Global Imbalances and Fund Surveillance*

By

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Abstract

Over its existence the IMF has been an instrument with multiple objectives. The main objectives have been (a) surveillance over countries' economic policies; (b) occasional provision of financial resources for countries undergoing adjustment under a Fund-supported program; (c) technical assistance for structural reforms and for institution building; and (d) "certification" over some desirable actions by counties. Over the years, some of these activities became more important than others. In the 1980s and 1990s for example assistance for structural changes and for institution building became important. After the 1997-98 financial crisis, certification for desirable standard and codes and for provision of particular data became important. To remain "universal" and useful to all its members the Fund must continue to promote multiple objectives. It cannot become a one purpose institution.

The Fund is now criticized for its limited role with respect to global imbalances which have become very large in connection with a few major countries such as the United States, China, and Japan. Fund surveillance is still bilateral, i.e. directed at single countries. Thus critics are demanding a larger role in multinational surveillance. However, multilateral surveillance is not likely to be very successful because of technical, organizational, and political obstacles. Some changes would, however, make the Fund more effective: the quotas assigned to the countries could better reflect their current economic power; some expansion in multilateral surveillance work should be planned, possibly by bringing fresh blood into this activity from outside the Fund; the Management and the staff should be instructed to be much more focused or even blunt in their views on countries' policies; the resources available to the Fund should be increased and the executive directors should be more independent from the countries that nominate them. It would however be a mistake to redirect on a large scale the resources of the institution toward an activity with a very slim chance of success.

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I. Introduction

At the time of the creation of the IMF: (a) World War Two was ending; (b) the Great Depression was still fresh in the memory of many people; (c) there was fear that the world economic would slide back into the Depression once the war ended; and (d) a "spirit of cooperation" was shared by the winners of the War.

The new institution was <u>designed by the victors</u> to promote their and presumably the world's interest. The losers played no role and, among the victors, Russia was not interested. Strong leadership was exercised by the American delegation in spite of Keynes' participation on the British team. In the end the "golden rule" prevailed: he who has the gold makes the rules. It was the Americans that had the "gold" at that time and they made the rules.

The new institution was born with particular characteristics: (a) It was small, rule-based, and subjected to strong political controls. (b) At the insistence of the U.S. delegation, it was based in Washington. (c) Also at American insistence it had a resident Board. This gave a great advantage to the United States because the U.S. Treasury was just a few blocks away at a time when communications were still limited. (d) Therefore, from the beginning the IMF was largely influenced if not dominated by the U.S.A. because of the latter's size, economic power, vicinity and the fact that the United States would occupy the number two position within the IMF. This position became particularly powerful in the 1990s. From the beginning, the Fund became a useful instrument for pursuing U.S. economic policy and interests.

II. Activities and Objectives of IMF

It is important to recognize that, de facto, the Fund has been an instrument with multiple objectives. Depending on the period, some particular objective has attracted the spotlight.

The main objectives have been:

a. Surveillance over countries' economic policies, to prevent them from pursuing policies that could damage the international economic system. This activity, connected with Article IV missions, has always attracted a large share of staff time. It has been related to individual countries so that it has been bilateral involving the Fund and the country. Fund staff are assigned to specific countries. They visit each country normally on a yearly basis and write a report. The report is discussed by the Board of the Fund.

b. Occasional provision of financial resources for limited periods when countries run into balance of payment difficulties and agree on a Fund-supported program to rescue the countries from their difficulties. The provision of these financial resources was intended to reduce the pain of adjustment for the country by distributing the adjustment over a longer period. However, at some point over the last two decades half of the membership had Fund-supported programs questioning the assumption that Fund program would be rarely needed. Furthermore, some of these programs were renewed several times <u>over the years</u> questioning the assumption that they were for short run adjustment.

c. Assistance to countries with structural reforms and with institution building. This activity became very important especially over the decades of the 1980s and 1990s. It was much appreciated by the countries that received assistance. It was often the kind face of the IMF. Technical assistance reports were not cleared by the Management of the Fund and were not discussed by the Board. Their recommendations were not imposed on the requesting countries. They were provided confidentially to the countries' authorities.

d. Some activity resembling "certification" (on exchange rates in earlier years, and on standards and codes and provision of some data in more recent years). The importance of this activity has grown in recent years and especially after the 1997-98 financial crisis. It has been promoted by some industrial countries who have argued that it would provide a global public good and make the international financial system more efficient. It is provided free and has been absorbing a lot of staff resources. To a large extent it has been absorbing resources that had previously gone into providing technical assistance.

