leadership. Plus, the recent economic crises, which have affected the developed economies as well, have contributed to the rebalancing of the distribution of the global economic power.
The world economy is much more reliant on the Emerging Market economies. For instance, the Chinese economy has experienced an annual growth rate of about 10 percent for the past thirty years, expanding from 59 US billion dollars in 1978 to 7.3 trillion in 2011. This number came at 7.7 percent for 2012 and 2013, and at 7.5 for 2014 Q2.

Figure-2.2
GDP Growth in main world countries and regions (% 2000-2012)

Source: IMF, World Economic Outlook database, April 2012

Figure-2.3
Contribution to World GDP Growth (% 2011-2013)

Source: IMF, World economic Outlook October 2012

The growth forecasts for advanced economies have been lowered further since the global economic and financial crisis. In 2012, the annual GDP growth rate for the euro area came at -0.7, and for 2013 was at -0.4. The United States is now experiencing some recovery since the end of 2010, although the crisis has undoubtedly accelerated a trend in the redistribution of global economic power which was already taking place. As shown in figure 2.3, the developing economies are growing at three times the rate of developed countries. Based on IMF calculations, if calculated on the basis of the purchasing power parity (PPP), China could surpass the economy of the US within the next decade. China’s GDP has grown at a 10 percent average rate since 2000 based on IMF calculations, but its speed has decreased during the last few years, where given a property market downturn and weaker export figures, the forecast for 2012 was seen a 7.8 GDP growth. For the time being, US GDP at current market prices still accounted for more than double that of China in 2011, accounting respectively, for US 15.1 trillion and US 7.3 trillion dollar.

2.4.2 Trade and Financial Integration

The global trade has been rising steadily from only 59 US billion dollars in 1948 up to 17.8 US trillion dollars in 2011 current prices since the end of the World War II. Trade is seen an annual growth rate of 3.5 percent. However, trade patterns do not seem able to follow a clear trend since they are affected heavily by economic instability. Dropping almost five times more than the fall in world GDP, the “sudden, severe and synchronised […] great trade collapse” of 2009, due to a demand shock following the year before crisis, was amplified by consumers’ uncertainty and concerned almost all world regions.

Mainly, the emerging economies and China are responsible for the increase in global trade. In the period of 2005-2011, South America with an annual percent recorded the highest increase in exports performance. The Chinese economy also

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42 Euro Zone GDP, 2013, (http://countryeconomy.com/gdp/euro-zone)
overtook Germany in 2009 and became the second largest exporter of the year expanding six times since it joined the World Trade Organization (WTO) in 2001. China owes this mostly to its labour-intensive manufacturing sector for export markets.

The world economy is becoming more and more open these years. Most of the Tariff barriers have been removed, mostly among the developed economies, while forms of protectionism, both in terms of tariff and non tariff barriers, still tend to persist among developing countries.\textsuperscript{46} Although an agreement within the WTO might sustain the process of global economic recovery at least by increasing security in international trade relations, further multilateral reductions have not been successful since the failure in Doha round on global trade liberalization in 2011. At present, there are 243 PTAs in force and they are generally bilateral agreements or take the form of Regional Trade Agreements (RTAs).\textsuperscript{47} While the most famous RTA is the European Community Treaty (ECT), RTAs have proliferated in Latin America and Asia and in both the EU’s and the US’s trade relations with developing countries. The dominance of this approach seems to represent the only way to push forward the global process of trade liberalization at the moment. However, the multiplicity of bilateral trade agreements is inefficient and detrimental to the global economic system, since overlapping PTAs and the lack of clear and unanimously agreed rules cause uncertainty. Provided that new efforts are made to restart the multilateral approach to trade liberalization, it would take years to achieve a widespread agreement. Bilateralism – or, at best, regionalism – is likely to be the key approach for further trade negotiations.\textsuperscript{48}


Table-2.1
Growth in World Trade, 2005-2011 (Country-wise and Region-wise)
(In Percentage)

<table>
<thead>
<tr>
<th></th>
<th>Imports</th>
<th></th>
<th></th>
<th>Exports</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>3.5</td>
<td>14</td>
<td>5</td>
<td>3.5</td>
<td>14</td>
<td>5</td>
</tr>
<tr>
<td>North America</td>
<td>1</td>
<td>15.5</td>
<td>4.5</td>
<td>3</td>
<td>15</td>
<td>6</td>
</tr>
<tr>
<td>Canada</td>
<td>3</td>
<td>14.5</td>
<td>8.5</td>
<td>-2</td>
<td>8.5</td>
<td>3</td>
</tr>
<tr>
<td>Mexico</td>
<td>0</td>
<td>23.5</td>
<td>6.5</td>
<td>3.5</td>
<td>21.5</td>
<td>4.5</td>
</tr>
<tr>
<td>United States</td>
<td>0.5</td>
<td>15</td>
<td>4</td>
<td>4.5</td>
<td>15.5</td>
<td>7</td>
</tr>
<tr>
<td>South and Central America</td>
<td>10</td>
<td>23</td>
<td>12</td>
<td>2</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Brazil</td>
<td>20</td>
<td>43</td>
<td>24</td>
<td>14</td>
<td>32</td>
<td>27</td>
</tr>
<tr>
<td>Europe</td>
<td>1.5</td>
<td>10</td>
<td>2.5</td>
<td>2</td>
<td>11</td>
<td>5</td>
</tr>
<tr>
<td>Europe Union(27)</td>
<td>1</td>
<td>9.5</td>
<td>2</td>
<td>2</td>
<td>11.5</td>
<td>5</td>
</tr>
<tr>
<td>Germany</td>
<td>8</td>
<td>14</td>
<td>19</td>
<td>7</td>
<td>12</td>
<td>17</td>
</tr>
<tr>
<td>France</td>
<td>6</td>
<td>9</td>
<td>17</td>
<td>4</td>
<td>8</td>
<td>14</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>4</td>
<td>16</td>
<td>13</td>
<td>4</td>
<td>15</td>
<td>17</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>17</td>
<td>30</td>
<td>30</td>
<td>14</td>
<td>32</td>
<td>30</td>
</tr>
<tr>
<td>Africa</td>
<td>14</td>
<td>15</td>
<td>18</td>
<td>11</td>
<td>29</td>
<td>17</td>
</tr>
<tr>
<td>South Africa</td>
<td>12</td>
<td>27</td>
<td>29</td>
<td>11</td>
<td>31</td>
<td>20</td>
</tr>
<tr>
<td>Asia</td>
<td>6</td>
<td>18</td>
<td>6.5</td>
<td>7.5</td>
<td>23</td>
<td>6.5</td>
</tr>
<tr>
<td>Australia</td>
<td>5.5</td>
<td>10</td>
<td>7</td>
<td>3</td>
<td>12.5</td>
<td>0.5</td>
</tr>
<tr>
<td>China</td>
<td>11.5</td>
<td>22</td>
<td>9.5</td>
<td>12</td>
<td>28.5</td>
<td>9.5</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>5.5</td>
<td>17.5</td>
<td>9</td>
<td>-5.5</td>
<td>-16.5</td>
<td>7</td>
</tr>
<tr>
<td>India</td>
<td>14</td>
<td>22.5</td>
<td>9.5</td>
<td>12.5</td>
<td>25.5</td>
<td>15.5</td>
</tr>
<tr>
<td>Japan</td>
<td>0.5</td>
<td>10</td>
<td>2</td>
<td>3</td>
<td>27.5</td>
<td>-0.5</td>
</tr>
</tbody>
</table>

Source: WTO, 2012
2.4.3 Capital Flows

Capital flows, along with trade, are the main forces that caused the expansion of the world economy and the rise of EMEs, and challenged the current institutions and equilibrium of economic governance. Financial integration has expanded considerably over the last decade. From 2002 to 2007, annual gross international capital flows rose from 5 to a peak of 17 percent of world GDP, particularly to and from advanced economies. With respect to Foreign Direct Investment (FDI), the financial crisis has led to a dramatic fall in inward and outward flows in the EU FDI flows since 2005. (Figures 2.4 and 2.5).

