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The International Monetary Fund and Regulatory Challenges

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Abstract

The International Monetary Fund (IMF) plays a substantial regulatory role in the international monetary and financial system. The IMF has been assigned a formal regulatory role in a limited number of areas such as obligations covering exchange rate policies. The Fund has a broader informal regulatory role derived from the voluntary consent of its members such as in surveillance over members' financial sector policies and international payments imbalances. The IMF's regulatory role is unlike that of its member governments within their own jurisdictions. The Fund's formal and informal regulation must be constantly nurtured and renewed via peer-review processes.

Keywords: IMF, Articles of Agreement, regulation, Special Data Dissemination Standard (SDDS), General Data Dissemination System (GDDS), Bretton Woods, WTO, special drawing rights (SDR)

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INTRODUCTION

The International Monetary Fund (IMF) is an intergovernmental organization of 186 member countries. Its role differs from that of a national regulatory organization. In the national context, regulation is established by law.[1] Following the provisions and procedures of such laws, the regulator sets and enforces rules that direct and often constrain the behavior of private agents, such as banks or drug companies. The regulator is directly linked to its government and the government's enforcement powers. In a democratic society the government, in turn, acts over time by the consent of the governed.[2]

By agreement among its member governments, the IMF is charged with regulating the policies and activities of those same governments. The IMF's regulation is largely principles-based rather than rules-based. Its principles take the form of formal obligations or informal agreements. In either case, they are implemented by peer-review processes that involve few potential, and fewer actual, penalties for member governments that fail to abide by the agreed principles. Thus, it can be argued, as does Louis W. Pauly (2008 and 2009), that the IMF's regulatory authority involves only—or primarily—soft laws of mutual self-restraint in which the role of the IMF is as an intergovernmental referee or a multilateral mechanism to blunt some of the destructive excesses of national sovereignty in a common global interest.

In contrast, the World Trade Organization (WTO) describes itself on its website as dealing with the rules of trade between nations that are negotiated, become contractual obligations among the parties, and are enforced through a dispute settlement process involving calibrated potential penalties. Binding obligations are central to the WTO. In the words of Robert Lawrence (2009), "A central purpose of the WTO is to establish the rule of law in the trading system. This is not going to be achieved if agreements are not mandatory. . .[and] binding on all members. . ." via potential enforcement penalties.

The IMF's regulatory role, broadly defined to include more than formal obligations, involves the entire range of economic and financial activities of member governments.[3] That role potentially includes, but is not limited to, governmental activities affecting specific sectors of the economy, such as the

1. The *American Heritage Dictionary* of 1994 defines the verb "regulate" as "to control or direct according to rule, principle, or law." The IMF's Articles of Agreement are technically national laws because they are ratified by parliaments and legislatures. However, the normal, national enforcement mechanisms generally are not available.

2. Some of the criticism of the IMF, and of other international organizations, is that some of its member governments are not sufficiently responsive to the wishes of the citizens of those governments. This situation leads to appeals by interest groups to other governments to impose greater responsiveness or responsibility on the irresponsible governments via the IMF itself. The IMF management, with the tacit support of IMF member governments, recently has reached out to these self-appointed, civil society groups as a "fourth pillar" in the process of reforming the IMF and its executive board. (IMF 2009a) The other three pillars are the IMF executive board, the IMF Independent Evaluation Office, and a committee of eminent persons under the chairmanship of Trevor Manuel.

3. The scope of IMF regulation has been broadened over time by the consent of IMF members to include areas of economic and financial policies that were off limits in 1944 because they were held to be purely domestic in their effects. That broadening has impinged to some degree on perceived national sovereignty and often has been controversial.

financial sector. Thus, IMF's regulatory scope is considerably broader in practice than that of a regulator in the national context, but that role is dependent on the initial mutual consent of governments to subject themselves individually to the IMF's oversight and subsequently to adjust their policies in response to that oversight. The oversight or regulatory role is enforced to a substantial degree via its members' self-application of peer-review processes.

The IMF's regulatory authority derives from its Articles of Agreement. Article I states the IMF's purposes that guide its policies and decisions, such as the promotion of monetary cooperation, the facilitation of the balanced growth of international trade, and the maintenance of a high level of employment and real income. The words in Article I are essentially unchanged from those agreed upon at Bretton Woods, New Hampshire, on July 22, 1944.[4]

The IMF's Articles also establish a limited number of specific obligations on member governments. They authorize various activities of the IMF, including undertaking additional collective activities in the context of the Articles that are consistent with its purposes.

Finally, the Articles establish various procedures to be followed by the IMF. The most important of those procedures involves the surveillance activities of the Fund with respect to individual members, groups of members or regions, and the global economy and financial system. Thoughtful critics such as C. Fred Bergsten (2009) argue that "The IMF has failed repeatedly to exercise effective surveillance over the policies of its major member countries and to create mechanisms that would foster coordination of either their macroeconomic policies or their financial regulation." However, one may ask who is the IMF in this context? My answer is that the IMF is not some disembodied abstraction located at 19th Street, NW in Washington, DC. The IMF in the end is its member countries.[5]

Even in the few areas where the Articles establish explicit and implicit obligations on member countries, enforcement is not automatic. Those obligations fundamentally are enforced via a peer review process. Moreover, aside from naming and shaming a member for its transgressions, the IMF has only a limited number of enforcement tools, such as denying access to IMF credit, limiting voting rights, and—at the extreme—expulsion from membership in the Fund. However, its members must decide to apply any of those tools to other members. This means that IMF members not only must: (1) agree in advance that they will individually benefit if all members abide by their explicit and implicit obligations; but (2) they must also, in effect, renew their agreement as part of a ongoing peer-review process—including at times when economic and financial conditions and perceptions of national self interest have changed relative to when the obligations were established.

