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Global Financial Governance: a Perspective from the International Monetary Fund

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ABSTRACT

An environment for the activities of the International Monetary Fund (the IMF) has fundamentally changed over the two recent decades. The strong development of financial innovations as well as of financial globalisation was among major forces driving the change and shaping the economic growth worldwide. As some economies were able - with the support from financial markets – to accelerate their growth, other countries suffered from turbulences, which were reinforced and transferred internationally through the volatile financial markets. The process of international financial contagion makes the case for global financial governance, which so far has been left behind the development of markets.
The IMF is mandated to play a central role in the global governance designed to ensure financial stability. The article reconsiders the Fund's role and includes an overview and assessment of its activities, particularly in the context of the global financial crisis in 2007-2010. In the aftermath of this crisis, the international financial stability may, however, again be at risk as several external imbalances in the global economy may be hardly sustainable. It is argued in the paper that, in addition to a gradually improving surveillance and lending as well as to adjusting resources by the Fund, an enhanced credibility of the institution is needed so that its role in the process of the stabilising global financial system is strong and effective.

Key words: international financial contagion; global financial governance; financial crisis; global imbalances; IMF.

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Introduction and Overview

Several recent decades have been witnessing an increasing deepening of financial systems as well as their international broadening. The development of financial systems - in terms of the quantity, quality and diversity of market participants, procedures, instruments as well as resources - has been impressive. Simultaneously, the pace of integrating domestic financial systems into an international network has accelerated and fuelled the process of financial globalisation, bringing it ahead of the globalisation of other sectors of the economy.

The links of finance to growth have been extensively examined in the economic literature. These linkages rank among the fundamental topics in the analysis of growth. The interest of economists and policy makers in the link between finance and growth has been motivated – to a large degree – by the performance of the US economy, which is most advanced in both economic and financial terms. For many years, the US has been achieving relatively high GDP growth rates while, simultaneously, enjoying rapid development of the financial sector and providing a benchmark for other countries.

There is a strong view advocating that, domestically, financial development positively affects growth. This view rests heavily on the assumption of perfect financial markets, which are also efficient. Improved financial markets, institutions and products can affect growth by raising the fraction of savings available for

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investment, facilitating the process of trading and of risk pooling and, above all, by improving the allocation of capital and producing a higher total factor productivity (McKinnon, 1973; Levine, 1997; Summers, 2000). More specific debates on the nexus between finance and growth include such issues as measurements of the financial depth, the structure of financial systems (in particular, the role of bank-based vs. capital market-based system) and a potential reverse causation from growth to financial development (Khan & Senhadji, 2000). The effects of the financial sector for growth are amplified in an international environment. A domestic process of financial deepening is complemented by the global process of financial broadening. Growth-enhancing effects of an improved allocation of capital and of the better diversification of risk increase as these processes occur worldwide. Free capital flows are considered fundamentally sound. Through an improved allocation of capital and better diversification of risk, they enhance growth and help smooth consumption (e.g. Fischer, 1998; Summers, 2000). In addition, more refined approaches conclude that several relevant domestic factors – such as strong development of a financial sector, prudent macroeconomic policy, strengthened institutional frameworks, improved public and corporate governance – correlate with external capital inflows. Depending on causality, these factors are considered either as conditions/thresholds needed to achieve growth benefits or as additional benefits/collaterals to growth (Kose et al., 2006). In particular, the availability of capital is broadened for the capital-scarce, less developed economies and is strengthening their opportunities to converge to economically advanced countries (Henry, 2007; Frankel, 2010).

Numerous empirical studies confirm a positive causal relationship from finance to growth, regarding as causes both the level of development of the financial sector (e.g. King & Levine, 1993) and financial globalisation (e.g. Henry, 2007). An experience of several European emerging economies demonstrates that a financial system, which was developed, to a large extent, through linkages with Western Europe, can be a positive factor for income convergence (Abiad et al., 2007). EU financial regional policy transfers add – to quantitative effects – also improvements of development policies in the new EU member states (Kengyel, 2009).

Under the opposite view, the assumption of perfect and efficient financial markets is challenged. Instead, these markets are characterised by several failures, such as information asymmetries or herding behaviour (Greenwald & Stiglitz, 1986). The process of financial development can also fuel market imperfections and increase aggregate financial risks. Global financial markets serve as amplifiers of those risks as well as channels of domestic financial turbulences worldwide. Under this approach, distortions dominate over efficiency while benefits yielded to individual market participants may be detrimental to overall stability and welfare (Eichengreen & Mussa, 1998).

A vast amount of research has advanced the development of the theory of financial crises. As these crises usually have the common, general background – unsustainable macroeconomic imbalances and misalignment of asset prices and of exchange rates – currency, banking, asset as well as foreign debt crises tend to occur together or around the same time, although this does not necessarily always imply a causal relationship. Banking and currency crises are referred to as "twin crises" (Goldstein, 2005). In particular, extensive studies on a currency crisis have produced a comprehensive typology running from first-generation models associated with inadequate macroeconomic policies (Krugman, 1979; Flood & Garber, 1984), through the second-generation associated with multiple disequilibria (Obstfeld, 1994; Obstfeld, 1996), to third-generation eclectic models associated with combined macro- and microeconomic issues (McKinnon & Phil, 1996; Corsetti, Pesenti & Roubini, 1998).