<table>
<thead>
<tr>
<th>Table-2.2</th>
<th>World FDI Inflows 2005-2010 (in million US$, current prices)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
<td>2005</td>
</tr>
<tr>
<td>Brazil</td>
<td>15066</td>
</tr>
<tr>
<td>China</td>
<td>72406</td>
</tr>
<tr>
<td>European Union</td>
<td>496075</td>
</tr>
<tr>
<td>India</td>
<td>7622</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>12886</td>
</tr>
<tr>
<td>United States</td>
<td>104773</td>
</tr>
</tbody>
</table>

Source: UNCTAD, World Investment Report 2011

<table>
<thead>
<tr>
<th>Table-2.3</th>
<th>World FDI Outflows 2005-2010 (in million US$, current prices)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
<td>2005</td>
</tr>
<tr>
<td>Brazil</td>
<td>2517</td>
</tr>
<tr>
<td>China</td>
<td>12261</td>
</tr>
<tr>
<td>European Union</td>
<td>608515</td>
</tr>
<tr>
<td>India</td>
<td>2985</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>12767</td>
</tr>
<tr>
<td>United States</td>
<td>15369</td>
</tr>
</tbody>
</table>

Source: UNCTAD, World Investment Report 2011

Having tripled their share since the mid-1990s, global FDI flows mark an overall dominance of EU and the US. The EU is world’s largest source and also the largest host of FDI, while the outflows to the US are still double the amount of those flows to the BRICS, and an inflow of more than 200 billion dollar from the US, ten times more than the amount of US FDI flows to the BRICS countries in 2011. Conversely, China, despite showing an extremely internationally integrated economy with regard to production and trade of goods, has limited connectivity with the international financial system. Europe has been the fastest growing destination for Chinese investments since 2008, which however are still minuscule (UNCTAD 2011). Nevertheless, Chinese outward FDIs are on a trend of steady growth, since they doubled to 5.3 percent of Chinese GDP in a decade, with a total stock of 364 billion US dollar worldwide, and are likely to continue for the years to come.

Figure-2.4

US FDI Outflows (in million US$, 2000-2011)

Source: Bureau of Economic Analysis, 2012

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With the growth of international transactions, the demand for US dollars has also increased. This advantage has allowed the US to expand both its debt and deficit without a corresponding rise in debt service costs.\textsuperscript{52} In other words, since China is holding significant dollar denominated assets, this has helped the US sustain its high levels of current account deficit and budget.\textsuperscript{53} This actually shows a trend of existing global interdependency and an increasing financial power by EMEs. Small share of these emerging market economies shows that their integration into the world economy is still very low. Nevertheless, a reversal in global finance is taking place, since the liabilities of emerging economies are not dominated anymore by external public debt but rather by FDI and portfolio equity flows, while their assets are increasingly in the form of foreign exchange reserves. Moreover, emerging markets have also become net exporters of capital to the advanced economies and have substantially reduced the risk emanating from the structure of their external liabilities.\textsuperscript{54} This represents a sharp contrast with the public accounts of the economies of the Organization for Economic


Cooperation and Development (OECD) member states, which have been affected by a massive increase in their liabilities during the last few years.

So, after the collapse of the Bretton Woods system, the IMS became a more decentralized and market-based model again. Major members in the system decided to float their exchange rates, and gradually liberalize their capital flows. Several other major economies also have adopted similar policies in recent years after realizing the difficulties of managing pegged exchange rate regimes with increasingly open capital accounts. A more market-denominated exchange rate has increased control of domestic monetary policy and inflation and has accelerated the development of financial sectors which has ultimately resulted in more economic growth.

2.4.4 Exchange Rates

The current international monetary system is known to be a hybrid or a non-system. This is because the systematically important countries do not share the same exchange rate regime. Almost two-thirds of the 40 largest countries in the world now have floating exchange rates, and the exchange rates of the other one-third are managed or fixed. Until recently, the number of countries with floating exchange rates had been increasing.

2.4.5 International Reserves

A very notable feature of the current IMS is that over the past decade, many emerging economies have accumulated high levels of reserves, concurrent with the increase in current account imbalances. Since 2000, these reserves have risen from less than US$1 trillion to almost US$7 trillion (Figure 2.6), much of which is invested in U.S. government debt. By most metrics, these levels far exceed the needed levels for precautionary purposes. For example, reserves have increased significantly as a percentage of GDP for the BRIC economies (Brazil, Russia, India and China) (Figure 2.7). Substantial and persistent current account imbalances and the resulting extraordinary accumulation of reserves speak directly to the lack of timely and symmetric adjustment of real exchange rates in the IMS.
2.4.6 Institutions

To promote compliance with a wide set of rules, standards and conventions in the system, there are a number of complex institutions in the IMS that make sure the countries abide by the rules. The ultimate goal is to preserve global financial and monetary stability. The key institutions that monitor and oversee the system—the IMF, the Bank for International Settlements (BIS), the Financial Stability Board (FSB) and the G-20—identified many of the risks that subsequently materialized during the 2007–09 crisis. However, they failed to realize the magnitude of the risks and their consequences to take the actions necessary to reform members’ policies and
allow adjustment to external imbalances. Table 2.4, depicts a historical overview of the international monetary system over the years and the changes in their structures.

Table 2.4

Historical Overview of the International Monetary System

<table>
<thead>
<tr>
<th>Exchange rate regime</th>
<th>Gold standard</th>
<th>Bretton Woods</th>
<th>Hybrid: Fixed to flexible</th>
<th>Market based: Flexible exchange rates with inflation targeting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutions that comprise the global financial architecture</td>
<td>Central banks (BIS)</td>
<td>World Bank</td>
<td>IMF</td>
<td>G-7/G-20 FSB</td>
</tr>
<tr>
<td>Capital controls</td>
<td>Capital mobility</td>
<td>Widespread capital controls</td>
<td>Managed capital flows conditional on exchange rate regime</td>
<td>Capital mobility</td>
</tr>
</tbody>
</table>

Source: ECB

Overall, the present regime is characterized by:

- Widespread currency convertibility and free capital mobility among advanced and emerging countries, with the major exception of China;

- Mostly free floating amongst advanced economies or zones, and various behaviors inspired by the fear of floating in emerging and developing countries (with the exception of Latin America and some European countries);

- Liquidity provision in case of emergencies based on IMF facilities as well as bilateral swaps and regional agreements (such as the Chiang Mai agreement in East Asia); This liquidity is however considered very insufficient, leading to reserve accumulation by many members to self-insure themselves;

- Monetary surveillance and cooperation at regional (EU) or multilateral (G20, IMF) levels, the effectiveness of which is disputable.
Compared to previous systems, the current IMS has been successful in facilitating the expansion of global growth, trade and financial integration: since the break down of the Bretton Woods, the global GDP annual growth has averaged more than 3 per cent, global trade has increased by nearly double the rate of GDP, and gross foreign assets and liabilities by more than three times. Most importantly, this expansion has included the integration of China and India—nearly one-third of the world’s population—into the global economy. Between 1980 and 2010, China’s economy rose from the world’s twelfth largest to the second largest, as its size increased more than twelvefold. Globalization, particularly in the form of trade and foreign direct investment, has allowed China not only to benefit from access to markets, technology transfer and increased specialization, but also to realize its comparative advantage in producing labour-intensive manufactured goods. Despite the banking, sovereign debt and currency crises that the IMS has experienced since the breakdown of the Bretton Woods system, it has generally functioned well in supporting increased trade and capital flows.

SECTION- II

2.5 Role of the IMF in the International Monetary System

The IMF has a very broad role in the international monetary system and many believe that it should also contribute more than it does today to substantial cooperation on national policies affecting the international economy and financial system.