4. The Articles of Agreement entered into force on December 27, 1945.

5. Biagio Bossone (2008) puts the matter more directly, "governments pretend to ignore—and public opinion worldwide does ignore—that the IMF is as relevant and effective as its member governments (especially the largest) want it to be." I would argue that "largest" should be read in the plural, but some would read it as the United States.

As part of this process, the IMF's member governments, primarily through the executive board and the International Monetary and Financial Committee, guide the activities of the IMF, including the activities of the IMF's management and staff. The management and staff of the IMF are highly relevant to the execution of the IMF's regulatory role. They can propose actions, prod member governments, seek to broaden support for initiatives, and implement decisions endorsed by members. However, if members do not consent, the management and staff are constrained in what they can do. In the end, the IMF management and staff must rely on their reputation for competence and impartiality to enhance their own credibility, influence, and legitimacy.

In IMF lending, the IMF management and staff have considerable influence over member countries and their policies, in effect, acting as policy regulators in the process. However, much of such lending and the associated regulatory activity is episodic and is not applied to all members equally because many members have no prospective need to borrow from the IMF. A decade ago, the IMF faced considerable criticism that its lending activities were insufficiently episodic. One consequence was that the first report of the IMF's new Independent Evaluation Office (IEO) addressed the perceived problem of "protracted users" of IMF resources (IEO-IMF 2002). Since that report was issued, reflecting the report's influence as well as benign economic and financial conditions that prevailed for several years until September 2008, the phenomenon of prolonged use has been reduced so that it now is relevant primarily to 20–30 members that are eligible to borrow from the Poverty Reduction and Growth Facility (PRGF). That lending does raise concerns about protracted use of IMF resources and the role of the Fund relative to the World Bank. However, it does not involve the IMF's regular quota resources. The resources are borrowed from other members specifically to finance PRGF lending. Moreover, until September 2008 the scope and scale of PRGF lending had declined significantly from earlier in the decade.

When a member country borrows from the IMF, normally it is required to alter its policies in order to qualify for financial assistance. The country is free to reverse those policies once it has repaid the IMF. In fact, most countries do not, suggesting that the new policies were more acceptable to the political leadership of the country than is implied by many critics of the Fund and its policy prescriptions. The actual policy content of IMF programs is the evolutionary product of the experience of other member countries. The staff and management of the IMF seek to apply the lessons of previous programs informed, or misinformed, by the current consensus about which economic and financial policies are effective and why. The programs themselves are approved by representatives of member countries who sit on the executive board.[6]

Many observers, in particular those who are critical of policy content of IMF-supported programs,

6. Some observers argue that the members of the executive board should and do represent the IMF as a whole rather than their individual countries or constituencies, but the reality is that they do not.

would challenge all or part of this characterization of the lending role of the IMF, including its regulatory role broadly defined in this activity. Those criticisms are somewhat justified. They are largely rooted in a critique of the IMF's governance—in particular the dominant influence of North Atlantic countries (post–World War II Europe, the United States, and Canada) plus Japan over the IMF's management and staff's policy preferences, decision making, and analytical frameworks. The IMF would remain an intergovernmental organization even if the IMF's governance were changed substantially to: increase the relative voting power of emerging and developing countries as a group to reflect their increased relative importance in the global economy; and to reduce both the voting power of the traditional industrial countries and the overrepresentation of European countries on the IMF's executive board.

It follows from this critique that one of the IMF's chief regulatory challenges lies in the fact that perceived weaknesses in its current governance structure adversely affect the IMF's legitimacy, effectiveness, and perceptions of the Fund's impartiality. Given that the IMF exercises its regulatory role largely by peer-review processes and mutual consent, member governments and ultimately their citizens must be comfortable with the IMF's decision-making processes. In the absence of such comfort, the IMF is perceived as an abstraction. The IMF's policy prescriptions, advice, and recommendations more easily can be portrayed as not being even handed. These governance concerns have some merit in my view. However, this article is not the place to address these issues. I and others have done so elsewhere.[7]

Setting aside the issue of IMF governance and how it relates to the IMF's regulatory challenges, the balance of this article illustrates some of the regulatory challenges, broadly defined, for the IMF and its members.

I first look at some of the challenges that flow from the obligations that members agree to when they join the IMF. These are areas of formal IMF regulation in the sense that these obligations are clear and, on their surface, might be viewed as essentially self-enforcing. These areas appear to be the simplest areas of regulation, but in practice they are not because actual enforcement requires recycling the basic provisions through a peer-review process.

In the second section, I examine an area of informal regulation that IMF members have agreed flows from the purposes of the IMF but that does not directly involve a formal obligation recorded in the Articles of Agreement: the IMF's Financial Sector Assessment Program (FSAP).

Finally, against this background, I consider an area of past and future IMF regulation: the global growth and adjustment. I conclude that the IMF's success in delivering this public good will depend less on its formal regulatory role and more on its informal regulatory role.

More broadly, even in areas in which IMF members have granted formal regulatory authority

7. A sample of some of the many treatments of these issues can be found in Bryant (2008a, 2008b), Cooper and Truman (2007), and Truman (2006a, 2006b, 2008, and 2009a).

to the Fund as an institution, the IMF's regulatory authority must be continuously nurtured and renewed through peer-review processes. Ultimately, those processes may become so ingrained that they become accepted convention and as such are self-enforcing. As a consequence, the IMF would acquire a substantial degree of de facto, independent, regulatory authority. However, that is not the case today.