Over the two recent decades, financial crises have been occurring with an increasing frequency and depth. The global crisis of 2007-2010 has predominantly affected economies with developed and sophisticated financial systems, such as the US or Western Europe. Local financial turbulences have been easily spreading internationally within the process of financial contagion.

An increased occurrence of financial crises and their international outreach has revitalised the debate on the role of the financial development in economic growth. In particular, the role of the IMF – the institution mandated to play a central role in ensuring global financial stability – has been put to a strong test. Towards the end of the 2010 decade, the turn from the global finan-

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cial crisis to a world recovery coincides with the 65th anniversary of the Fund. In the economic literature, positive assessments of the IMF role in stabilising the international financial system and enhancing growth, particularly of economies under transition, have been - over time - increasingly joined by the criticism of the institution (e.g. Feldstein, 1998; Radelet & Sachs, 1998; Stiglitz, 2002).

The article reconsiders the IMF role and identifies avenues for its strengthening. It is organised as follows. Section 1 discusses an increasing international financial contagion which makes the case for the global financial governance. In subsequent sections, several areas of IMF policies, which are relevant for financial contagion, are examined: those regarding international capital flows (section 2); surveillance, exchange rates and global imbalances (section 3) and lending policies (section 4). Some issues of the Fund's internal governance, which affect the credibility of the institution, are discussed in section 5. The final section briefly concludes.

1. Financial Contagion and the Case for Global Governance

The 1990s and 2000s brought a tremendous increase in the magnitude of the international financial flows, together with the surge in their volatility. Several big crisis episodes affected some economies and spread to others. Apart from the 2007-2010 US-rooted global crisis, there were two major waves of turbulence on financial markets affecting a remarkable number of both emerging and advanced economies. In the mid-1990s, turbulences started as currency crises and spread to other financial segments and to real sectors of emerging economies, ranging from Mexico to East Asia, with Russia and Brazil as major cases. In the early 2000s, an excessive boom in high-tech assets valuations in the US, together with the WorldCom, Enron and Arthur Andersen defaults, has ignited a recession in the US, which has spread to other advanced economies in Europe and has also coincided with financial disruptions in emerging economies like Argentina, Turkey and Ecuador. In 2007, the collapse of the world's largest US financial sector took the real economy down to a deep recession and the US financial and economic turmoil has developed into a global crisis.

The global financial governance becomes an issue when the process of spreading financial turbulence across countries – referred to as financial contagion – is gaining momentum.

Two factors are relevant for contagion. First, it is an involvement of the systemically important economy or of the financial centre (they are usually the same area), which may be the source of strong regional, or even world-wide, spillovers. The common shocks, such as a steep rise in world interest rates, strong deterioration of global output or sharp shifts in investors' sentiment, are usually rooted in developments in large and significant economies. The Latin American debt crisis of the 1980s as well as the Mexican crisis in 1994/95 was triggered by a considerable increase in US interest rates. In 2007, the turmoil of the US financial sector and the collapse of demand in the US has ignited a credit crunch and a deterioration of economic activity in many countries as well as the flight of investors to a safe haven from economies perceived as vulnerable to the crisis, sometimes regardless of their fundamentals.

Secondly, financial (and other) linkages serve as channels for contagion and affect its magnitude. These linkages are likely to be considerable among neighbouring economies and manifest themselves in the form of large, cross-border financial exposures.

The large presence of Western European banks in Eastern Europe during the 2007-2010 financial crisis is a relevant case. Prior to the crisis, Western European parent banks have been increasingly funding their subsidiaries in Eastern Europe in order to allow them to meet the rapidly growing demand for loans. However, in case of problems on any side and regardless of their reputational considerations, parent banks might be unwilling or unable to continue lending to their subsidiaries. In Europe, an increasing size of parent subsidiaries, or more broadly, home-host exposures, have been enhanced by their growing concentration as well as by "the common lender" cases, and resulted in the magnified regional financial contagion.

The case for the mutual non-negligible exposures, heavy concentration and, therefore, serious but confined contagion risks, refers to Swedish bank ownership in the Baltic states. The region-wide contagion was - in the early 2009 - more likely in the case of Austrian banks, which are visibly exposed and more diversified across emerging Europe and could be the source, or the common lender, in the process of regional spillovers. On the one hand, due to their heavy dependence on Austrian banks, the Balkans were especially vulnerable (MacFarquhar & Pinder, 2009; Arvai et al., 2009). On the other hand, against the financial instability of many Eastern European economies in the early 2009, Austria was, albeit shortly and not unanimously, considered to be at risk of financial instability. It was estimated that in the case of banking crisis in Eastern Europe, the mostly affected countries would be Austria and Sweden, assuming that parent banks would recapitalise their subsidiaries, or Balkans and Baltic states, assuming that host countries would decide to keep their banks afloat with fiscal injections (MacFarquhar & Pinder, 2009).