Over the years, the relative importance of the above activities tended to change reflecting the relative needs or the perception of the needs at the moment. Over the years the Fund proved to be flexible enough to adjust to these needs. Thus, it remained the dominant international financial institution.

The Second Amendment to the Fund Articles in 1976, following the collapse of the rule-based Bretton Woods system, reduced the Fund activity vis à vis the exchange rates thus reducing the attention and the staff time that had been directed to exchange rates.

In the 1980s there was increased attention to structural policies realizing their importance for macroeconomic outcomes. There was increasing awareness at that time that, over the medium run, structural policies determine macroeconomic outcomes. The Fund realized that it was naïve to think that macroeconomic outcomes could be separated from structural policies except in the very short run. This change was also influenced by the so-called supply-side revolution of the Reagan era that gave more prominence to the growth of potential income and less to aggregate demand.

As a consequence of the debt crisis that started in Mexico in 1982, and of the increasing cross-country flow of capital that had allowed some governments and some countries to overspend, there was an increased use of

Fund resources in the 1980s and 1990. The number of countries with Fund-supported programs increased significantly.

The 1990s brought also the need for institution building when some 30 new countries (many from the Soviet block) joined the Fund. These countries did not have some of the institutions necessary for market economies such as central banks, treasuries, budget offices, tax administrations, and so on. These institutions needed to be created and the Fund became a useful adviser to countries for creating them.

All these activities were important and were <u>forced on the Fund by circumstances</u>. Often the Fund seemed to be the only game in town especially because the World Bank seemed to be in permanent reorganization. The Fund was seen by the member countries as the institution that could move quickly and efficiently and provide the required expertise. Most importantly, all the changes were <u>promoted</u> and <u>approved</u> by the "political principals" and especially by the U.S. Treasury. The changes did not occur because the Fund staff wanted them. They were needed and were politically promoted. A most recent and more questionable example of political promotion is the Anti-Money Laundering and Combating the Financing of Terrorism Initiative and the Surveillance on the Off-Shore Centers. These activities started after September 11, 2001 and were pushed on the Fund by its "political principals" even though there are doubts about what the Fund can contribute in this area.

Some changes in Fund activities were made necessary by the <u>increasing universalism</u> of the institution. The Fund membership went from

40 at its creation to 184 countries at this time. Within the membership different groups of countries have different needs. The new members had different needs from the original members. These needs included: (a) technical assistance in specific areas (central banking, fiscal policy, statistics); (b) institution building (creation of budget offices, tax administrations treasuries, etc.; (c) de facto longer term financing because the needed adjustment required more time.

III. Current Criticisms of the Fund

Some ask: what is the IMF for? Do we need the IMF? The honest answer is: the World survived for thousands of years without the Fund; so it could survive without it. But the really relevant question is whether the Fund is useful, not whether it is essential. Does it contribute to the World's welfare more than it costs? In terms of the World's total output the annual cost of the Fund is truly an insignificant factor that ought to be kept in mind.

Today's critics tend to evaluate the Fund in relation to their specific objective. They ignore the fact that the institution has multiple objectives that have different value to different constituencies. They also ignore that the membership is universal. What is fundamental or important for G7 countries, or for some of them, is likely to be less important to emerging markets or to poorer African countries. Thus, an evaluation of the criticisms of the Fund cannot ignore where the criticism is coming from. There have always been critics of the Fund but the criticism keeps changing with the times and the circumstances.