FORMAL IMF REGULATION

The IMF Articles of Agreement specify a small number of obligations on members that many would regard unambiguously as regulation. Most of the obligations are found in Article IV on exchange rate arrangements and policies, Article VIII on general obligations of members, and in Articles XV–XXV on special drawing rights (SDR). They relate, for example, to financial transactions with the IMF and among members. In this section, I examine three of those obligations to illustrate some of the complexities of the IMF's regulatory role: the provision of information to the management and staff of the IMF, exchange-rate policy guidelines, and the role of SDR.

Under Article VIII, section 5, the IMF may require members to furnish a detailed list of information to discharge the duties assigned to the Fund, including designing lending arrangements and conducting its surveillance functions. Members supply information to the Fund that is not on the list, but they do so only voluntarily. The list in Article VIII includes information on official holdings at home and abroad of gold and foreign exchange. However, as reported by the Independent Evaluation Office of the IMF (IEO-IMF 2007), countries sometimes fail or decline to provide that information. In some cases the management and staff have been reluctant to press the issue and bring it to the attention of the executive board for enforcement.[8] One reason is that the enforcement of even such a well-defined obligation is not self-executing. Enforcement is via a peer-review process conducted by the executive board, which may decide to overlook a specific transgression.[9]

Under these circumstances it is hardly surprising that member countries holding almost 40 percent of reported total holdings of foreign exchange reserves decline voluntarily to provide the IMF staff information on the currency composition of their reserve holdings—even when the IMF staff has promised to control tightly access to such apparently sensitive information and only to report it on an aggregate basis.[10] Without such information the IMF is hampered in monitoring aggregate trends in the diversification of international reserve holdings and their effects on the stability of the international financial system as a whole. In their analysis, the staff can only extrapolate from the information they do have.

8. Some examples of shortfalls in data provision to the IMF are recorded in Appendix II of IMF 2008b.

9. Alternatively IMF management and staff may decide not to bring the issue to the executive board because they suspect that the board will not support them in their view that the country in question has failed in its obligation to cooperate with the IMF.

10. In fact, at least two dozen members of the IMF publish information on the currency composition of their reserves.

Similarly only 63 countries, about a third of the total membership, subscribe to the IMF's Special Data Dissemination Standard (SDDS), which is designed to provide economic and financial information about countries to market participants under an agreed standard of timeliness and comprehensiveness. Another 96 members subscribe to the less exacting General Data Dissemination System (GDDS).[11] Only 27 members do neither. Since the establishment of the SDDS in 1996 only six countries that formerly were subscribers to the GDDS have upgraded to the SDDS. It is also noteworthy that two of the Group of Twenty (G-20) countries (China and Saudi Arabia), whose members are often identified as the major systemically important countries, do not subscribe to the SDDS. It is plausible to infer that some of the emerging market countries that do subscribe to the SDDS might not do so except that they were strongly encouraged to do so in the context of receiving IMF financial support in the late 1990s.

The original articulation of the SDDS and the encouragement of members to adhere to it is an example of informal IMF regulation discussed in the next section, but it is a natural outgrowth of formal IMF regulation. The SDDS has been a success in the sense that the participating members now provide a public good, and some of the scope that governments had to disguise impending economic and financial problems from markets and citizens has been reduced. On the other hand, it is natural that the authorities of some countries resent the manner in which this "voluntary" activity was imposed on them. They see it as mission creep that undermines the IMF's legitimacy.

Given the fact that seemingly trivial regulatory matters, such as the provision of information to the IMF staff, are a challenge for IMF members to implement and enforce, it is no surprise that the challenge is even greater when it comes to members' exchange rate obligations. Exchange rates, of course, have always been central to the IMF's core mission. Under the Bretton Woods Articles of Agreement, members were to maintain par values and were only to change them to correct a fundamental disequilibrium in their international payments, and then only with the consent of the IMF. The framers of the IMF Articles may not have intended the system to be as rigid in practice as it turned out to be. On the other hand, there were a few exceptions to that rigidity in the other direction. For long periods before the breakdown of the Bretton Woods system of exchange rate arrangements in 1971, the Canadian dollar floated. Canada, a widely perceived paragon of an internationally responsible country, in effect flouted its IMF obligation in this area.

After the final collapse of the Bretton Woods exchange rate system in March 1973, the collective wisdom of the finance ministers and central bankers on the Committee of Twenty was that exchange arrangements should continue to be based on "stable but adjustable par values" though countries were to be allowed to "adopt floating rates in particular situations subject to Fund authorization, surveillance,

11. Hong Kong, a Special Administrative Region (SAR) of China, subscribes to the SDDS and Macao, an SAR of China, subscribes to the GDDS as does China.

and review" (IMF 1974). It was not until late 1975 that a consensus was forged permanently, at the sole discretion of the individual countries, to allow countries to float their currencies and at the same time remain in compliance with their IMF obligations. That agreement did not become effective until April 1978 when the second amendment of the IMF Articles of Agreement entered into force. The 1975 compromise language on exchange rates included a provision that by an 85-percent majority vote the members of the IMF could return to a system based on stable but adjustable par values.

Under Article IV on exchange arrangements, member countries have an obligation to collaborate with the Fund and other members "to assure orderly exchange arrangements and to promote a stable system of exchange rates" and also to "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." The Fund itself, meaning its members as well as the management and staff, was directed to oversee the international monetary system to ensure its effective operation and to monitor each member country's compliance with its policy obligations.

To this end, in 1977 the IMF executive board adopted a decision to guide IMF surveillance over members' exchange rate policies[12] (IMF 1977).