The Fund’s role in this section involves:

1. Surveillance
2. Exchange rates and policies
3. Capital account and financial sector issues
4. Regional arrangements

2.5.1 Surveillance

Surveillance and the associated process of policy coordination and cooperation are central roles of the IMF. Effective surveillance can help solve the type of coordination problems that undermine the health of the global economy in the 1930s during the Great Depression and led to the founding of the IMF at the
end of the World War II. Under the Bretton Woods system, coordination was forced through the fixed exchange rate system. With the forced abandonment of that system in the 1970s, surveillance remains an instrument to deal with imbalances in the global economic and financial system.

Surveillance is done at three levels: national, regional and multilateral. It is principally in its multilateral surveillance role that the IMF becomes concerned with the functioning of the international monetary system. To the extent that the policies and performances of individual countries or groups of countries affect the health and smooth functioning of the system, national and regional surveillance are also relevant.

There are many gaps to fill in this area on how the Fund should be involved. However, there are many proposals under development and assessment.

2.5.2 Exchange Rates and Policies

An important subtopic in surveillance is the exchange rates and policies of the members. This section became of greater attention after the collapse of the Bretton Woods system. The instabilities in the flexible exchange rate regime of each member country can hurt the entire system. It is very disruptive for more vulnerable countries acceptable only to those whose job is to provide profitable cover against those fluctuations.

As a part of its responsibilities in the international monetary system, the IMF should pursue aggressively countries that engage in currency manipulation by pegging their exchange rates for extended periods of time at undervalued levels while piling up foreign exchange reserves and frustrating the international adjustment process.

Managing director of the time in 2005, de Rato, in his report to the IMFC called for a “deeper treatment of exchange rate issues” and noted that the executive board as held a seminar on operational aspects of moving toward greater exchange rate flexibility. However, the IMF and its staff are not even close to

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being sufficient in this area. Many policy makers are far from convinced that exchange rate flexibility is ever desirable.

2.5.3 Capital Accounts and Financial Sectors

As part of its surveillance functions, IMF reviews the countries’ capital accounts, including the size and composition of their external debts and potential for capital account crises. These crises, in turn, are often closely linked to financial sector development and stability, an area in which the IMF has been assigned a major surveillance role along with the World Bank. Plus, capital controls should go with the exchange rate policies surveillance to present effective balance of payments adjustment. All these functions are integral to the role of the IMF in the international monetary system.

This part is gaining more importance day by day because of the growth of liberalization all over the world. Many officials speak of the necessity of ensuring the orderly liberalization of capital flows. It states that the IMF is uniquely placed to assist this process; however, they believe that it should be bold, but cautious in implementation at the same time. At a point in time, it was also speaking of making liberalization of capital movements one of the purposes of the Fund and to extend the Fund’s jurisdiction over the process. But the studies find no evidence that the IMF as an institution used its leverage to push countries to move faster that they were willing to go in liberalizing their capital account transactions. Individual fund staff, however, did in general encourage those countries that wanted to do so to move ahead without paying attention to the risks involved, the proper sequence of liberalization, and the interaction with domestic financial sector development.

This lack of attention to sequencing and financial sector development was caused in part by the absence of an official IMF position on capital account liberalization that allowed individual staff members the attitude espouse their own disparate views when it came to advising members on these issues.

However, the IMF’s analysis of these issues is widely regarded as not satisfactory and it has so many shortcomings. One point of controversy is that publication of the resulting analysis is voluntary. A second controversy is that a
major, systematically important country—the United States—has not had an analysis plus the Japan which has recently had it.

2.5.4 Regional Arrangements

A final important area of the IMF’s interface with the international monetary and financial system involves the Fund’s relations and interaction with other formal or informal international organizations.

First of all, the Fund’s relation with the World Bank is very disputable. The two institutions’ functions overlap at times and one may enter the other organizations’ territory of functions which is a waste of expertise and resources. The turf battles between these two are frequent and cooperation and coordination fall short of what a rational person would view as desirable.

Secondly, the Fund’s relation with the Bank for International Settlements (BIS) is very important. However, this relation is better than that in the past, because the BIS is seen less and less as a rival to the IMF.

Third, relations with the WTO are uneven, and, one motivation for amending the IMF articles of agreement with respect to capital account liberalization was to establish the capital account as the IMF’s turf at least with respect to financial flows and prevent the WTO from extending its authority.

Fourth, the IMF has generally cordial relations with the Organization for Economic Cooperation and Development (OECD), with its more limited membership; here the competition is largely in the area of research and ideas.

Finally, the IMF’s involvement with the regional development banks is of great importance. This relation is very limited except in the times of crisis during which the Fund and these banks seek to provide the best financing and policy advice possible for the member countries to deal with the underlying policy challenges. On the other hand, the regional development banks have been known to support countries whose macroeconomic policies the IMF has faulted. The Asian Development Bank is also perceived to be a strong supporter of the establishment of an Asian Monetary Fund (AMF) as an alternative to the IMF.
What should be the IMF’s posture towards such regional arrangements? In many situations that the IMF deals with, regional arrangements should shoulder a greater share of the general burden of emergency financing, in particular, and policy advice as well. IMF might seek the promotion of regional subsidiaries. If the regions with the mini-IMFs do not like being subsidiaries of a global institution in Washington dominated by the G-7 countries, how should the IMF seek to structure its relationship with independent organizations with essentially the same mandates to maintain economic and financial stability? The answer is that they should find a way to facilitate mutual assistance because the global monetary system cannot function effectively with more than one set of rules and conventions.

2.6 Changing Role of the IMF in the International Monetary System

The IMF was established in 1944 with a clear objective of preserving the stability of the fixed exchange rate system. The original 39 members of the Fund were among the advanced economy members of the global economy and they had more or less limited needs and similar backgrounds. As a result, the role of the IMF in the fixed exchange rate system was limited to just helping a limited number of countries with similar economic backgrounds. The use of IMF financial resources were also limited to short term balance of payments needs to those advanced economy members.

However, 3 major factors contributed to the changing role of the IMF in the international monetary system:

1. Breakdown of the Bretton Woods system
2. Changes in the dynamics of the international monetary system
3. diversity in the membership of the Fund

Each of these factors led the Fund to change its role and as a result of that its operations in the international monetary system. The factors are explained below.

After the breakdown of the Bretton Woods system in 1971, the Fund lost its most important role in the international monetary system as the major agent for preserving the stability of the fixed exchange rate system.
As a result, the IMF lost its total identity in the international monetary system. The guidelines to amend the Articles of Agreement of the IMF and to restore the role of the IMF in the IMS provided very limited guidance on how the Fund should perform. The guidelines failed to mention clearly the responsibilities of the Fund with respect to the functions of the member countries. As per the guidelines, each member state had to “endeavour to direct its economic and financial policies toward fostering orderly economic growth”; to “seek to promote stability by fostering orderly underlying economic and financial conditions”; and to “follow exchange rate policies compatible with the undertakings” of Article IV.\textsuperscript{56} The amended article also suggested that the IMF needs to look at any aspect of the member state’s economic and financial policies and policy making arrangements that could affect its “orderly economic growth”, its external balance of payments and the value of its currency. In other words, the Second Amendment has resulted in the IMF dramatically expanding the scope of its Article IV consultations. It has also led to an expansion in the range of conditions that the IMF attaches to its financing.\textsuperscript{57}

Apart from the collapse of the par value system, the international monetary system has also gone through major changes. Over the years, the emergence of the developing nations such as China and their higher contribution to the developments in the global economy has resulted in having a more complex monetary system. This led to higher financial and trade integration, higher flux in capital flows and as a result of all higher fluctuations in exchange rates. Thus, the nature of the monetary system shifted to become a more complex system where the stability of the system was more in danger than before. The IMF was thus faced with more challenges to preserve the stability of the system.

Moreover, as the members of IMF increased over the years, the Fund had to deal with a more diverse group of countries each with different economic and social back grounds and needs. The Fund was no longer dealing with similar countries with similar financial and technical needs. The financial needs of the members were no longer limited to just short term balance of payments needs of the countries. The new developing and low-income member countries had each different needs the IMF had to attend to.