Current Criticisms:

Some critics question the usefulness of the Fund in today's world. Others want more Fund or a different Fund. At times one is reminded of the customer who at the end of a meal in a restaurant complained about the bad food and the small servings. Some criticism comes from members of the G7 countries; some from emerging markets; some from developing countries; some from participants in the financial market, some from academics. Each would like to reform the Fund to better suit his/her own interests.

Critics have raised questions about (a) the legitimacy of the Board; (b) the role of the Board; (c) the adequacy of the Fund's financial resources; (d) the Fund role vis á vis growing global imbalances and the effectiveness of the surveillance function of the IMF; (e) the effectiveness of its financial programs; (f) the use of conditionality; (g) and so on.

While all of the above criticisms have some merit, often they go into different directions. Satisfying one set of critics is likely to increase the dissatisfaction of others. For example, focusing excessively on multilateral surveillance, as some critics now ask, is likely to reduce the attention of the Fund to the problems of poor countries that are rightful members of the Fund. This would be especially true if the staff resources of the institution were reduced in response to the fall in the income of the IMF that has been forecast after the recent repayment of loans to the Fund by Brazil and Argentina and the reduction in the number of Fund-supported programs especially for large countries.

To remain “universal” and be useful to all its members the Fund must continue to promote multiple objectives. It cannot be both universal and focussed exclusively on one objective or on one group of countries. For the rest of the paper the discussion will relate mainly to the surveillance function of the IMF.

IV. Global Imbalances

The surveillance activity of the Fund has recently been criticized from several important quarters and the criticism has attracted the attention of major newspapers and Fund management. Some critics have pointed at the growing global imbalances and at the limited role (or timidity) of the Fund in dealing with them. The U.S. current account deficit and the growing surpluses of some countries and especially of China have been prominently in the news. The Fund has so far played no significant role vis á vis these developments. This is seen as evidence of failure by the Fund in exercising its most fundamental function, that of maintaining international financial stability. The American Treasury has criticized the Fund for not taking a more forceful position against the exchange rate policy pursued by China. Somehow it is assumed that an appreciation of China’s currency would automatically results in a reduction of the American deficit. Some critics believe that a continuation of current trends would lead to potentially serious problems for the international financial system, Therefore the Fund should intervene. The current debate is similar to the one that took place in the first half of the 1980s when the U.S. current account also widened considerably and was assumed to be unsustainable. At that time the Fund also played a very limited role but somehow the international financial system survived.

The liberalization of capital movements in recent decades sharply increased the flow of financial capital from surplus countries into deficit countries. Large capital flows may be stimulated by differential private rates of return on investment in different countries. Thus, they can be seen as desirable developments if they increase the <u>social</u> rate of return to world savings, thus raising world standards of living. In such circumstances, these movements ought to be encouraged. However, capital flows may have a less benign explanation. They may be driven by speculative bubbles, poor information, or fiscal imbalances. Generating <u>better information and more transparency</u> on the international financial system is a global public good that the IMF has been trying to provide with its work on data dissemination and on standards and codes in the aftermath of the 1997–98 South East financial crisis. This work was pushed on the IMF especially by the United Kingdom. However, while it has absorbed a lot of staff resources, the consensus seems to be that so far it has produced little value. It has not changed substantially countries institutions and has received limited attention by the capital market.

Capital movements can be stimulated by differences in the flexibility and depth of the domestic financial systems that facilitate borrowing for consumption on the part of the residents of some countries compared with those of other countries. Especially when, for various circumstances, including the policies followed by major central banks such as the Fed, the Bank of Japan, and the European Central Bank, interest rates are low, flexible financial systems can stimulate consumption and the purchase of particular assets, such as houses, in some countries. This stimulation can be financed by the savings of the rest of the world.

U.S. citizens can easily get credit to buy houses or to refinance their mortgages when interest rates fall while those of many other countries, cannot. This creates a bias toward consumption and house ownership in the United States and some other countries. When interest rates fall, and the value of houses rises as a consequence, the owners of houses can borrow against their (higher) house values in order to increase their consumption. The perceived increase in personal wealth that accompanies the increase in the prices of houses and the low interest rates discourage saving and encourage consumption. Many economists believe that this has been happening on a large scale in the United States (and in a few other countries) in recent years. They also believe that these developments expose the consumers of these countries and the international financial system to the danger of a sharp drop in the value of their assets. Because much of the borrowing is externally financed, such a drop could have major negative consequence for the international financial system. It could lead to sharply higher interest rates and lower value for the dollar.