In 2010, the Eurozone fiscal crisis has ignited a considerable stress in the EU sovereign debt markets. Almost half of the total public debt of the most heavily indebted Greece, Portugal, Spain, Italy and Ireland is owed to creditors concentrated in three countries: UK, France and Germany. The most heavily indebted countries owe a certain, lower position of their debts to one other. Altogether, we arrive at a complicated cobweb of exposures and at a door that opens to a regional contagion.

In the middle of 2010, rumours of the bad shape of Hungarian public finances brought some presumption of a possible contagion in Europe as European banks and investors were strongly present on the Hungarian market. The risk of contagion was cushioned with the new fiscal austerity measures undertaken by the authorities.

Financial linkages help propagate contagion which, obviously, go beyond regions. In 2007-2008, the US financial turmoil led to systemic problems in the international banking sectors of Western Europe. US "toxic assets" were concentrated in highly leveraged European financial institutions. The sharp deterioration of funding channelled the crisis to the real economy in Europe. By contrast, the then limited financial linkages to advanced countries of emerging Asia have reduced spillovers to Asian financial institutions, whereas the region felt the global crisis predominantly through trade channels.

Given the existing common shocks and international linkages, the magnitude of contagion depends, ultimately, on the vulnerability of individual economies when facing the crisis. During the 2007-2010 crisis, some economies of emerging Europe (e.g. Poland) turned out to be relatively resilient to external shocks, whereas others (e.g. Latvia, Hungary, Romania) were vulnerable and were severely affected by a regional market turbulence. In order to be able to survive, the countries of the latter group had to search for an international financial support.

The magnitude and longevity of contagion depends upon possible exits from the crisis. The wave of currency crises lasting from the mid- to late-1990s was basically confined to a group of emerging economies as many advanced countries remained unaffected and could help others get out of problems. In the early 2000s, the crisis affected (mainly high-tech) corporates in the advanced countries, while the exit was left through households, banks and a real estate sector as well as through emerging markets. From 2007 onwards, the crisis has spread from the real estate market to companies and banks in the US and to other advanced countries as well as to emerging markets. The only exit from this overall turbulence turned out to be the large increase in public sector indebtedness, which – as can be seen in the case of southern Eurozone member countries as well as of Ireland – posed other serious risks. To contain these risks, the international financial support from the EU and the IMF was needed. However, unless the public debt in these countries is cut, the exit can hardly be seen on the horizon.

The waves of international financial crises and of contagion manifest the case for global financial governance. Due to their inherent failures associated with the information asymmetries, financial markets tend to react excessively and to abruptly switch their behaviour. Such responses lead to extreme volatilities as well as produce negative externalities. The amount of externalities increases across frontiers and is fuelled by financial globalisation. Loss of investors' confidence in one economy may also affect other economies in a peer group, although in the latter case, the flight of investors may be unrelated to fundamentals. As a result, the international financial contagion is gaining momentum. A developing contagion implies problems that cannot be dealt with exclusively by individual countries. Simultaneously, the stability of the global monetary and financial system may be at risk.

Nearly all stakeholders have an interest in maintaining the stability of the system as it helps to distribute

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financial resources across countries more efficiently. This common goal, or a public good, implies an effort undertaken by a number of countries together; since then, it is more effective. In the past, international governance actions have been heavily influenced by national and regional considerations. Global financial governance seems to have been "left behind the curve". Over time, a coordinating approach has been increasingly declared, although less often implemented. Governance actions should be designed to better identify financial interconnectedness and locate, assess and eliminate the weak spots in the financial network, which are relevant for building up systemic risk. The IMF is the natural platform to play the central role in these actions.

2. IMF and International Capital Flows

The stability of the international financial system depends, to a considerable degree, on international capital flows. These flows have surged during the last two decades. An accelerated growth of capital flows reflects – in broad terms – the progress in financial globalisation, with the IT revolution and the explosion of financial innovations as strong contributing factors. Private capital flows from industrial to developing economies have increased from 174 billion dollars during the 1980s to 1.3 trillion dollars during the 1990s (Summers, 2000). During the 2000s, these flows have increased further; they peaked around 2007 and, after a deterioration during the global financial crisis, they continue increasing during and after 2010. International capital flows have dwarfed trade flows and replaced them as the determinant component of the payments balances .

Together with the growth in magnitude, an increased volatility of capital flows has been one of the profound developments in international finance over recent decades. The waves of surges and drops in capital flows can be identified. The excessive surges in inflows were among factors leading to the currency and financial turmoil in several countries. The Latin American debt crisis in the 1980s, the Asian currency crisis in 1997 or the global financial crisis in 2007-2010 were preceded by considerable surges in capital inflows to emerging economies. Those inflows, however, suddenly and abruptly reversed, directly contributing to the eruption of the crisis and catalysing financial contagion. In each case, the confidence of investors to the whole class of emerging economies has dropped visibly.