Exchange rate policies continued to be controversial for the IMF. For a considerable period after 1978, many members remained intellectually attached to par values or fixed exchange rates. For some members, that attachment continues to this day, generally via pegs to the US dollar. Over time an increasing number of members became more comfortable with exchange rates that floated substantially or to some degree. But some countries remained committed to pegged exchange rates.[13]

Some observers argue that the IMF has been an inadequate umpire for member countries in their conduct of their exchange rate policies—tolerating too much rigidity in certain exchange rates to the detriment of the process of external adjustment (Goldstein 2006 and Mussa 2008). These critics of the Fund's regulation under Article IV were supported by a scathing report by the IMF's Independent

12. As reported by Pauly (2008), there was great resistance in the executive board at the time to granting the Fund effective new powers including any surveillance over members' economic policies. When the IMF was founded, its surveillance activities were limited to countries that had not accepted the obligations of current account convertibility in Article VIII and were in a transitional status under Article XIV. In 1960, at the initiative of the United States, voluntary Article VIII consultations were introduced. Under the new Article IV of the second amendment to the Articles of Agreement, these consultations became required for every country. Nevertheless, some countries have refused to cooperate from time to time.

13. Except for a small country with close economic and financial ties to a larger country, it is unclear in this context what a country gains if its bilateral exchange rate is fixed to another country's currency when that other country's currency fluctuates substantially vis-à-vis other major currencies. The answer given by some is that the fixing country can import the monetary policy of the country to which its currency is fixed. That argument is less than persuasive when the first country has strong capital controls, which provides scope for an independent monetary policy even when its currency is pegged. Another answer argument is that issuers of the major currencies should limit the movement of their currencies vis-à-vis each other, perhaps, based on a set of reference rates defined in effective terms as an average against all, or all relevant, currencies (Williamson 2006 and Cline and Williamson 2009).

Evaluation Office (IEO-IMF 2007) that documented the extent to which the IMF executive board, management, and staff in recent years had ignored the 1977 guidelines on surveillance of members' exchange rate policies. In carrying out their *informal* surveillance roles as part of the *formal* IMF regulation of such policies, the management and staff of the Fund, according to this view, failed to do their jobs and in the process undermined the IMF's legitimacy. In response to the critics, members of the IMF through the executive board revamped the decision on exchange rate surveillance in June 2007. (IMF 2007a). It introduced two new concepts, "external stability" and "fundamental misalignment," into reviews of members' exchange rate policies.[14]

The 2007 decision was criticized for not breaking any new ground and for confusing, rather than clarifying, the nature of the exchange rate obligations of members. The decision focused only on the bilateral surveillance of a member's exchange rate policies, sidestepped issues of surveillance of the multilateral consequences of such policies and of the member's internal policy consistency. For example, Stanley Fischer (2007), the former deputy managing director of the IMF, was critical of the 2007 decision for placing too much emphasis on external stability and too little on other policies, such as fiscal policies, that may affect internal balance as well as external adjustment. The decision also essentially gave a pass to any country whose exchange rate is floating, such as Japan, but whose policies, nevertheless, may be frustrating the functioning of the global balance of payments adjustment process via their effects on exchange rates.

More importantly, more than a year later in 2008, the 2007 decision had produced no tangible results affecting members' exchange rate policies. It was widely understood outside the IMF that the staff had identified for the executive board a few situations that, under the new decision, merited consideration of the implications that a country's exchange rate policy had for its own external stability or that might involve fundamental exchange rate misalignment, but the executive board declined to accept the staff's judgment in their exercise of peer review. In addition, the completion of several countries' Article IV consultations was blocked by the authorities of the countries involved, including systemically important countries such as China. This was not an accident; China reportedly had voted against the 2007 decision.

In response to this lack of results, the executive board in August 2008 implicitly endorsed the IMF management's procedural clarification of the 2007 decision that involved the possible option of an ad hoc consultation with a member in cases where a member might not be observing the principles for guidance of its exchange rate policies or where its exchange rate might be fundamentally misaligned (IMF 2008a). The clarification did not break the stalemate surrounding IMF executive board consideration of Article IV surveillance reports for countries where sensitive exchange rate issues were involved.

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14. The 1977 decision had been tweaked before, for example, by adding in 1995 a reference to unsustainable private capital flows, but fundamentally it was unchanged from 1977 to 2007.

As a consequence of this second failure to implement new procedures for bilateral surveillance of exchange rate policies, the IMF management reversed course and, in June 2009 (IMF 2009d) informed the executive board that it was withdrawing its 2008 guidance about the possible use of an ad hoc consultation as part of its surveillance tools with respect to a member's exchange rate policies. Additionally, among other changes, it was revising its procedural guidance in connection with the 2007 decision on bilateral exchange rate surveillance to eliminate the required use of labels such as "fundamental misalignment." The stated purpose was to break the stalemate with respect to the Article IV consultations with certain members, including China. In that respect, the changes were successful, and a public information notice on the completion of China's 2008 review was released on July 22, 2009.[15] One interpretation of this sequence of events is that the IMF management and staff and members of the institution ultimately failed in their collective formal regulatory role in this area.

An alternative interpretation of this situation is that there never had been substantive agreement about each member's exchange rate policy obligations as an area of formal, required IMF regulation. In trying to establish or reestablish one in 2007, the new procedures had been skewed so that they were not evenhanded—in particular with respect to the application of labels and resulting judgments about a member's policies and their consistency with that member's obligations in the IMF. In short, the IMF management and staff, with the support of some members, were not being fair. As a by-product, according to this view, the legitimacy of the institution as a whole was being undermined.