In recent years some countries (China, Japan, Korea, Russia, and several others) have been running large trade surpluses and accumulating large reserves held mainly in US dollars. China's foreign exchange reserves in the fourth quarter of 2005 reached an estimated U.S.$854 billion or about 44 percent of its GDP, surpassing those of Japan. The accumulation of reserves by some other, especially Asian economies, such as Taiwan, Korea, India, Hong Kong and Singapore, are also huge. This accumulation has been facilitated or made possible by the large current account deficits that, especially, the United States has been running, a deficit that has exceeded six percent of the U.S. gross domestic product in recent years and that is approaching seven percent of U.S. GDP. Total official foreign reserves in the world have increased from U.S. $1783 billion in the fourth quarter of 1999 to U.S.$4171 billion in the fourth quarter of 2005.

These current account deficits by the United States and the large capital inflows to finance them have:

(a) allowed Americans to spend much more than they produce, thus creating the ethically unattractive situation whereby the richest and largest economy in the world overspends <u>mostly for consumption</u> by borrowing from much poorer countries. To a large extent, poor Chinese workers are financing the consumption habits of much richer American citizens.

(b) increased the supply of liquidity to the rest of the world making it possible for many countries to accumulate large reserves that, for them, eliminates or reduces the probability of having to go to the Fund for loans in case of need. It is interesting to observe that among the 12 countries with the largest official foreign exchange reserves, eight are countries that over the past decade had major balance of payments difficulties and some of them needed Fund financial support. The eight countries are: Korea, Russia, India, Malaysia, Mexico, Turkey, Thailand and Brazil.

(c) To some extent, and for several important countries, the U.S. current account deficit, by making possible the large accumulation of foreign reserves in U.S. dollars, has reduced the usefulness to them of the IMF at least for the foreseeable future. With their accumulation of reserves, the surplus countries feel that they have acquired the protection against financial crises, a protection that they could have gotten from a properly financed IMF. This may have reduced these countries' interest in the Fund. The fact that the financial needs of some of these countries--in the event of a recurrence similar to the 1997-1998 financial crisis--would be so large as to overwhelm the Fund's current resources must also have contributed to their decision to accumulate reserves. The fall

> in the resources available to the Fund, as a proportion of world trade or of capital movements, has been considerable. In some sense the Fund has shrunk over the years. However, without the large U.S. imbalances the accumulation of reserves would not have been possible.

Questions have been raised about how long the imbalances described above can go on. The NBER website (Friday 10 March 2006) states that "Never in the history of modern economies has a large industrial country run persistent current account deficits of the magnitude posted by the U.S. since 2000." And a recently released report by the European Central Bank reached the same conclusion. When I was at the Fund (until the end of 2000) much smaller imbalances would make all alarms start ringing. At some point these imbalances must clearly come to an end. If this occurred too quickly, as already said, the economic effects for the world economy could be devastating. In other words there is a potentially growing danger for the soundness of the world financial system. This raises obvious questions about what role, if any, the Fund could play vis á vis these imbalances.

V. Surveillance Role of the Fund

What role should the Fund play vis á vis the debtor country (or countries) and the creditors countries? Should the Fund pressure the surplus countries to appreciate their currencies or perhaps to invest abroad the surpluses that they are holding in foreign reserves? And would this appreciation necessarily reduce the imbalances of the deficit countries? Or should the Fund pressure the deficit countries (mostly the United States) to reduce their fiscal deficits and to increase their interest rates? Most observers agree that so far the Fund has not played much of a role in this context. However, interest rates in the United States have been going up at a significant pace and to a limited extent fiscal deficits have been going down. Thus, some adjustment in what should be the desirable direction has started. Apart from whether there could be agreement on precisely what the Fund should ask the relevant countries to do (that they are not doing), what would be the requirements for the Fund for playing a more forceful role? Let us address the question of these requirements.