Historic examples of the nexus between the capital flows and the rate of economic growth as well as its volatility are considerably mixed. During the 2000s, several economies of emerging Europe were able to converge with Western Europe largely due to an increased inflow of external private capital, even allowing for the positive impact of their EU membership (Cihak & Mitra, 2009). However, an extremely rapid growth is also possible with capital flows that are not liberalised as can be demonstrated by the experience of Japan in the 1950s and the 1960s and of China in the 1990s.

Regarding growth volatility, examples of capital flows which help stabilise growth refer mainly to FDI, while in the case of non-FDI flows, the opposite impact dominates the picture. In particular, Williamson concludes that in the late 1990s, the most affected by the crisis was economies with liberalised capital flows, such as Thailand, Indonesia, Malaysia, Korea, whereas other countries, such as China or India, with similar macroeconomic characteristics but less liberal on capital flows turned out to be relatively resilient (Williamson et al., 2003). Against this diversity of individual examples, it is not surprising that the evidence from cross-country studies, with differences in methodology, is also not clear-cut.

The issue of international capital flows is linked to IMF responsibilities, namely those for the stability of the international monetary system as well as for exchange rates and payment balances of Fund members. In 1944, under Article VI of the Articles of Agreement countries, they were permitted, when they considered as necessary, to exercise control over overall capital flows, whereas the role of the IMF was limited and somewhat ambiguous. The decision undertaken in Bretton Woods reflected concerns over volatile international capital movements and their effects undermining the independence of national policies in the interwar period. The new, post-war monetary system was supposed to be stable and to encourage trade and growth.

Many perceive the IMF as an institution, which has permanently, strongly and indiscriminately been advocating capital account liberalisation. This is not accurately so; at both conceptual and operational levels, the

Fund has rather been adjusting its position to changing developments in capital flows. What matters more is whether the IMF actions were retro- or proactive.

During the early to mid-1990s, when external capital inflows have been fuelling growth of many economies, the Fund has been paying greater attention to capital account issues and made efforts to amend Articles of Agreement to gain greater jurisdiction over the capital account. At that time, the IMF tended to overemphasise benefits and to undervalue risks associated with the liberalisation of capital flows. Several East Asian economies, which decided to fully and quickly liberalise their capital accounts, did not receive timely and adequate warnings, arguably also from the IMF, against risks of sudden flow reversals and of currency crisis. It was, therefore, not surprising that the efforts, subject to safeguards, to include capital account liberalisation in the Articles as an obligation of members failed to receive sufficient support among the Fund members. Instead of an amendment of the Articles, the Fund has arrived at the concept of the "orderly" capital account liberalisation, which included a set of necessary preconditions, e.g. building strong domestic financial systems as well as the rationale for implementing the liberalisation along the appropriate sequence, from less to more volatile types of flows.

Temporary and preferably market-based capital controls were not excluded as a prudential measure. Prior to that, however, several countries have implemented such measures. Evidence from these episodes is mixed, with some cases, e.g. of Chile, which are acknowledged as more successful in lengthening the maturity of capital inflows and with less consensus on reducing their levels.

In addition, the IMF concept of the orderly capital account liberalisation was not an entirely new one. Poland has launched the process of the cautious and gradual liberalisation already existent in the early 1990s. FDI flows were liberalised in 1991; the first measures on liberalisation of portfolio flows were enacted in 1993 and have been gradually extended during the decade. Short-term flows were fully liberalised in 2002. Successive liberalising steps were consistent with comprehensive macroeconomic reforms and with the strengthening of the financial system. Poland's economy turned out to be relatively crisis-resilient as compared to other emerging European economies, such as Russia or the Czech Republic, which liberalised capital flows fully and promptly.

During the 2000s, the IMF increasingly and proactively responded on the operational level to developments relevant to international capital flows. The Fund timely warned emerging European economies, in particular the Baltic states, against the risks of macroeconomic destabilisation associated with the surge of external capital inflows and with the boom in domestic loans, also in foreign currencies. The IMF paid much attention to risks to the international monetary system, which are associated with the increasing global imbalances by providing a timely and comprehensive analysis and undertaking efforts designed to implement counteractive policies. When the next surge in capital inflows to emerging economies was predicted for and was materialising in the 2010, their sustainability and domestic impact were also comprehensively examined (IMF, 2010).

During the 2000s, the Fund became increasingly accommodative of the use of capital controls, albeit under many conditions. It carried out a comprehensive analysis and assessment of the effectiveness of different types of capital controls implemented during the decade. Most measures are effective on the volume of outflows and on maturity, rather than on the volume of inflows. Market-based measures have similar effects as administrative controls. In any case, capital controls may be regarded as temporary, complementing measures after chief instruments of macroeconomic policy and prudential regulation are exhausted. It has to be emphasised that the IMF points out also to multilateral, mainly adverse, effects of capital controls, such as capital market distortions, preventing the necessary appreciation of undervalued currencies or expanding the international contagion of control measures (Ostry et al., 2010).