\textsuperscript{56} Hagan, Sean, 2006, “Article IV of the Fund’s Articles of Agreement: An Overview of the Legal Framework”

\textsuperscript{57} De Rato, Rodrigo, 2006, “The IMF’s New Priorities, New Directions”, p 1-3.
As a result of all these changes, the role of the IMF in the international monetary system changed where the Fund had to expand its role beyond just the preservation of the fixed exchange rate system. With respect to the developed nations, these members gained some independence against the IMF as they were in no need of future financial resources. As a result, the involvement of the Fund with these countries became more and more limited and this involvement shifted to other developing and least-developed nations. The number of IMF programs with the developed nations decreased and the focus were shifted to other members of the IMF. However, over the past few years and after the emergence of the global financial crisis more developed nations have turned to IMF for financial assistance to help them with their crisis prevention or crisis resolution policies.

The fund has become more and more involved with its developing and low-income members. However, in dealing with these countries the IMF has gone beyond its previously defined role and expanded its role in the international monetary system to be able to preserve the stability of the flexible exchange rate system and as a result the stability of the monetary system.

Especially with respect to its low-income member countries, the IMF expanded its role to become a developmental institution. This could be seen in the conditions the Fund attaches to its financing. The Fund focused on issues that were mostly the duties of the World Bank. The focus of the Fund on issues like the education, poverty reduction, health and etc caused the Fund to become a developmental financier. The increasing number of structural reforms in the conditionality of the IMF focusing on developmental issues changed the role of the IMF that it clearly did not have the adequate resources or expertise for. As for its developing members, the IMF became involved in helping many of these countries in their liberalization process. The Fund encouraged and even sometimes pushed these countries too hard to achieve liberalization. This could also be seen in many Asian countries.

Over involvement of the Fund in these countries plus high levels of interconnectedness of the countries in the international monetary system increased the number of crisis over the years. The IMF could face a group of countries in crisis in need of financial resources to overcome their problems. The Fund which was
originally offering its resources only for balance of payments needs was now faced with countries in need of finances for different reasons. As a result, the IMF became a global financial safety net for the troubled countries which the countries would turn to since other sources of finance were not enough or costly for them. IMF reformed many of its existing facilities and also introduced new facilities for different needs of the borrowing countries to help them overcome their difficulties. The contributions of the IMF in the recent financial crisis are a good example of this case.

Apart from offering financial services to these country members, the IMF introduced an early warning system that would identify any sources of risks that would threaten the stability of the countries and the international monetary system. Although the developments in this area are not enough and the Fund is acting very weak, this can be a start of a new role of the IMF.

IMF has also started its technical assistance services for its low-income member countries. The volunteer countries can start a review of their policies and operations and in case of any reforms needed, IMF can offer its series of financial assistance to help these countries.

To be able to stay in the international monetary system as the leading institution for preserving the stability of the system, the IMF went from being just the institution supporting member countries with their short term balance of payments needs to become an agent helping its member countries overcome crisis they were facing or any potential future crisis. Plus, the Fund became a developmental financier and a technical assistant mostly to its developing and low-income country members. Recently, the IMF is also involved in anti-terrorism and anti-money laundry activities. The dynamic spirit of the international monetary system forces the IMF to change dynamically along with the changes to stay effective and be legitimate.

2.7 Problems and Issues with the Current IMS

The IMS has evolved continuously over the last century, reflecting ongoing changes in global economic realities and in economic thought.\(^{58}\) Throughout this

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whole period, there has been a continuous search for an effective nominal anchor. In the process, the binding rules that marked its passage through the gold standard and the Bretton Woods regimes have fallen by the wayside. The gold standard provided the anchor in the pre-World War I period: a period characterized by free capital flows and fixed exchange rates and, hence, no independent monetary policy. The interwar period was marked by confusion, which yielded to the Bretton Woods system of semi-fixed exchange rates and controlled capital flows that provided scope for an independent monetary policy. The collapse of the Bretton Woods system in the early 1970s led to the introduction of the prevailing system of floating exchange rates, free capital flows and independent monetary policy in the major advanced economies. Within this post-Bretton Woods framework, the monetary policy framework also transitioned from a monetary targeting regime in the 1970s and the 1980s to inflation targeting frameworks. Given the preference for open capital accounts, and the belief in efficient financial markets, financial sector regulation moved from an intrusive framework to a light-touch framework.

However, given the recent frequency of financial crises, the IMS appears to be far from perfect where there can be found a balance between the domestic stability versus external stability versus global stability. The pursuit of sustained growth with price stability may not guarantee a balance of payments position that does not have disruptive effects on exchange rates. Threats to global stability cannot be prevented by just domestic and external stability. Neither can the global stability guarantee the domestic or the external stability.

The post-Bretton Woods era performance of the IMS has been very mixed. Average global growth has been very volatile, mainly due to recent developments in the advanced economies (AEs), while the growth in EDEs has tended to provide some stability to the global growth. As can be seen in table 2.5, Inflation and its variability moderated globally in both the AEs and the EDEs. The period of the Great Moderation is generally believed to have begun with the taming of inflation in the early 1980s and extends up to 2007, when the global crisis struck. However, while the variability of growth did come down in the 1990s relative to the preceding decade, it was still higher than in the 1970s. The lowest variability in inflation seems to have

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been in the 1970s for the AEs and in the 2000s for the EDEs. This discussion, however, provides no information on causality; it is difficult to infer whether the post-Bretton Woods IMS is responsible for heightened instability, or whether it exists in a period of heightened volatility.\(^\text{60}\)

**Table-2.5**

**IMS- Key Metrics**

<table>
<thead>
<tr>
<th></th>
<th>Average (Percent)</th>
<th>Variability (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth</td>
<td></td>
<td></td>
</tr>
<tr>
<td>World</td>
<td>4.2</td>
<td>3.1</td>
</tr>
<tr>
<td>AEs</td>
<td>3.6</td>
<td>3.1</td>
</tr>
<tr>
<td>EDEs</td>
<td>5.7</td>
<td>3.4</td>
</tr>
<tr>
<td>CPI Inflation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>World</td>
<td>10.3</td>
<td>15.8</td>
</tr>
<tr>
<td>AEs</td>
<td>8.6</td>
<td>6.5</td>
</tr>
<tr>
<td>EDEs</td>
<td>15.1</td>
<td>41.7</td>
</tr>
</tbody>
</table>


During the Great Moderation period (1984-2007), the real GDP growth in the AEs stayed the same at 3 percent, as in the preceding 14-year period (3.1 percent during 1970–1983), while its coefficient of variation went from 63 percent to half of its previous value at 32 percent over the period. Inflation declined from 8.9 percent in 1970–1983 to 3.0 percent in the Great Moderation phase, but the coefficient of variation was higher — it increased from 34 percent to 44 percent. However, the Great Moderation period was immediately followed by the NAFC, with large output losses and volatility. Arguably, the macroeconomic and financial policies that were followed during the Great Moderation period contributed to the subsequent crisis. Accordingly, the Great Moderation and the post-crisis periods must be considered together (so, 1984 to 2011) to assess macroeconomic outcomes. In this case, real GDP growth in the AEs falls to 2.6 percent during 1984–2011 from 3.6 percent during

---


The increase in the incidence of crises of various types in comparison to past eras of the IMS (a notable feature of the post-Bretton Woods period) provides causal evidence. The frequency of banking and currency crises has, in particular, increased dramatically, with the period 1973–1989 being particularly prone to crises, including defaults. The incidence of banking crises was even higher than in the turbulent inter-war period. In the subsequent period, that is, 1990–2010, the incidence of all types of crises has remained high by historical standards, with the exception of external defaults (table 2.6). This is of great concern since financial crises have not only a short-term but also a persistent and long-lasting adverse impact on output levels, and on levels of public indebtedness.\(^\text{61}\)