The requirements for a more effective Fund role in multilateral surveillance are daunting. Some are of a technical nature. Some of an organizational nature. Some of a political nature.

Let us start with the <u>technical requirements</u>. The Fund would need to have a large degree of trust in its own technical analysis to use it to convince the relevant countries and the world that what it says is correct. In the first place it must have staff of clearly superior quality and reputation<u>. That staff must be very good and must be seen as being very good.</u> It must be able to sort out benign capital flows, promoted by differential rates of return to investments, from less benign ones promoted by bubbles, speculation, poor information and others. The analysis must allow the IMF to reach strong conclusions as to the policies that those who import capital and those who accumulate reserves must adopt. This is obviously very difficult. The Fund must also allocate a significant share of first-rate staff members to this activity taking them away from bilateral surveillance and from other tasks that remain important to a large share of its universal membership.

Does the Fund have, or can it have, such staff in sufficient number? Given the competition for top economists coming from universities, central banks, the financial market, think tanks, national governments, and other international institutions, it is an open question whether the Fund would be able to attract these people in sufficient numbers. Given the reductions in Fund salaries and benefits being discussed within the institution at this time, would it be able to attract these individuals if it tried? Would the reallocation of positions to multilateral surveillance reduce the attention that the Fund pays to other activities and other areas? For example, would the poor countries lose out in this reallocation? What about the Millennium Development Goals and the work required to achieve them? These are relevant questions in a context in which reduction in personnel is being considered by the institution.

The analysis must be convincing and must be seen as superior to that of other institutions (including several prominent institutions nested within the G7 countries) that might reach different conclusions. In these circumstances each side might argue that it is the other side (i.e., surplus versus deficit countries) that must take action. For example Alan Greenspan had not shown much concern about US current account deficits as some thought that he should have. Compare for example, his position vis á vis that of Rogoff in the Cato Journal of Spring Summer 2004. Some well-known economists, such as Richard Cooper, have dismissed the concern. Would the Fund analysis win the competition for the best analysis? Although many would agree that the Fund has a competent staff and does good work, it is long past the time when it was seen as the acknowledged leader in this kind of work.

The fact that so far the United States has had no problem in attracting the capital needed to finance its current account deficit, and that it is still seen as one of the most creditworthy nations (see recent ranking by the Institutional Investor Biannual Country Credit Survey) indicates that the Fund would have a hard time convincing the financial market that the U.S. imbalances are a major problem at least over the short or medium run and the U.S. government that it is the one that must act. And it is not obvious that, say, an appreciation of the currency by China, if the country could be pushed to act, would eliminate the U.S. imbalance. Imports might simply be shifted elsewhere if American consumers insisted on maintaining their current saving rates. Thus the Fund would have to push several other countries in changing their exchange rates. This of course would make its job even more difficult.

To be able to promote and develop the proper analysis, the Fund would need to have access to a lot of detailed information that it does not have at this time. For example, it does not receive information on the composition of foreign exchange (COFER) from some important countries. Under current rules, the Fund cannot force countries to provide this essential information.

Some important countries consider this information an important state secret and are not willing to give it. Furthermore, the increasing transparency of Fund documents that would be required for this activity is likely to make some countries less candid, less open about declaring their policy intentions, and less disposed to provide particularly sensitive information. It may not be a coincidence that unallocated reserves have shown a sharp increase in recent years from U.S.$420 billion in the fourth quarter of 2000 to U.S.$1354 billion in the fourth quarter of 2005. This was the period when t he Fund became more transparent.

Because of the large number of individuals that would be involved in this analysis, and because of the access that Board members and their assistants would have to it, the countries that provided this information must be willing to see it become public. It is difficult for the Fund to keep secrets and almost impossible when the information is distributed to all the 24 members of the Board. Some countries would remain strongly opposed to providing particular information to the Fund.