The proposals of more permanent capital controls, such as a small transaction Tobin-type tax on all foreign exchange transactions, such as that proposed by Rodrik, do not comply with the Fund's toolkit (Helleiner, 2009).

For the near future, in view of the likely divergence of positions among the membership on the amendment of the Articles, other proactive actions of the Fund could be envisaged. One possible avenue is to work out common guidelines on capital flows and incorporate

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them, as non-binding recommendations, in bilateral and multilateral surveillance. The issue is pressing as the IMF is given the responsibility to ensure the stability of the international financial system, for which the stability of capital flows is highly relevant.

3. IMF Surveillance, Exchange Rates and Global Imbalances

Promoting exchange rate stability is among the purposes of the IMF. This objective is clearly related to other key purposes of the institution, such as facilitating the growth of international trade, preventing disequilibrium in the external balances of members as well as cooperation on international monetary problems (Article 1 of the Articles of Agreement). In order to achieve these purposes, the Fund is entitled to exercise firm surveillance over the exchange rate policies of members. The surveillance process should address monetary stability not only of individual countries, but also of the whole international system to ensure its effective operation (Article IV, Section 3).

Exchange rate policies include several issues like the exchange rate regime and level and its misalignment as well as other problems, such as international competitiveness and external imbalances, which are directly affected by the exchange rates.

The issue of the optimal exchange rate regime has been debated among economists for a long time. The debate gained particular momentum in the 1970's, after the Bretton Woods system was replaced with the system of floating exchange rates among major currencies. In the increasingly open economies, the choice of the exchange rate regime significantly affects macroeconomic policies.

Different regimes, in particular for emerging market economies, have been advocated over time. The overall advocacy moved from fixed – in the early 1990s – to floating regimes around the end of the decade; then the support turned to a bipolar view, to corner solutions at the detriment of intermediate regimes, and again towards flexible systems, to ultimately lead to the conclusion that there is no unique, best regime. Each regime has its strengths and weaknesses. What matters is rather an individual macroeconomic environment. A currency board worked well in Hong Kong in 1997-1998 during the time of the Asian crisis, but collapsed in Argentina in 2001. In 2008-2009, a floating regime helped Poland weather the crisis well and did not help Hungary. Similarly, under the managed floating regime in 2009, Indonesia was able to maintain high growth rate, while Thailand and Malaysia fell into recession. It has to be emphasised that the IMF members have the right to determine their own exchange rate regime.

The Fund should not be in a position to directly determine the optimal level of the exchange rate. Identifying misalignments with the equilibrium level, that is based on fundamentals, should not be equivalent to fine-tuning the exchange rate configuration. However, the institution needs quantitative assessments in order to be able to provide advice on exchange rate policies of its members. These assessments carried out under bilateral surveillance should be consistent with the circumstances in the global monetary setting examined by multilateral surveillance. The Fund's role on exchange rates is extremely complex and politically difficult.

In an uncertain environment of the aftermath of the Bretton Woods system in 1977, the IMF has approved the Decision on surveillance. The Decision narrowed the scope of the Fund's responsibility as it focused exclusively on the bilateral exchange rate surveillance. In particular, the Decision addressed the problem of devaluations designed to gain an unfair competitive advantage. The Fund's Decision, however, failed to fully address issues arising from financial globalisation, which are also relevant to the exchange rates.

Two recent decades saw the process of building up global imbalances, i.e. of a pattern of large current account surpluses in some economies and deficits in others. On the surplus side, the leading economies of China and Japan were joined by other East Asian countries, Middle East and other major oil exporters, and Germany. The deficit side is dominated by the US and includes also the UK as well as countries of Southern and Eastern Europe. In the peak 2006 year, the US deficit was around 6% of GDP, while the Chinese surplus climbed to almost 10% of the GDP.

The concerns over such a pattern have been increasing over time. It was argued that imbalances originate from distortions, such as a bubble-driven asset inflation and excessive public borrowing in deficit countries (e.g. Cline, 2005). Other causes of imbalances were identified: the underdevelopment of financial systems, lack of social insurance, export-led growth with undervalued currencies and excessive accumulation of reserves in surplus countries as well as unusually high world oil prices (Blanchard & Milesi-Ferretti, 2009). The main risk was that, at some point, a relatively smooth adjustment, under which surplus economies have been financing deficits of their counterparties, would be suddenly disrupted. That would result in a sharp and disorderly depreciation of the US dollar and lead to the turmoil in currency markets and in international flows and also adversely affect the real economy.

Under a different view, global imbalances reflected a savings and investment behaviour, which was responding to natural differences in the rates of return on capital and in the degree of risk and liquidity. In particular, as a major supplier of financial assets, the US attracted savings from elsewhere. Under this "new paradigm", such trend was a structural one and could be continued for a long time (Xafa, 2007).