From a systemic point of view, this sorry tale is informative as well as distressing. It illustrates the limits to the IMF's formal regulatory role even in circumstances in which that role would appear to be firmly grounded in the IMF Articles of Agreement. It may well be that the management of the Fund was not sufficiently aggressive in implementing its responsibilities. However, the central point is that not enough members of the IMF wanted the IMF management to be proactive in this area. An individual country would find it difficult to flout this type of obligation without the tacit consent of a sufficient number of its peers. Those peers had their own individual motivations, which doubtless were many and complex. The unfortunate result, as viewed by some, is a weaker IMF. As viewed by others, the IMF may be stronger because it has become more balanced and legitimate in implementing its regulatory responsibilities.

One clear inference from this situation is that proposals to enforce IMF exchange rate obligations via the WTO's dispute settlement apparatus (Mattoo and Subramanian 2009) are nonstarters, or if started are doomed to a similar death. The reason is that the WTO process enforcing foreign exchange obligations requires two triggers. One trigger is at the IMF, which would have to find a violation of an IMF obligation. The other is at the WTO, which would have to act on that finding. Based on recent history, the first trigger would never be pulled, making the second trigger irrelevant. The likely

15. As of November 2009, four months later, China had not agreed to the voluntary release of the underlying staff report.

consequence of trying to implement such procedures would be that both the IMF and the WTO would lose legitimacy.

A third example of an obligation that IMF members have under the Articles of Agreement concerns their policies on reserve assets. Article VIII Section 7 obligates each member "to collaborate with the Fund and with other members in order to ensure that the policies of the member, with respect to reserve assets, shall be consistent with the objectives of promoting better international surveillance of liquidity and making the special drawing right the principal reserve asset in the international monetary system." Many observers would be surprised that members of the IMF have these two obligations, which were part of the second amendment of the Articles in 1978. For decades, members by mutual, universal, implicit consent have not acted individually or collectively on either aspect.

Until April 2, 2009, when the G-20 leaders in London endorsed the IMF issuance of $250 billion in SDR, very few well-informed observers under the age of 60 would have been able to describe the SDR or their formal intended role in the international monetary system.[16] In June 2008, SDR were less than 0.5 percent of global (nongold) reserves.[17] Over the past 30 years, since the approval of the second amendment of the IMF Articles, members of the IMF clearly have not collaborated with each other or the Fund to make the SDR the principal reserve asset in the international monetary system, nor have they paid any attention to the growth of international liquidity.

The reasons are two: First, the SDR provisions were introduced into the IMF Articles at a time when the authorities of many member countries desired and expected a return to a more rigid, or disciplined, international monetary system based primarily on par values, but on par values that were not to be linked to gold, which—along with an individual national currency—was explicitly excluded by the second amendment to the IMF Articles as the common denominator for par values.[18] Second, although there was a second allocation of SDR in 1979–81, following the first in 1970–72, agreement could not be reached subsequently to resume SDR allocations. Instead, countries added to their reserves by, in effect, relying on the private market through capital inflows and current account surpluses to accumulate additional foreign exchange reserves largely but not exclusively in US dollars. This process of ad hoc reserve creation was implicitly considered by IMF member countries to provide an appropriate level and growth rate of international liquidity.[19]

16. John Williamson (2009) details the history of the SDR.

17. In September 2009—with the approval of the fourth amendment to the IMF Articles of Agreement authorizing: (1) a special allocation of about $33 billion in SDR to members, which were not distributed in proportion to current IMF quotas; and (2) the general allocation of $250 billion in SDR, which were distributed in proportion to IMF quotas—the SDR's share was still less than 5 percent.

18. The presumption was that the SDR would be the common denominator, but Schedule C of the Articles of Agreement permitted the IMF to establish another common denominator without specifying what such an alternative might be.

19. Strictly speaking, to the extent that the alternative involved an allocation of SDR, such an allocation would have

This implicit judgment was loosely consistent with international surveillance of liquidity as required by the IMF Articles, but it was a rather indirect way for IMF members to discharge their mutual obligation. In fact, over the past decade the IMF and its members have exercised very little in the way of surveillance over international liquidity even as the world holdings of nongold reserves increased by 3.5 times from the end of 1999 to the end of 2008 as world GDP, measured in US dollars, only doubled. Even more so than has been the case with exchange rate policies, members of the IMF were unconcerned about the resulting explosion of global liquidity. The IMF management and staff also did not push for an examination of the issues involved. By tacit, mutual consent, these two obligations calling for formal IMF regulation were ignored by the IMF's peer-review processes.

During the first half of 2009, suggestions were made not only to revive the SDR as the principal reserve *asset* in the international monetary system but also to establish the SDR as a reserve *currency* (Ocampo 2009). As discussed by Barry Eichengreen (2009), the latter would be a technically complex task, in particular given the past lack of market acceptance of, and enthusiasm for, composite currency units. Moreover, to establish the SDR as the principal reserve asset and to limit the use of national currencies in this role would require a thorough reconfiguration of the international monetary system. Many countries would have to agree to a substantial number of additional obligations with respect to their economic and financial policies that would require much more in the way of formal IMF regulation than anything currently contained in the IMF Articles of Agreement and agree to their effective enforcement via IMF peer-review processes.