The analysis and the conclusions reached at the technical level must be evaluated politically by the Management and the Board of the IMF. This raises questions about the legitimacy, political independence, and willingness of Fund Management and the Executive Board to make strong and politically sensitive statements about the policies of powerful countries and the need to change in those policies. The "fudge factor" would likely play a significant role thus reducing the sharpness of the conclusions. The chief economist of the IMF was quoted recently as having complained publicly about attempts by some large countries to prevent objective and clear public statements on their policies by Fund spokesmen.

As to legitimacy, some have argued that a redistribution of Fund voting power (quotas) from some countries (presumably European countries) toward others (China, India, Mexico, South Africa and poorly represented low income countries) would increase the legitimacy and, in their view, the power of persuasion of the Board.

The question of Board legitimacy can be related to the existing formula that determines voting power. This formula is supposed to base the quota of a country on the country's GDP, its foreign trade, and its credit position vis á vis the Fund. Or the formula itself can be questioned proposing an allocation of voting power based on other criteria (one country, one vote; quotas based on population size). The current quotas are adjusted periodically and are often behind recent economic developments. Applying faithfully the existing formula to current data would give more voting power to China, and to some other countries because of their recent fast growth and growing openness. It would also give more voting power to European Union countries because of the appreciation of the euro vis à vis the dollar and some other currency. On the other hand, it might give less voting power to poor and especially African countries. To protect the quotas of the latter countries some exception to the application of the current formula would be required.

Trying to change the formula is likely to be a political non starter because it would be opposed by some powerful countries.

Regardless of the validity of the arguments in favor of the reallocation of the voting power and quotas to give more legitimacy to the Board, it is not obvious why this reallocation of voting power would make the Board necessarily more powerful and more persuasive in its recommendations. The politically feasible reallocation of voting power would in any case be marginal, under realistic circumstances. Furthermore, the Board rarely votes and it would still have 24 members, too many in the view of some critics for serious discussion of issues. The largest countries, and especially the United States which is at the center of the debate about global imbalances, would still dominate it.

As to the political independence of the Board, it must be noticed that especially the G7 countries tend to send to the Board of the IMF individuals who are relatively low in the political totem pole of their countries. They are for the most part medium level civil servants. These people have no political independence and, on important issues, they simply read the instructions that they receive from their principals in their capitals. Often even those who send instructions are not too high up in the political pecking order. Major changes would be needed to make the Board, as an institution, more politically independent. But these changes do not have much of a chance of being made.

Recent writing has described how, in recent years, the Executive Board has become progressively less independent from the political principals or from the "capitals." See Cottarelli, 2005. Recently Mervyn King, the Governor of the Bank of England, proposed that the Board be made a non resident one, to allow more senior policymakers to attend periodic and not too frequent meetings. He also expressed reservations about the large number of directors (24) that, in his view, make any serious discussion at the Board too time consuming and difficult. He proposed: to reduce the number of directors; to give the Managing Director more day to day power; and to reserve the big decisions for the absentee Board members who would be senior leaders in their governments. This of course is what the Interim Committee and its successor, the International Monetary and Financial Committee were supposed to do. It is easy to see that if such a reform were carried out, the developing countries would be the losers.

King's proposal would likely meet the same faith as a similar one made by Keynes at the Bretton Woods conference of 1944. It would be shot down. At the same time King is right in calling attention to the micro management of the Fund by the Board. While the real power over truly important decisions has moved away from the Board, mostly towards the capitals of the G7 countries, the Board has busied itself with more minute matters absorbing a lot of the limited time of management and staff and, as a consequence, reducing the staff and the managing director's power.

A major problem with current Fund surveillance is that it reflects to a large extent the spirit of the past. It is directed at single countries and is not as frank in its prescription as it could be. The Fund is largely organized along geographical areas. Most economists are assigned to deal with specific countries so that their input tends to be country specific. Only few people, mostly in the Research Department, pay some attention to global or multi-country problems although this has started to change and some attempts at regional surveillance have started to be made. Over past years the number of people assigned to multilateral surveillance has remained small. Thus, as it has been pointed out in some recent criticism of the Fund, the analyses continue to be largely country specific and the surveillance bilateral. In this analysis small countries, that are not significant from a global point of view, often absorb as many staff resources and Board time as globally significant ones. However, politically it has been very difficult to streamline this process in order to reduce the staff resources assigned to small countries. The argument has been made that small and less developed countries benefit more from the Fund surveillance (Article IV missions) because often it is the main technical input that the policymakers of these countries receive. The larger countries have inputs from other sources. In this one can easily see the conflict between the universal character of the Fund and the attempt by some critics to make it a tool for larger countries.