**Table 2.6**

<table>
<thead>
<tr>
<th>Period</th>
<th>Banking Crisis</th>
<th>Currency Crisis</th>
<th>External Default</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gold Standard (1870-1913)</td>
<td>1.3</td>
<td>0.6</td>
<td>0.9</td>
</tr>
<tr>
<td>Interwar Period (1925-1939)</td>
<td>2.1</td>
<td>1.7</td>
<td>1.5</td>
</tr>
<tr>
<td>Bretton Woods (1948-1972)</td>
<td>0.1</td>
<td>1.7</td>
<td>0.7</td>
</tr>
<tr>
<td>a) 1948-1958</td>
<td>0</td>
<td>1.4</td>
<td>0.3</td>
</tr>
<tr>
<td>b) 1959-1972</td>
<td>0.1</td>
<td>1.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Post-Bretton Woods (1973-2010)</td>
<td>2.6</td>
<td>3.7</td>
<td>1.3</td>
</tr>
<tr>
<td>a) 1973-1989</td>
<td>2.2</td>
<td>5.4</td>
<td>1.8</td>
</tr>
<tr>
<td>b) 1990-2010</td>
<td>3</td>
<td>2.4</td>
<td>0.8</td>
</tr>
</tbody>
</table>

Source: Bush, Farrant and Wright (2011) [Table A, p.7]

The latest financial crisis and the concomitant recession have led to historically high and rising levels of public indebtedness across the AEs. Empirical evidence indicates that episodes of such large public debt overhang are associated

with lower growth than during other periods and the cumulative shortfall in output from debt overhang is potentially massive.\textsuperscript{62} According to Cecchetti, Kohler and Upper (2009)\textsuperscript{63}, financial crises are more frequent than most people think, and they lead to losses that are much larger than one would expect. In a sample of 40 financial crises, the authors found that one-fourth resulted in cumulative output losses of more than 25 percent of pre-crisis GDP and one-third of the crisis-related contractions lasted for three years or more. It is clear that the past four decades have seen a significant increase in financial crises and are associated with large and persistent output and employment costs. Arguably, the post-Bretton Woods system of flexible/floating exchange rates, freer capital flows and the practice of independent monetary policy have not brought financial stability to the global economy.

The problems with the current international monetary system can be classified as:

- Exchange rate volatility
- High flux in capital flows and no global oversight framework for cross-border capital flows
- Interconnectedness across borders and high risk of contagion
- Reserve accumulation and inadequate global adjustment mechanisms

2.7.1 Exchange Rate Flexibility

The evolution of the exchange rates of the major currencies in the IMS has perhaps been the most debated aspect of the IMS. From an early stage, the linkage between the exchange rate, balance of payments and full employment has been reinforced by the foundations laid for simultaneous analysis of internal and external balance in an open economy\textsuperscript{64}, and the integration of asset markets and capital mobility into open economy macroeconomics.\textsuperscript{65} In the 1960s, there were several runs on the US dollar. The infamous “Triffin Dilemma” also questions the credibility of

the US dollar as the key reserve currency and ignited strident calls for a post-Bretton Woods system, which led to the creation of the Special Drawing Rights (SDRs).66

After the invention of the free floating regime, the role of the exchange rates became central to the process of external adjustment, which was the necessity for the stability of the balance of payments, and the economic stability. Wide gyrations and persistent misalignments characterized the 1970s and 1980s, and the Plaza Accord of 1985 turned out to be an ineffective response. The 10-yearly coefficient of variation of major currencies, which measures their volatility, appears to be the highest in these two decades (Figure 2.8 and Table 2.7). The 1990s was the decade of currency crises — the European exchange rate mechanism (ERM) crisis of 1992-93; the Mexican peso (1994); the Asian crisis (1997-1998); the collapse of the Russian ruble and long-term capital management (1998); and, to a lesser degree, the Turkish lira (2000-2001), the Argentine peso (2001) and the Brazilian real (2002).

In 1999, the euro was introduced with expectations to bring stability to the IMS. Since early 2010, when the Modern Greek tragedy started to unfold, financial markets have battered the assumptions on which the euro came into existence.67 As a result, many are beginning to question the future of the euro as an international reserve currency.

Any disruption of confidence in the sustainability of the US economy would make it difficult for the dollar to play its role as the international reserve currency, although so far, in spite of the tribulations experienced by the US dollar and the US economy, such confidence remains broadly intact. The Triffin dilemma from the 1970s is back to haunt us again.68 In fact, the dramatic swings in major currencies and consequent high volatility observed in the 1970s and 1980s appear to have returned in the period since 2000; these heightened fluctuations seem to be accentuated if data for the years 2010–2012 (up to March) are also taken into account (Figure 2.8 and Table 2.7). Contrary to expectations that they would promote stability, floating exchange rates over the past half-century appear to have imparted instability to the balance of payments of nations and to the global economy at large.

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One of the most important features of the current IMS, which is also the root of its malfunctioning, is the massive increase in movement of capital flows across borders, along with its high volatility, the surges, sudden stops, and reversals, with their impact on exchange rates.
Up to the 1970s, most of the international capital flows were among the industrial economies. Most of these countries, however, still practiced some form of capital controls. The United States removed the restrictions in the mid-1970s; where Germany and the UK continued with the controls up until the late 1970s. Japan removed the restrictions in 1980. Developing countries continued to persevere with controls, although some Latin American countries did embark on flawed liberalization as part of exchange rate-based stabilization programs in the mid-1970s.

There were strong private capital flows to the developing countries during the 1970s until the debt crisis of 1982. By the end of the 1980s, FDI inflows to the developing countries accounted for almost one-eighth of flows to the developed nations. Portfolio flows to these developing countries were almost non-existent. In the 1980s and the 1990s, several developing countries in Asia undertook capital account liberalization as part of unilateral financial deregulation and towards more market-oriented reforms. As a result of that, the developing world gained some investor confidence in the early 1990s, and net capital flows surged again. This surge in capital flows occurred at the same time where monetary policy was being eased in the United States, and federal rates fell from 10 percent in April 1989 to 3 percent by January 1993. Foreign direct investment (FDI) accounted for the bulk of private capital flows to EDEs, going through a six-fold jump between 1990 and 1997. The share of FDI in net capital flows increased from a fourth in 1990 to over a half by 1997. During this period, the international bank lending increased at a very sharp rate for the developing countries, especially for Asia, followed by Eastern Europe and Latin America. Thus, whereas debt flows through banks formed the bulk of capital flows to the EDEs in the 1980s, FDI was predominant in the 1990s. Financial openness in the 1990s was more deep and more universal compared to the gold era.

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In the late 1990s, capital flows to developing countries suffered several shocks (Figure 2.10). Bank lending and bonds flows to the EDEs went through another fall reflecting uncertainty and risk aversion. However, the improved macroeconomic fundamentals in the EDEs and also monetary easing in the United States led to revival of capital flows to the developing countries in 2002, and a record high in 2007. This volatile pattern could be seen again during the recent financial crisis. Net capital flows to the developing countries went from US$165 billion in 2002 to a peak of US$1.2 trillion in 2007, but fell to US$621 billion in 2009 before recovering to around US$1 trillion each in 2010 and 2011.72 While full information on the recent capital flows to the EDEs is not yet available, the available data confirms the existence of continued volatility in the flows. (Figure 2.11).