For example, the dollar may be the principal reserve currency today, but it accounts for less than 65 percent of all reported official holdings of foreign currency reserves. Countries not only would have to give up or limit their accumulation of US dollars in their reserves, but also would have to give up or limit the accumulation of reserves denominated in euro, yen, sterling, Swiss franc, and all other national currencies. To be effective, the issuers of all such currencies also would have to agree to limit the use of their currencies in the reserves of other countries, for example via an asset settlement obligation to convert balances of their currencies accumulated by other currencies into SDR. To support this structure, there would have to be an enforceable mechanism to control the overall expansion of international liquidity in the form of further accumulations of foreign exchange reserves. This would imply much tighter surveillance over exchange rate policies and other aspects of the international adjustment process than is the case today. Finally, unless the structure of the international private financial system was dramatically transformed, the international role of the US dollar would be essentially unaffected by any changes governing the official use of the US dollar or any other reserve currency. Official holdings of US dollar assets in the international financial system are today a small part of total holdings. As of the end

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required an 85-percent weighted majority vote and that majority was not forthcoming.

of 2008, official holdings of US dollar assets were less than 15 percent of a conservative estimate of total international dollar assets.[20]

The result would be a vast expansion of the role of the IMF as a formal regulator. Some may think that countries not only should, but also will, agree to such an expansion of the IMF's role, consent to the associated new obligations and strictures on their behavior, and abide by collective judgments on their compliance with those new formal regulations. I am highly skeptical.

Successful formal regulation by the IMF requires more than a strong mandate to be effective. It requires a supporting peer-review process that continuously renews commitments of countries to accept limits on their sovereign discretion. In each of the three examples that I have discussed, the IMF's mandate for formal regulation has been clearly established. However, IMF-member peers have chosen by their actions and inactions collectively to ignore much of the substance of those mandates.

INFORMAL IMF REGULATION

Areas where the IMF plays an informal regulatory role are those in which there is no direct link in the IMF's Articles of Agreement. In these areas, IMF member countries first must agree that the IMF should play a role and, second, they must voluntarily participate. One example that I have already mentioned is the SDDS/GDDS program. Another prominent example is the FSAP. In one part of this program, a member country volunteers to have a team assembled by the IMF—and in some cases by the World Bank—examine the strengths and weaknesses of its financial system and identify key sources of risk. The results of these comprehensive examinations may be published, but only with the permission of the country. Reports also are produced and, with permission of the country, published on a country's observance of a dozen internationally agreed standards and codes, ranging from transparency standards such as the SDDS or GDDS, to anti–money laundering standards and principles for corporate governance. These reports are called Reports on the Observance of Standards and Codes (ROSCs). The FSAP process also includes Financial System Stability Assessments (FSSAs) that, along with the other elements of the FSAP process, feed into IMF surveillance of each member's economic and financial policies as parts of the Article IV consultation process and into associated policy dialogues. In many, but not all, circumstances reports are published.[21]

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20. Total international holdings of dollar assets in this calculation include all financial claims on the United States plus other international financial assets denominated in US dollars in the form of bank deposits held, money market instruments issued, and notes and bonds issued outside the United States. It does not include international contracts denominated in dollars such as for the delivery of agricultural products, gold, or other natural resources.

21. In 2008, the IMF executive board reviewed Article IV and similar reports for 176 of its 185 member countries and 82 percent of them were published—in some cases with deletions. There were no reports prepared for 9 members, including G-20 members Argentina and China, and reports were not published for 31 other members, including G-20 members Brazil and Saudi Arabia. In 2008, only 46 percent of the 28 completed FSSAs were published, and only 58 percent of the completed ROSCs were published (IMF 2009c).

This type of activity by the Fund began in a systematic way in the late 1990s in the wake of the Mexican and Asian financial crises. As described by Carlo Gola and Francesco Spadafora (2009), financial sector surveillance by the Fund has evolved with the evolution of global financial markets, albeit with somewhat of a lag. However, this evolution also has been controversial within the IMF membership. Some countries argued that the FSAP reviews were either too intrusive or in some respects essentially irrelevant to them or to IMF's mission. Other countries argued that topics such as money laundering and terrorism financing are not properly on the agenda of an international *monetary* organization. Still others argued that the expenditure of staff resources in this area was disproportionate to the associated benefits. Participation in the entire FSAP process is voluntary. Moreover, it would not have been agreed, and implemented as broadly as it has been, without the impetus from the financial crises of the 1990s. Following those crises, countries had to reestablish their bona fides with the private market and one way to do so was to agree to participate in the FSAP process.

However, not all IMF member countries have done so. As of the end of September 2008, 126 members of the IMF had participated or were completing their participation in the program, including 15 of the 19 countries that are regular members of the G-20. The exceptions were Argentina, China, and Indonesia, as well as the United States. In 2006, the United States belatedly agreed to participate after first having agreed to do so in 2000 and then changing its mind.[22] China has also signed up recently.

In the context of the 2007–09 global economic and financial crisis, each of the G-20 countries has now committed to participating in the FSAP program, including periodic updates. (It took a crisis to establish, as well as to reinforce, the IMF's informal regulatory role in this area.) It is likely that the IMF's informal regulatory role, with respect to the financial system, will be further reinforced over the next several years via the adoption of new internationally agreed standards and codes. Possible topics include standards for: the resolution of complex cross-border financial institutions; the liquidity of financial institutions; the rescue of financial institutions; and determining whether a financial institution, market, or instrument is systemically important.[23]

One should not minimize the positive contributions from IMF informal regulation under the FSAP, but it is important to be clear about the nature of that regulation. Even more so than with explicit

22. It is highly doubtful that an FSAP for the United States conducted, for example, in 2003 when it most likely would have been scheduled, would have produced a diagnosis of either the problem of excessive leverage in the US financial system or flaws in lending standards for housing finance. However, the United States might have escaped considerable, well-deserved criticism and received some marginal benefits as well. Certainly, the international financial system and peer-review processes generally would have benefited. The role of the IMF as an evenhanded, informal regulator would have been enhanced.