While views on the link from global imbalances to the global financial crisis also differ, the prevailing mainstream position seems to emerge that whereas imbalances contributed to increasing asset bubbles and to distortions in financial markets and, therefore, to the eruption of the crisis, the more prominent role in the crisis should be attributed to other factors, such as an inadequate financial regulation and supervision.

The global financial crisis has brought some unwinding of global imbalances. Due to some rebalancing of demand (in favour of surplus countries) and shifts in terms of trade (in favour of oil importers) as well as to past dollar depreciation (until the autumn of 2008), in 2009, current account imbalances contracted visibly in the US, Europe and in oil-exporting economies. However, some of these adjustments are cyclical, so risks related to global imbalances cannot be excluded also in the medium term. In particular, in the US and other advanced countries, the contraction in private demand was being partly offset by a fiscal deterioration. In Asia, surpluses are likely to continue. Crisis-related, lower oil prices are going into reverse, so current account surpluses of oil exporters are being restored. IMF baseline medium term projections predict a slight decline in the US current account deficit and increases of surpluses in China and oil exporters as counterparts. In a net result, global imbalances would stabilise. However, one could also think of worse scenarios. Some authors allow for such scenarios and suggest that imbalances are not the problem of the past and still have to be addressed (Blanchard & Milesi-Ferretti, 2009). What matters here is the policies of major "players" as well as the IMF surveillance.

Prior to the global crisis, when imbalances have been mushrooming, the Fund has responded to the process on several fronts. First, the institution provided a timely and comprehensive diagnosis. Second, the IMF worked out scenarios, including a scenario of a sudden unwinding, which provided warning about the risks associated with global imbalances. Third, the Fund proposed policy recommendations designed to avoid a sudden unwinding of imbalances. Fourth, it offered new, relevant procedures – Multilateral Consultations – for a discussion and an agreement on necessary policies. In 2006, the first Multilateral Consultations on global imbalances were attended by the US, China, the EU, Japan and Saudi Arabia.

There is a rationale, both theoretical and practical, for the Fund's coordinating role in dealing with global imbalances. Theses imbalances involve several externalities, which can be internalised in a coordinated policy response, so that superior outcomes are achieved. Applying adequate national policies everywhere without coordination does not necessarily mean that there are no international systemic problems (Eichengreen, 2008).

The Fund's platform can be helpful in working out an agreement on global imbalances and on their severity, causes and policy measures when views, particularly between major players, are divergent. Negotiations held under the Multilateral Consultations arrived, indeed, at the Action Plan for each of the five participants. Despite that, however, the US still keeps blaming China for an undervaluation of its currency and threatening the Asian country with the status of the "currency manipulator", whereas China keeps reproaching the US with the fiscal profligacy.

Two issues are relevant here. Firstly, the mechanism to bind participants so that they implement the agreement, is not sufficiently effective. Participants operate in a Nash-type environment, in which they have incentives to renege from the agreed commitments. In particular, in the aftermath of the global financial crisis, countries may have temptations to use the exchange rates to promote their exports and that could lead to a process of competitive devaluations and currency wars. Secondly, the effectiveness of surveillance depends upon the credibility of the institution. The Fund's credibility has been, and still is, challenged; the process of necessary governance reforms is on track, but not yet completed.

In order to improve surveillance over exchange rate policies and to reinforce its implementation, in 2007, the IMF has amended the 1977 Surveillance Decision. The main objective was to extend the Fund's surveillance on all major causes of external instability related to the exchange rate policies, in particular, to equip the IMF with the power to deal, in addition to competitive devaluations, with restraining by members' appreciation, that would be consistent with fundamentals. The new concept of "external stability", i.e. the balance of payment position, that is not generating – and not likely – to generate disruptive exchange rate movements, was expected to be useful in extending the scope of surveillance. However, major players remain immune to the IMF recommendations regarding external stability; if these recommendations are not implemented, Article IV remains formally unbroken. What may be harmed here is rather (only) the reputation of the country.

During the global crisis, the Fund has shown pragmatism, tailoring its recommendations on exchange rates to individual circumstances. In the case of Latvia, the IMF ultimately decided on maintaining the peg and did not insist on devaluation, which would entail negative spillover effects for the credibility of fixed regimes in neighbouring countries aiming, as Latvia is, to implement the euro. In the case of Iceland, the Fund has taken into consideration the need for financial flexibility and was in favour of a float.

Recent research on exchange rate regimes, including work done within the IMF, explores particular strengths and weaknesses of pegged, intermediate and floating regimes, with the crisis risk to a country and to the speed of adjustment as well as risks to the whole international monetary system as key factors in trade-offs around the regimes (Ghosh et al., 2010). One of the challenging options for future research on exchange rate policies could be the monetary union and paths of the euro adoption since current policies of candidate countries vary broadly.