An analysis of capital flows to developing economies (as percent of their own GDP) and for major categories of flows reveals the boom-bust pattern, as well as the vulnerability of countries receiving large debt flows. Net capital flows for these nations increased from 1.4 percent of their GDP in 1970 to 4.1 of GDP in 1977. This increase mainly reflected the recycling of oil revenues and easing of monetary policy in the United States.73 After this period, and as a consequence of the Latin American debt crisis, the capital flows fell to 1.5 percent of GDP in 1986. As the debt crisis eased, capital flows boomed to 5.1 percent of GDP in 1997, but again fell quickly to 2.7 percent in 2000 as the Asian financial crisis took its toll on investor confidence. The upswing resumed in 2002, coinciding with an excessively loose monetary policy in the United States,74, and capital flows reached an all time high of 7.7 percent of GDP in 2007, but again more than halved to 3.6 percent of GDP in 2009 (Figure 2.12). Such a large change in the volume of capital flows to EDEs in a short period leads to excessive volatility in their exchange rates, domestic liquidity and monetary conditions, and in asset prices, and hence to complexity in overall macroeconomic management aimed at fostering growth while attempting to maintain financial

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stability. These developments were quite conspicuous most recently once again during May-August 2013 on the news of possible UMP tapering by the US Federal Reserve and have taken a significant toll on the near-term growth prospects of the major emerging economies.

Figure-2.9
Capital Flows to Developing Countries (US$ billion)

Source: World Bank, 2011
Figure 2.10

Monthly Equity and Bond Flows to EMEs

Source: EPFR and Haver Analytics, 2013

Figure 2.11

Capital Flows to Developing Countries (Percent of GDP)

Source: World Bank, 2011
Capital flow volatility is not just a threat to EDEs. The recent crisis proves that even the advanced economies are not able to cope with enhanced magnitude of cross-border capital flows and their heightened volatility. Capital inflows to and from the AEs are just a multiple of the respective EDE inflows and outflows. For example, in 2006, capital inflows to the AEs were almost eight times those of the EDEs (Figure 2.12). The volatility of capital flows of AEs is more striking than those of the EDEs. For example, net capital inflows (from non-residents) to the AEs fell dramatically from US$9,384 billion in 2007 to US$4 billion in 2008, reflecting the lack of certainty in the financial system of these economies after the crisis; net outflows by residents from the AEs turned negative, reflecting repatriation by residents of their overseas assets. While gross capital inflows and outflows to/from the AEs are a multiple of the corresponding inflows and outflows to/from the EDEs, net capital inflows received by the EDEs (in US$ terms) are broadly comparable to the AEs. However, as percent to their respective GDP levels, net capital inflows received by the EDEs have been higher than the AEs (1.9 percent of GDP for the EDEs and 1.2 percent of the AEs during 2003-10).

**Figure 2.12**
**Capital Inflows and Outflows (Advanced, Emerging and Developing Economies)**

Source: BOPS, World and Regional Aggregates. IMF, 2011

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Reflecting large cumulative two-way capital flows, total international assets for the group of the AEs increased from 144 percent of their own GDP in 2003 to 231 percent in 2010; this ratio for the EDEs increased from 52 percent of their GDP in 2003 to 66 percent in 2010. The existent large capital flows have increased the interconnectedness among financial sectors across borders, which created channels for a stronger impact of the recent crisis on the AEs with large financial sectors (figure 2.12). As a result of this interconnectedness, the risks to domestic financial stability can arise even when resident financial institutions act merely as intermediaries of capital flows, rather than the ultimate users. Large two-way gross capital flows can transfer risk within the IMS, even if the associated net flows are small.76

2.7.3 Reserve Accumulation

After the Asian financial crisis, the emerging and developing economies started accumulating their international reserves as their first response against possible future shocks. The accumulation was also in a reaction to the stigma associated with the IMF lending and the condition attached to the lending rescue package. Between the end of March 2000 and the end of June 2012, the global level of reserves recorded a six-fold increase; with reserve levels in the EDEs going up 10 times compared with the three-fold increase in the AEs the global reserve levels increase six times their previous value (Table-2.8). Most of these reserves accumulated by different nations are still denominated in US dollars.

The significant concentration of global reserves in US dollars could pose problems for IMS stability. First, high levels of global demand for US government debt lowers its yields below the market equilibrium levels. This will act as an incentive for holding higher deficits and debt. Sustained US government deficits will question the public debt sustainability. This could create conditions akin to the Triffin dilemma. Less confidence will result in a rapid switch out of US dollars, giving rise to large and disruptive exchange rate causing interruptions in the smooth functioning of the international payments and as a result of all instabilities in the global financial system. Second, the persistence use of the US dollar as the dominant international currency will result in an “exorbitant privilege” for the United States. To avoid this,

there have been many proposals for a multi-currency monetary system or even an international reserve currency such as SDR.

All EDEs have contributed to the reserve accumulation since the 1980s. By 2011, Asia’s share in global reserves was a dominant 38 percent, accounting for more than half of the reserves of all emerging economies taken together. In the 1990s, emerging Europe’s reserves grew faster than all other emerging nations. In the 2000s, it was the oil-exporting Middle Eastern and North African countries that experienced a fast pace of reserve accumulation, with levels rising nine-fold (table 2.9).

Table-2.8
International Reserves

<table>
<thead>
<tr>
<th>Region</th>
<th>Total Reserves (US$ billions)</th>
<th>Allocated Reserves (US$ billions)</th>
<th>Currency Composition of Allocated Reserves (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>1. World</td>
<td>1809</td>
<td>1401</td>
<td>71.5</td>
</tr>
<tr>
<td></td>
<td>(5.6)</td>
<td>(77.4)</td>
<td></td>
</tr>
<tr>
<td>2. Advanced economies</td>
<td>1132</td>
<td>1019</td>
<td>70.7</td>
</tr>
<tr>
<td></td>
<td>(4.4)</td>
<td>(90)</td>
<td></td>
</tr>
<tr>
<td>3. Emerging and developing economies</td>
<td>677</td>
<td>382</td>
<td>73.5</td>
</tr>
<tr>
<td></td>
<td>(10.3)</td>
<td>(56.5)</td>
<td></td>
</tr>
<tr>
<td>Year 2000</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>1. World</td>
<td>10523</td>
<td>5845</td>
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</tr>
<tr>
<td></td>
<td>(14.6)</td>
<td>(55.5)</td>
<td></td>
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<td>2. Advanced economies</td>
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<td>3152</td>
<td>64.1</td>
</tr>
<tr>
<td></td>
<td>(7.9)</td>
<td>(89)</td>
<td></td>
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<tr>
<td>3. Emerging and developing economies</td>
<td>6982</td>
<td>2694</td>
<td>59.3</td>
</tr>
<tr>
<td></td>
<td>(25.8)</td>
<td>(38.6)</td>
<td></td>
</tr>
</tbody>
</table>

Note: Figures in parenthesis in column 2 are percent to GDP (world GDP or respective regional GDP), while those in column 3 are ratios (in percent) of allocated reserves to total reserves.

Source: Currency Composition of Official Foreign Exchange Reserves (COFER), IMF, 2013
### Table 2.9

**IMS, International Reserves**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>98</td>
<td>461</td>
<td>990</td>
<td>2070</td>
<td>10705</td>
</tr>
<tr>
<td>AEs</td>
<td>73</td>
<td>274</td>
<td>629</td>
<td>1326</td>
<td>3745</td>
</tr>
<tr>
<td>EDEs</td>
<td>21</td>
<td>162</td>
<td>202</td>
<td>739</td>
<td>6955</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>3</td>
<td>15</td>
<td>13</td>
<td>36</td>
<td>178</td>
</tr>
<tr>
<td>Developing Asia</td>
<td>4</td>
<td>28</td>
<td>68</td>
<td>325</td>
<td>4058</td>
</tr>
<tr>
<td>Emerging Asia</td>
<td>1</td>
<td>5</td>
<td>19</td>
<td>104</td>
<td>871</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>5</td>
<td>74</td>
<td>52</td>
<td>118</td>
<td>1108</td>
</tr>
<tr>
<td>Western Hemisphere</td>
<td>6</td>
<td>40</td>
<td>49</td>
<td>157</td>
<td>740</td>
</tr>
<tr>
<td>Memo:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>World reserves with gold at market prices</td>
<td>100</td>
<td>1089</td>
<td>1374</td>
<td>2314</td>
<td>12186</td>
</tr>
</tbody>
</table>

Source: IFS, IMF, 2012

As seen above, countries have accumulated reserves far more than their needs. This can be seen as a means for self-insurance against future shocks since these countries have lost their confidence in the international institutions such as IMF if they need financing in case of a crisis. This process is also dangerous, since a country with high amounts of reserves delays the adjust process in its exchange rates to deal with the imbalances, and hence leads to further imbalances in the global monetary system. A perfect example of this problem is China, which with a great supply of reserves accumulated during the last two decades, is a great cause of imbalances to the monetary system since it has managed to keep its exchange rates at much undervalued rates for a very long time and accumulate more and more reserves by doing so.