23. In most but not all cases, the international standards are drawn up by standard-setting bodies outside the IMF but under the general purview of the expanded Financial Stability Board. The IMF and World Bank accept the responsibility, when asked by a country to do so, to police adherence to these standards. One standard now covers insolvency and creditor rights, but it has been under revision for several years.

obligations under the IMF Articles, countries must consent voluntarily to a peer-review process governing IMF informal regulation. Peers along with market forces can exert powerful pressures on the authorities of countries to grant such consent. Once granted, the authorities of those countries may pay a price for withdrawing from the process of informal regulation, but some countries have done so and some even have openly rejected IMF formal regulation. For example, Argentina and Venezuela have recently opted out of Article IV surveillance reviews of their economies and policies.

Is informal IMF regulation effective? My answer to that question is yes. First, informal regulation realistically is all that is available to the international financial system. The nations of the world are not ready for a framework of formal regulation in the financial area that comes even close to being self-enforcing. As was illustrated by the examples presented in first section of this article, formal IMF regulation to date often has been largely ineffective. To be effective, IMF formal regulation requires a supplemental peer-review process, which makes it broadly equivalent to informal regulation. Second, in areas such as FSAPs, the SDDS, IMF lending operations, and even the creaky procedures of its bilateral and multilateral surveillance over members' economic and financial policies, the IMF does provide valuable global public goods to the benefit of the international financial system as a whole and to the benefit of individual participants in the public and private sectors. The IMF could do more, as discussed in the next section, but it is up to its members on a continuing basis to want the IMF to do so.

FUTURE IMF REGULATION

As we have seen, international financial crises and periods of high volatility or stress in the international financial system tend to induce countries to consider the potential benefits of collective action to expand the IMF's regulatory role either formally by establishing new obligations, such as those governing exchange rates, or more frequently through voluntarily submitting to informal regulation without associated formal obligations. One important potential area of intensified IMF regulation is the global adjustment process. This is not a new area of IMF involvement.

The global adjustment process is tightly connected with the formal obligations of IMF members. Article I lists facilitating the expansion and balanced growth of international trade and contributing to high levels of employment as one of the Fund's purposes. Under Article IV members undertake the obligation to direct their economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability. IMF lending programs are intended to mitigate the negative effects of economic and financial crises on the specific member country as well as on other members.

The global adjustment process involves the avoidance of policies that promote or sustain international and domestic imbalances in the real and financial sectors. These policies include exchange rate policies as well as other policies. In the area of exchange rate policies, members have formal obligations under the IMF Articles. Thus, the global adjustment process should be central to the IMF's mission as a regulator, broadly defined, both formal and informal.

However, as we have seen in the area of exchange rate policies, the record of the IMF and its members has been uneven at best. The "firm surveillance" by the Fund that is called for in Article IV often has been controversial either in encouraging countries to adjust their exchange rate policies when the countries did not want to do so, in not encouraging countries to adjust their exchange rate policies when at least some other countries favored an adjustment, or in ignoring the issue entirely.

In recent years, the staff of the IMF reported frequently on the topic of global imbalances and the risks that they posed or did not pose to the stability and continued prosperity of the global economy. In the spring of 2006, the management of the Fund initiated a "multilateral consultation on global imbalances" involving China, the euro area, Japan, Saudi Arabia, and the United States. However, the results were disappointing to many observers (IMF 2007b). As far as an outsider could tell, the management of the Fund exerted no pressure on the participants to make new, specific policy commitments and participating members (the peers in the process) were unwilling to engage. The participants' resulting statements of their policy intentions contained nothing new. This is an instance where peer pressure did not produce results. The mutual consent to engage in the process at best resulted in an increase in understanding and minimized differences. The IMF management and staff had not done their peer-review homework in advance of the initiative and chose not to name and shame the participants when they failed to participate fully.

Curiously, the IMF staff in a paper prepared for a UN conference on the economic and financial crisis (IMF 2009b) identified global imbalances as the third of four causes of the economic and financial crisis of 2007–09.[24] The staff paper states that the IMF-sponsored multilateral consultations in 2006–07 included specified policy shifts and goes on to say "the agreed initiatives in general were not implemented as planned." This statement is curious for two reasons. First, when the conclusions from the multilateral consultations were released in April 2007, the outbreak of the crisis in August 2007 was only three months away. Logically, it was by then too late to do anything about the macroeconomic, or the financial regulatory, origins of the crisis. Second, the multilateral consultations identified no new policy initiatives or enhancements to existing policies. Each participating country or unit merely pledged to continue on their current policy trajectories.

Global imbalances did not lead to a global financial crisis in the form—and via the mechanisms—

24. The four causes in the order in which they are listed in the IMF staff paper are: financial regulation, excessive risk taking by the private sector, macroeconomic policies (global imbalances), and the global architecture with respect to gaps in information, regulations, and markets.

that many observers feared would occur: a sharp, disruptive decline in the foreign exchange value of the US dollar and soaring dollar interest rates as a consequence of reluctance by foreign and domestic investors to accumulate additional or continue to hold existing dollar-denominated assets on prevailing terms. During the first phase of the crisis, the dollar did decline about 8 percent in real terms from July 2007 to March 2008, according to the Federal Reserve Board staff's broad US dollar index, and about 9 percent against the major currencies. The dollar was stable for the next four months, and then rose sharply, by about 13 and 15 percent respectively, over the eight months to March 2009. On the whole, dollar-denominated assets became more attractive, not less attractive, during the depths of the crisis.[25]

Notwithstanding the fact that the canonical doomsday scenario identified in connection with the buildup of global imbalances in advance of the crisis did not play out as most adherents to this view were predicting, a case has been made that it played a role in the crisis. For example, Lorenzo Bini Smaghi (2009) argues, "These imbalances [in part as a consequence of certain countries' exchange rate policies] were ultimately the symptom of the creation of excessive international liquidity by countries like the United States and of excessive savings by countries like China, and were associated with a reduction in the cost of capital and interest rates, in particular in the United States. This spurred an unsustainable boom in consumption as well as excessive risk-taking, both among consumers and financial institutions."