4. IMF Lending

Like surveillance, IMF lending also serves multiple purposes for the Fund. In particular, IMF lending programmes are instrumental not only in the resolution of the crisis in a member country's economy, but also – through improving market confidence in a member – in the crisis prevention. They also help attract financing from sources other than the IMF (i.e. they catalyse financing) and help restrict the financial contagion. In order to fulfil these roles, the Fund needs adequate financial resources as well as efficient vehicles necessary to channel funds when and to where they are needed.

Restricting contagion is particularly important in the global context. In theory, by providing liquidity when private providers are reluctant to provide, the Fund helps prevent or reduce default of a debtor country and that outcome benefits also other countries. Otherwise, the equilibrium world interest rates would go up and borrowing costs would increase, which is a negative externality; such an effect is also generated by the deterioration of the macroeconomic situation by a systemically important economy (Clark & Huang, 2001).

The demand for IMF resources has significantly fluctuated over the past two decades. The 1990s and the early 2000s saw surges in demand due to lending programmes, which supported transformations in an emerging Europe as well as due to the wave of financial crises in emerging economies, from Mexico in 1994-1995 to Argentina in 2001. Thereafter, until 2007, the trend has reversed for several reasons, including ample global liquidity; reduced vulnerabilities and, therefore, also needs for the balance of payment financing, an improved access for many developing economies to private financing as well as considerable growth of foreign reserves in these economies.

The global crisis of 2007-2010 has strongly tested the Fund's financing role. In 2008 and 2009, many emerging and developing economies experienced dramatic declines in capital inflows and in trade. The demand for IMF financing has sharply increased. From September 2008 until March 2010, 21 countries applied for the IMF loans under stand-by arrangements totalling up to 57 billion dollars, whereas three countries applied for the flexible credit lines, which almost doubled stand-by lending and brought the total lending commitments of the Fund to approximately 160 billion dollars.

Responding to the severe crisis, the IMF has taken extraordinary decisions on its resources. An additional allocation of SDR equivalent to 250 billion dollars and raising the total SDR holdings to over 300 billion dollars was agreed. The value of the members' quotas, currently close to 370 billion dollars, will be doubled as a result of the 2010 quota reform. The resources borrowed under the New Arrangements to Borrow were increased from 50 billion to approximately 580 billion dollars.

Prior to the 2007-2010 crisis, the IMF has emphasised the fact that in many emerging European economies, domestic and external imbalances were accumulated. These imbalances were manageable in good times, but the global crisis turned them into severe problems. Under these circumstances, the Fund has brought into the region a badly needed liquidity which, however, was linked to the conditionality that commits the economies to necessary adjustments. Against the backdrop of 2010, Greek sovereign debt crisis and its likely contagion to vulnerable Eurozone and other economies, the IMF declared its readiness to provide, on an individual basis, financial assistance totalling up to 200-250 billion euros. This declaration has materialised in the case of the financial support for Ireland towards the end of 2010.

Over time, in order to adapt to a changing environment, the IMF has redesigned its lending frameworks, albeit usually on an ad hoc basis, with each adjustment targeted at a specific balance of payment problems. The global financial crisis has brought another substantial challenge to the Fund's lending framework and financial policies. Many economies, which in terms of their fundamentals, were in a good or reasonable shape, remained nevertheless exposed to the international financial contagion caused by shifts in market sentiments and were, therefore, at the risk of liquidity problems. The major response from the IMF to that challenge was the implementation of the new facility – a flexible credit line (FCL) for "strong performers" and of a precautionary credit line (PCL) for countries, which – due to somewhat weaker fundamentals and policies – do not qualify for the FCL. Both facilities are basically of a precautionary nature and are designed to signal market participants on countries with adequate policies, i.e. to discriminate among economies, to which investors could go with their resources.

In parallel to a debate on lending instruments, a discussion on international reserves seen as an insurance against crisis, is enhanced. It is likely that in the aftermath of the crisis, the demand for financial resources will increase due to the strengthened precautionary behaviour and possibly to a higher risk aversion. Global, long-term liquidity needs are projected to be clearly large as compared to their pre-crisis levels.

Many countries have accumulated foreign exchange reserves, which help them prevent and solve the crisis; reserves are available promptly and without conditionality. But national reserves also entail costs as they yield a lower return than an interest rate to be paid on a country's external debt and as they reduce the space of manoeuvre for domestic monetary policies. Moreover, at the global level, country reserves entail inefficiencies in terms of economies of scale as well as disadvantages as they contribute to global imbalances and to associated risks. As compared to practical benchmarks, such as indices of the import coverage, short-term debt or broad money, reserves of many countries are found to be excessive. International reserves of several emerging economies have been rising faster than their short-term external debt and exceeding the benchmark, which is related to the vulnerability of the economy to a capital account crisis.