### 2.8 An Overall Assessment of the IMS

Having a stable and high global growth environment of overall macroeconomic and financial stability have been the primary objective of the IMS. However, the evidence suggests that the IMS has not been very successful in
achieving its objective in recent years. Global growth has been both lower and more volatile in the post-1984 period than in the preceding decade. Compared to the Bretton Woods regime, the frequency of banking and currency crises has increased in the post-Bretton Woods regime. The flexible exchange rates system was created to reduce the volatility in the real economy, but seems to have led to higher volatility in exchange rates. The post-Bretton Woods regime has been characterised by increased openness of capital accounts. However, these capital flows to and from both the AEs and EDEs have been volatile significantly due to the monetary stance of major advanced economies. Thus, the global economy has witnessed periodic episodes of surges and then sudden crashes in capital flows, which have then been associated with booms and busts in asset prices and correspondingly financial crises. The recent NAFC has shown that even the AEs cannot effectively handle the large volatility in capital flows.

The global economy in the pre-NAFC period was also characterized by global imbalances - large current account deficits in some major countries and large surpluses in others. These imbalances reflected not only the exchange rate policies, as well as the accommodative monetary policies in major advanced economies during 2002-05. The accommodative monetary policy in the US then forced other AEs and EMEs to pursue more-than-desired accommodative policies.

Given the increasing openness of their capital accounts and the volatility of these flows, the EDEs have accumulated foreign exchange reserves to ensure stability by self-ensuring themselves against future potential threats. These foreign exchange reserves have then been recycled by the EDEs back to the AEs. The AE authorities argue that the recycled reserves put downward pressure on their long-term interest rates; however, this view ignores the fact that the recycled reserves were in first place the outcome of excess private capital flows to the EMEs, in turn, reflecting the stance of monetary policy in the AEs and overall macroeconomic policies in the AEs, particularly the US. Overall, it would appear that IMS has not succeeded in its key objective of growth with stability in the global economy in the post-Bretton Woods regime.

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To reform the International Monetary System, IMF is at the centre of attention. Significant reforms to the IMF will bring important changes to the IMS and hence bring about stability and confidence to the system.

SECTION- III

2.9 Reforming IMF for a Better IMS

IMF, as the most important member of the IMS, should change for a better international monetary system. Changes in the IMF should take place at all aspects of the institution. Unless and until these changes happen, the member states will not regain their confidence in the IMS, and the global monetary system will be directed for more global instability and further crises. Some of these changes require significant Articles of Agreement reforms which will definitely take longer and will be objected by important countries. However, there is no other way around.

Reforms of the IMF should take place in the following categories:

- IMF surveillance
- IMF lending resources and precautionary lending
- IMF technical assistance
- IMF governance

2.10 Importance of Surveillance

IMF is held responsible for overseeing its 188 member countries and their economic and financial policies. Since the global financial crisis of 2008-2009, there is considerable introspection on the shortcomings of the IMF surveillance. IMF’s warnings were found to be too scattered and unspecific to attract domestic policy reaction. IMF failed to recognize the combined risk across sectors, and the importance of financial sector feedback and spillovers. While the IMF warned about global imbalances, it missed the key connection to the looming dangers in the shadow banking system.\(^78\)

Because of the crisis, there were systemic vulnerabilities that emanated from the AEs this time; financial sectors and markets in the AEs were assumed to be strong and developed enough to absorb any financial shocks. Thus, they could not be the source of financial instability in the global economy. However, these shocks did not get absorbed despite the flexible and market determined exchange rates and interest rates. Due to the interconnectedness of the countries in the international monetary system, the shocks spread very fast across the countries. Accordingly, post-crisis, the IMF began to step up work on enhancing the quality and effectiveness of its surveillance. Overall, improvements were sought through increasing the synergies among various products produced by the IMF. The products the World Economic Outlook (WEO) and the Global Financial Stability Report (GFSR), supplemented by the introduction of an Early Warning Exercise, the Fiscal Monitor, the Spillover Report, the Pilot External Sector Report, and the G20 Mutual Assessment Process. Improvements in bilateral surveillance were undertaken, including providing Article IV reports with multi-country/cross-country/cluster analyses, and improvements in timeliness. The Financial Sector Stability Assessment (FSSA, a major component of FSAP) was made mandatory for 25 countries with systemically important financial sectors. IMF also cooperated more effectively with standard-setting bodies, including the FSB. All these initiatives were undertaken within the existing legal framework of the surveillance and no changes were made to the framework.

2.11 Triennial Surveillance Review of 2011

Article IV of the IMF’s Articles of Agreement provides the framework for the surveillance responsibilities of the IMF. The surveillance of the IMF is reviewed every three years. 2011 triennial surveillance review of the IMF studied the progress made in the surveillance of the Fund and found gaps in the framework of the surveillance. The focus of this review was mostly on the actions taken by the Fund before and during the recent global financial crisis and the euro zone crisis. Although progress could be seen in the IMF surveillance of the Fund since 2008, the following gaps were also identified:

2.11.1 IMF and Capital Flows and Financial Markets Surveillance

This section is an attempt to study the Fund’s Role in Capital Flows and Financial Markets Surveillance. The recent financial crisis made it very clear how
inter-connected the world’s financial system has become. Due to this interconnectedness, capital as well as the risk flows across borders. The extent to which the risk is spread across borders is determined by the web of institutions that create the instruments that are bought and sold across borders. The regulatory systems overseeing capital markets and financial institutions are highly interdependent. Since those markets and institutions operate across borders, the supervisory and regulatory agencies within the country have also 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. Despite the coordination among these agencies, there are still gaps in the responsibilities of each of these institutions. Unlike as in the current account restrictions, where the IMF has clear jurisdiction, or in the area of trade where WTO has complete oversight responsibility, international capital flows, and the coordination and monitoring of banking and other financial supervision across borders, lacks an institution and a clear coordinating mechanism for clear oversight responsibility. The global system needs to be reformed to fill this gap and should make clear what the role of the IMF should be in that system.

2.11.2 IMF and Capital Account Liberalization

Since the establishment of the IMF, the global financial system has changed dramatically. Before, 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. Over time, more countries liberalized their accounts, and the volume of capital flows exploded. Most of the balance of payments crises that have struck countries in recent decades are due to the disruptions to capital flows.

In the beginning, IMF was supportive the liberalization of capital accounts. The OECD however was more active in this area, especially among the industrial countries. Much of the initiative for capital account liberalization beyond the OECD came from the countries themselves. Although the Fund was supportive in this
direction and helped the countries with technical assistance to members, its role was very 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.”

The member countries attempted to amend the Articles of Agreement in the mid-1990s to give more jurisdictions to the IMF over capital controls. The IMF, with its universal membership, seemed an appropriate institution to promote an orderly liberalization of capital movements. The reform efforts were put on hold due to the Asian crisis and also by the opposition that arose to giving such power to the Fund. They argued that more jurisdictions given to the IMF in this area would give the Fund more authority to push a more ambitious agenda of liberalization on emerging market and developing countries. However, the intention of giving this authority to IMF was to help make possible an orderly liberalization, and also to make available the Fund’s expertise on this issue to member countries with liberalization programs. Moreover, to give more confidence to members retaining restrictions, clear safeguard provisions were to be included. These safeguards were similar to those that were successfully employed by the Fund in removing the current account transactions. The safeguards would ensure the maturity of the liberalization program, and also the existence of flexible approval policies for the maintenance of restrictions, and that financial support would be available to members undertaking liberalization programs. The amendment initiative from the Interim Committee to the executive board, however, faltered during the course of 1998.