The Board generally discusses one country at a time –the so-called Article IV discussions—except for particular occasions, as for example, when the World Economic Outlook, the Financial Market Report produced by the International Capital Market Department and occasional regional surveillance studies are discussed. Also given the fact that criticizing powerful countries can be dangerous for staff careers, and that economics is never totally definitive and objective in its conclusions, the message that comes out of these meetings is often too sanitized to have much of an impact, either on the countries authorities or on public opinion. It is thus unlikely that it can lead to policy changes that would reduce the risks to the international financial system.

VI Possible Reforms

No single change is likely to make a major difference in the effectiveness of Fund surveillance. But several changes can make some difference. Let us consider some of these changes.

It would be desirable to apply more faithfully and more rapidly the formula that allocates quotas and voting power to countries in order to remove anomalies. This change, which is consistent with current rules, would increase the Board's legitimacy, though not necessarily its power of persuasion, and ought to be feasible though not easy. China, India and some other large countries should have the voting power that reflects their current and not past economic weight in the world. This is especially important for fast growing countries. However, some poorer countries and especially those in sub Saharan Africa might lose out if the formula were applied rigidly. To protect them, some preference might have to be given to particular areas. Changing the current formula to adopt other criteria could be too disruptive as it would be to reduce the number of executive directors. While these changes might be desirable from some points of view, they are not likely to be politically feasible.

Two proposals that have been mentioned by some observers are: (a) the use of gross domestic products measured using purchasing power parities that presumably better reflect the real size of the countries' economies; and (b) have the 12 European Monetary Union countries be represented by a single Board member.

The first of these proposals would seem to have some merit. However, its adoption would necessarily be conditioned, inter alias, on whether the calculations of GDPs based on purchasing power parities are made on the basis of accepted accounting standards. There are now, for most countries, no <u>officially</u> <u>accepted</u> measures of GDP based on purchasing power parities. These calculations were originally made by an institute at the University of Pennsylvania. There were always major questions about their quality. A couple years ago the World Bank took over the project and it has been trying to improve the quality of the estimations. The calculations are made every few years and not annually. In the in between years they are interpolated using indices of price changes. It does not seen likely that, at this juncture, these data could be used for calculating quotas. For European Union countries Eurostat calculates official PPP data for the member countries.

The second proposal, pushed by some writers, is based on the view that the 12 European Monetary Union countries have essentially become one economy because they now use a common currency. The proponents of this proposal argue that trade among these countries should no longer be counted in the formula that determines the countries' voting power because it is no longer international trade. The quota so saved could then be allocated to other countries and especially to Asian countries. The view that the EMU countries have become one economy that should thus speak with one voice must clearly come as a surprise to the governments of these countries that continue to be divided by differences on many issue and by questions as to whether the euro will survive as a common currency. Furthermore, as a recent paper has pointed out, the legal base for representing the 12 countries with one Board chair is simply missing. See Phillips, 2006.

It would be desirable to add fresh blood to the group of individuals who, within the IMF, work on issues related exclusively to global imbalances. People from universities and other leading economic institutions, who have distinguished themselves for the quality of their analysis in this area, could be invited to the Fund for limited periods of time, say two years, at attractive salaries, to provide their support and to add their prestige to the work that the Fund carries out in this area.

The managing director and the staff should be given clear signals that honesty and even bluntness must be encouraged. Board members should be instructed to refrain from trying to influence what staff members say or write about the countries that the Board members represent. It is not possible to be effective in surveillance work if the staff and especially the heads of Fund missions may be replaced when the countries that they deal with consider them too blunt. A true culture of independence has not existed within the Fund and would need to be created. Too many qualifiers and too much diplomacy reduce the impact of the message that need to be given to countries.