It is, therefore, suggested that the insurance against the crisis is – to some degree - moved to an international level, including to the IMF. In order to play an increasing, anti-crisis role, the Fund would have coped with several challenges, including:

- to further expand and modernise its lending facilities so that countries are encouraged to draw on the IMF rather than hold their own reserves, when needed (Helleiner, 2009);
- to solve the associated moral hazard problems, e.g. by restricting payments to cases of crises triggered by exogenous shocks (Mateos y Lago et al., 2009);
- to adjust to regional financial arrangements, e.g. in case of the coordinated EU-IMF balance of payments for support programmes.

5. IMF Credibility

An improved Fund offer in the field of surveillance and lending is highly relevant, but not entirely sufficient, for a considerable strengthening of the role of the IMF in the global financial governance. Apart from higher efficiency, an enhanced credibility of the Fund is also needed so that member countries feel strong ownership when they participate in IMF activities. This credibility has been at stake, largely due to flaws in the internal governance of the institution as well as in the quality of surveillance and lending as perceived by some members.

An internal governance has several components, which affect, directly or indirectly, the process of decision making. In the case of the international cooperative institution, the appropriate voting structure is of prime significance. The voting structure in the IMF is largely determined by the structure of members' quotas, which are slightly corrected with the system of basic votes.

The objective of the IMF quota is to reflect a country's weight in the global economy and in the international financial system. The widespread recognition remains that the current quota structure still fails to meet its main objectives. The quota reforms agreed in 2008 and 2010 will improve the alignment of the quota structure with the structure of the global economy and finance, but these reforms are not yet effective. Under the current quota structure, emerging economies are, in broad terms, under-represented while advanced countries are over-represented. What matters here is the benchmark for the representation. Under the most usual and standard measurements, i.e. the country's GDP-PPP share in the world GDP, the combined quota share in 2009 of four BRIC's – Brazil, China, India and Russia - plus Mexico, was approximately 100% lower than what it should have been. In the case of the Eurozone economies combined, the misalignment was at approximately 50% to the opposite (see Table 1).

In addition to the GDP, IMF quotas include three other components: trade openness, international reserves and variability of flows. BRIC's plus Mexico are modestly under-represented in terms of trade openness (measured with exports) and strongly under-represented in terms of reserves, whereas the US and the Eurozone countries remain, although to a different degree, over-represented (except trade openness in the case of the Eurozone). These misalignments are illustrated below.

Table 1. Macroeconomic measurements and IMF quotas of different economies in 2009 (% shares of totals)

	GDP-PPP	Exports	International reserves	IMF quotas
US	20.5	9.9	1.7	17.7
Eurozone	15.2	28.8	9.1	23.1
BRICs + Mexico	25.7	15.1	44.5	12.2

Source: IMF.

The pattern of the relative over- and under-representation in the Fund is more complex. Among emerging economies are also over-represented countries, such as Saudi Arabia, South Africa, Argentina, Pakistan or Nigeria, whereas some of the advanced countries, such as Spain, Ireland or Luxembourg, are underrepresented. However, many sizeable Asian emerging economies, including China, Turkey, South Korea, Thailand or Vietnam, remain clearly under-represented. Under the 2010 quota reform, there is a consensus on an ad hoc 6% shift of quota shares to dynamic emerging and developing countries, but it remains to be seen whether it is satisfactory across the membership or further quota adjustments and realignments will be demanded.

Everything above the quotas assumes that the current quota formula is adequate. However, the formula is being contested on several fronts. One of the proposals assumes incorporating the population variable into the formula, which would be much in favour of large emerging economies (population of BRICs plus Mexico is approximately 10 times higher than that of the US or the Eurozone). Another possible avenue is to include some measurements of the financial openness of the economy. A discussion on the quota formula is to be reopened soon and to be completed until 2013.

Conclusions

Over time, the IMF has been making strong efforts designed to improve its policies in order to efficiently cope with the challenges originating from the continuously and increasingly changing financial environment. These challenges can be attributed to an increased volatility in international financial markets, which resulted in more frequent and deeper financial crises over the two recent decades. Financial crises were spread internationally with the process of the financial contagion. Those developments call for enhancing the global financial governance and the Fund is designed and equipped to play the central role in this process.

In response to the challenges, the IMF has been improving its surveillance and lending policies as well as adjusting its resources, but the institution did not avoid mistakes and criticism. In the aftermath of the 2007-2010 global financial crisis, several risks to the stability of the international financial system still remain and they represent remarkable problems for the Fund.

It is reasonable that the IMF policies continue shifting the major emphasis from the crisis resolution to the crisis anticipation and prevention areas. The Fund should also remain sensitive to an increasing role of those policies and instruments, which go beyond the national scope. It is also desirable that the IMF improves its credibility through a more adequate distribution of the quota shares and of the voting power. The distribution of quotas needs further realignments of quota shares to real weights of Fund members in the global economy and finance. Finally and beyond the scope of this paper, an enhancing of the Fund's role in the global financial governance depends also on the proper delineation of competencies between the IMF and other international financial institutions in order to avoid overlaps as well as loopholes in the process.

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