In addition to give the Fund jurisdiction over capital account restrictions, many believed that formalizing the Fund’s role in this area would encourage greater

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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. To encourage this work in the Fund, creation of new departments and reorganization of others were also encouraged. Although these administrative changes have produced positive results in the Fund’s work in this area, the Fund has not yet established itself as the central institution in the system. Thus, the gaps still remain.

IMF should be given a clear mandate in a renewed effort. It should be decided where exactly the IMF should be given jurisdiction in the area of capital accounts 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 is chosen, the IMF should be given jurisdictional authority through an amendment to the Articles of Agreement after more experience with this expanded mandate is gained.

### 2.11.3 The IMF and 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. Although this is correct, it should not delay the needed work to build institutions in each country that can provide effective supervision. There is a need to monitor the policies and the practices of supervisory agencies to assure that best practices guide those agencies. This is essential to be implemented in all countries regardless of their economic strength. Unfortunately, such a desirable system for monitoring and assessment does not exist. There are numbers of agencies who play some role in this area, but no one has oversight authority or the coordination mechanism for such oversight.

There is however, a need for an overall review of the weaknesses in the system and an assessment of the role of the Fund in the system. There needs to be an integration of the capital account regime in countries with the domestic financial supervisory framework. There is a need for an institution to monitor the strength of
those systems at the global level. Under IMF mandate, this is a natural role for the Fund to foster global economic and financial stability.

The Fund already plays an important role in assessing the quality of countries’ financial systems. Through its bilateral and multilateral surveillance, the IMF assesses the risks towards the countries, the regions or the entire system 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 should encourage the member countries, the regional and also the international groupings practice appropriate regulatory actions and stability assessments through a more strengthened surveillance process. The Fund should consider:

- Making the FSAP a compulsory component of IMF surveillance;

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- 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, since it already is the major agency for macroeconomic surveillance in the international monetary system, and it has the developed methodology and staff to conduct the necessary financial assessments. Efficient surveillance of IMF could help reduce the fragmentation of responsibility that has existed across a multitude of forums and agencies with more limited memberships.

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.

To make the IMF surveillance effective for the next three years, the Review proposed the following operational priorities for 2011-2014:81

- Interconnections. Surveillance should be more multilateral. Promote spillover analysis and more cross-country surveillance work.

- Risk assessment. Identify the systematic discussion of risk through bilateral and multilateral surveillance. Deeper understanding of risk transmission channels and their policy implications should be achieved.

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• Financial stability. Adopt a strategic agenda for the Fund’s financial sector surveillance. Take further steps to mainstream financial stability analysis in bilateral surveillance. Strengthen understanding of financial interconnectedness and continue to address data gaps.

• External stability. Improve consistency and transparency of exchange rate analysis and ensure discussions of external stability in staff reports extend beyond exchange rates.

2.12 New Instruments to Strengthen the IMF Surveillance

Following the triennial surveillance review of 2011, the IMF has taken initiatives to respond better to a more globalized and interconnected world. These initiatives include revamping the legal framework for surveillance, deeper analysis of risks and financial systems, and stronger assessments of the members’ external positions. In order to do so, the Fund has established new instruments to achieve stronger surveillance.

2.12.1 Integrated Surveillance Decision

Since 2010, the legal framework for surveillance has been extensively discussed both within the IMF and outside it. The growing interconnectedness of the global economy is the main reason to seek integration of all surveillance work. Accordingly, the IMF introduced a new Decision on Bilateral and Multilateral Surveillance in July 2012 (the Integrated Surveillance Decision [ISD]).

While the exchange rate policies oversight of the member countries are at the core of IMF surveillance, the Integrated Surveillance Decision enhances the authority of IMF surveillance in a number of important ways: First, it puts a greater emphasis on multilateral surveillance by focusing more on issues relevant to global economic and financial stability. ISD gives more scope to the multilateral surveillance by allowing the Fund to discuss with the member countries the full range of spillovers from its economic and financial policies onto global stability. Plus, the ISD improves IMF’s bilateral surveillance by guiding the member countries with respect to their exchange rate policies and how their domestic stability is affected by it, and by

helping the member countries take better policies to improve their domestic stability. Finally, it enhances the scope of multilateral surveillance by guiding the member countries to be more mindful of the impact of their policies on global stability. ISD also provides a framework for multilateral consultations.

Bilateral surveillance is at the core of IMF’s mandate at the moment although the recent crises brought forward the urgency of strengthening the multilateral surveillance. The overlay of multilateral considerations sought to be brought into Article IV consultations under the guise of integration of bilateral and multilateral surveillance in the new ISD should not compromise the pursuit of robust and even-handed bilateral surveillance, and better peer review with symmetric treatment of all countries. While there is merit in integrating top-down multilateral analyses with country-level surveillance, it is important to further improve the incisiveness and traction of bottom-up approaches, as they deliver granularity to monitoring and policy advice.

The success of the surveillance is ultimately contingent on the underlying analytical framework. In this context, the findings of the Independent Evaluation Office (IEO) report on the IMF’s surveillance during 2004-07 are relevant report.83 The IEO report observed: “The IMF’s ability to correctly identify the mounting risks was hindered by a high degree of groupthink, intellectual capture, a general mindset that a major financial crisis in large advanced economies was unlikely, and incomplete analytical approaches. Weak internal governance, including unclear lines of responsibility and accountability, lack of incentives to work across units and raise contrarian views, a review process that did not “connect the dots” or ensure follow-up, and an insular culture also played a big role, while political constraints may have also had some impact”.84 If the factors flagged by the IEO report are not adequately addressed, the ISD is not going to facilitate more effective surveillance.

83 International Monetary Fund, 2011, “IMF Performance in the Run-Up to the Financial and Economic Crisis.” January. IEO.
2.12.2 Pilot External Sector Report

To assess the external stability and external imbalances in the international monetary system better, the IMF established the Pilot External Sector Report in 2012. This initiative was taken to identify the causes of external instability and minimize its effects sooner. The report will have a thorough analysis of the world’s largest economies since their actions affect the stability of the monetary system most of all. The report should contain a multilaterally consistent assessment of members’ external balances, currencies, and policies. The analysis broadens external sector surveillance by more systematically assessing, in addition to exchange rates, current accounts, balance sheet positions, reserves adequacy, capital flows, and capital flow measures. The first Pilot External Sector Report was published in July 2013.

Apart from the ISD and the Pilot External Sector Report, the IMF continues its spillover reports that are published yearly to assess the impact of economic policies in the world’s five largest economies. These economies include the United States, China, Japan, the United Kingdom and the euro area. The 2013 report examined potential spillovers arising from the euro area crisis, U.S. fiscal and monetary policy, structural and fiscal reforms in Japan, and a possible slowdown in China.

Finally, it is important to recognize that traction, the final objective of surveillance — the translation of succinct and sharp policy advice into concrete policy actions —depends on trust and the perception of even-handedness without any sacrifice of candour. This is inextricably woven into the IMF’s governance structure. Modernization of surveillance must flow from and cannot precede reforms in governance. As governance reforms progressively reflect the changing global economic realities, so too will the IMF’s surveillance gain legitimacy, incisiveness and traction.
2.13 Conclusion

The next surveillance review of the IMF will take place by the end of 2014. The review will consider how effectively the Fund is implementing its integrated surveillance framework; examine the consistency and focus of the IMF’s policy advice; and look at the even-handedness of IMF surveillance across its membership. It is important to note that the surveillance becomes more effective when it is more integrated with the IMF lending and its technical assistance. All these instruments together will be able to detect the instabilities of the international monetary system at earlier stages. However, it is important to note that all other aspects of the IMF are affected by the governance anomalies. Until and unless the countries are confident in their position in the IMF, all other actions including the surveillance of the IMF will be affected by it.