Ben Bernanke (2005), in the period leading up to the crisis, provided a similar analysis in his well-known speech about the global savings glut and its role in the US current account deficit. However, he did not draw any particular conclusions for US policy. Rather, he urged developing countries to improve their financial systems and become borrowers rather than lenders. Although Bernanke did not touch on Federal Reserve policy, the subsequent inference by most observers was that the ex ante excess supply of global saving, which he posited explained the conundrum that Alan Greenspan (2005) had identified: as the Federal Reserve raised short-term dollar interest rates, longer-term interest rates did not increase as normally would be expected. In other words, because of the global imbalances associated with the policies and circumstances of other countries that were generating large inflows of foreign savings to the United States, the restraining effects of Federal Reserve policies on consumption and risk-taking were blunted.

I am not convinced that global imbalances played a major causal role in the economic and financial crisis of 2007–09. My view (Truman 2009b) is that the imbalances and the crisis were jointly caused by failures of macroeconomic policies in the United States and many other countries compounded by regulatory and supervisory failures that contributed to an orgy of excess by the financial sector.[26] On the other hand, one does not have to believe the global imbalances played a major role in the 2007–09

25. Over subsequent months of 2009, after the nadir of the crisis in early March 2009, the US dollar retraced most of its effective appreciation.

26. The draft of a paper by Olivier Blanchard and Gian Maria Milesi-Ferretti (2010) reaches a similar conclusion contrary to the argument in IMF 2009b. The IMF does not speak with one voice!

economic and financial crisis in order to be concerned about global imbalances, or more precisely about sustained, balanced global growth going forward. However, the lack of agreement on the contribution of global imbalances to the 2007–09 crisis is a complicating factor; sound diagnosis normally is required to help find an effective cure.

Timothy Geithner (2009) implicitly addressed the issue of global imbalances in April 2009 when he signaled his concerns about the postcrisis pattern of global economic expansion. He emphasized the IMF's role in this context, "The IMF needs to ensure going forward that the distribution of global demand is far better balanced" and we do not return to a global economy "characterized by large global imbalances and reliance on a single or a few engines of growth, . . . [C]ountries around the world [will need to] rebalance their economies and put in place sound frameworks for domestic demand." Geithner concluded that it is "critical that the IMF exercise greater candor and clarity on exchange rate issues and follow through on the 2007 surveillance decision" on exchange rate policies.

The leaders of the G-20 countries appear to have agreed with the Geithner diagnosis. At their Pittsburgh meeting in September 2009, they set forth their vision of a balanced global expansion in the form of a Framework for Strong, Sustainable and Balanced Growth (G-20 2009). They assigned to the IMF a role in helping them to achieve their objective. The IMF role falls under the heading of informal regulation. However, as reflected in the Geithner remarks in April 2009, the IMF's role implicitly draws upon the IMF's formal regulatory role with regard to exchange rates. In particular, coming out of the crisis some members of the IMF will be concerned about the issue of competitive nonappreciation of currencies that have been severely depressed during the course of the crisis and the tendency of their authorities to resist the recovery of those rates either to build up their foreign exchange reserves or to promote the growth of their economies.

From the perspective of the IMF's regulatory role, the G-20 countries have embraced a peer-review process in which the management and staff of the Fund will be called upon to assist them in achieving their common objectives. However, many of the underlying issues have bedeviled the IMF and its members almost from the founding of the institution, starting with the asymmetrical nature of the global external adjustment process that places more pressure on countries in deficit than on those in surplus. Those contentious issues contributed to the breakdown of the Bretton Woods system and the inability of countries to agree on how best to put it back together. In the words of Paul Volcker (2009), "The present state of world affairs has made clear that our international monetary arrangements have not provided a needed element of discipline either for surplus or deficit countries."[27]

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27. Paul Volcker was the principal architect of a 1972 US proposal to use developments in countries' holdings of international reserves to trigger balance-of-payments adjustment (Council of Economic Advisors 1973). That proposal advanced the possibility of IMF enforcement actions—formal regulation with teeth—on countries with surpluses in the form of general import taxes or surcharges, loss of scheduled SDR allocations, or taxes on the country's excess reserve holdings. Eichengreen (2009) also mentions the last possibility.

Whether the IMF as an institution can rise effectively to this regulatory challenge remains to be seen. An informed observer might plausibly reason that the economic and financial crisis of 2007–09 has increased the value that IMF member countries should place on the type of global public goods that the IMF can provide. However, the IMF's success in helping to guide the global economic expansion in the wake of the 2007–09 crisis will depend less on the formal regulatory role it has now (or may acquire in the future) and more on the informal regulatory role that its members assign to it via the peer-review processes of the institution itself. Fundamentally, the IMF's regulatory role, whether derived formally from obligations in the Articles of Agreement or informally from mutual agreement among IMF members, must be continuously renewed by active peer-review processes that nurture that role.

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