Independence could also characterize the position of Executive Board directors. Now they are just promoters and spokesmen for their countries. It would be preferable if the individuals that occupy these positions were not civil servants but well established professionals who were told that when they become executive directors they should pursue the interests of the world's and not of their specific countries. More distance between them and the countries that elects them would be desirable. They could be appointed for a fixed term during which they would not be subject to removal.

As Mervyn King has suggested, much more attention should be directed by Fund staff at <u>national balance sheets</u>: (a) to get a full picture of financial claims that countries have against other countries; (b) to acquire a sense about the potential speed of any likely adjustment, say in countries such as the United States or China. For example, how quickly could China shift a given share of its foreign reserves out of dollars and into, say euro without creating major global difficulties? How quickly it could devalue to move its exchange rate to a presumably new equilibrium rates if such a rate could be determined? How quickly could the United States eliminate its fiscal deficit? What would be the impact of such a policy on its exchange rate?; (c) to have a sense of the impact of changes in relative prices on the value of assets and liabilities. What impact would a substantial appreciation of the Rinminbi have on the balance sheets of the Central Bank of China and of the Chinese banking system? For answering these and similar questions information on national balance sheets of globally important countries would be useful.

The IMF's has started to pay more attention to balance sheets and especially to the composition of foreign exchange owned by countries. However, this work is still limited by staff resources and by the reluctance of some countries to provide the needed information. Balance sheets go well beyond the ownership of foreign exchanges and much needed information would not be available for many countries. Thus much work remains to be done at a time when the yearly income of the IMF is going down and there is increasing talk about reducing staff benefits and even staff.

An aspect of multilateral surveillance that merits a mention is the possibility that at some future time several emerging markets or other groups of countries might run into difficulties because they have been increasing their spending at a time when commodity prices have been high. A significant slowdown in the growth of world output that sharply reduced commodity prices, that inevitably will come sooner or later, could leave some countries with significant needs for financial resources to spread out in time the cost of adjusting their economies. As it happened in the past, many countries have been behaving as if the current good times and the high commodity prices would last forever. They have not made provision for "rainy days" <u>except</u>

through the increase in foreign reserves. If a sharp reduction in commodity prices should occur, and if the value of their reserves, held mostly in U.S. dollars, should fall, they could discover that the accumulated reserves might not be sufficient to prevent financial difficulties. In such a situation the current talk about the global financial market having made the Fund redundant could quickly end.

The Fund would again be propelled to center stage and would be expected to play the role that it has frequently played in the past, as the lender of last resort. It would be discovered then that the world had changed less than many believed. However, the Fund's total resources have become awfully inadequate to cope with such an eventuality. This realization might have been one of the incentives that have pushed some countries to accumulate foreign reserves. Thus worrying about multi country surveillance means also worrying about the resources available to the institution for both its regular activities and for activities related to financial crises. To remain a valid insurance for a universal membership, the Fund will need to have larger resources available to it than it has available now.

VII. Concluding Remarks

Changes that occurred in recent years have pointed to the need to make some adjustments to the Fund governance, structure, resources, and modus operandi. It is always difficult to change institutions. It is especially difficult to change them when the changes must be approved by many countries with different objectives. There is the danger than the more politically powerful countries will impose their will on the institution at the expense of the less powerful ones. One worry is that some of the changes suggested by recent commentators go against the multi-objective and universal character of the IMF. These changes would have negative implications for the role that the Fund should play toward the achievement of its multiple objectives including those connected with the Millennium Development Goals.

The Fund definitely needs reform but these reforms can be accommodated within the present framework. Realism indicates that the Fund will never by given the power to impose on the large countries the policy corrections that some feel are needed as a consequence of the large imbalances in the current accounts that have appeared in recent years. At the same time the Fund could do better what it has traditionally done. It should not abandon its traditional roles in the hope of performing a role that the major players will not allow it to perform.

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