INTERNATIONAL MONETARY FUND

Executive Board Progress Report to the IMFC on the Fund's Mandate

October 6, 2010

- ***Aim***. This paper responds to the IMFC call to review, in light of the crisis, the Fund's mandate over macroeconomic and financial sector policies bearing on global stability.
- ***Approach***. The crisis exposed weaknesses in economic oversight—national, regional, and global—prior to the crisis, prompting major institutional innovations to uncover risks and meet large and diverse financing needs. Despite progress, it still needs to be asked if the mandate in the Fund's Articles is up to the challenges ahead. The Board's deliberations, which are far from complete, have prompted it to emphasize practical steps to deliver on the Fund's broad stability mandate, with any need to amend the Articles reconsidered in light of experience. The effectiveness of these steps will also depend on quota and governance reform, as confidence in the Fund as an impartial overseer of global stability and lender of last resort rests on its legitimacy.
- ***Action***. The Executive Board has taken the following mutually-reinforcing steps:
  - *Surveillance*. To sharpen financial sector surveillance, financial stability assessments will become mandatory for members with systemically important financial systems. Initiatives such as the Early Warning Exercise will alert to emerging risks. The Fund is also working on new modalities for integrating spillover analysis on a trial basis for systemic economies in order to provide more candid assessment and debate of the global effects of domestic policies. Surveillance can also be better integrated by drawing together policy messages of the WEO and GFSR.
  - *Lending*. Since last year's introduction of the Flexible Credit Line (FCL) and modernization of the lending toolkit and conditionality, including for low-income countries (LICs), two further crisis prevention initiatives have been approved: strengthening the FCL and introducing the Precautionary Credit Line (PCL).
  - *International monetary stability*. The mandate debate has brought back to the policy agenda complex long-term issues such as structural impediments to external adjustment, volatile capital flows, and high demand versus narrow supply of reserves.
- ***Next steps***. Many issues require more work—the need to develop spillover analysis; the case for a formal decision on multilateral surveillance and its relation to bilateral surveillance; the need for a framework for lending in *systemic* crises; international monetary stability. The Board will return to all these issues and update the IMFC.

I. Introduction

1. ***Mandate***. Formally, the term refers to the Fund's legal framework, the purposes and powers guiding its work, which is anchored in the Articles of Agreement. Although that mandate is often cast in the language of bygone concerns (e.g., trade and payment restrictions) rather than today's most pressing problems (e.g., systemic risk in globalized finance), a review by the Executive Board has concluded that the Articles are not necessarily an obstacle to anticipating or responding adequately to crises. Indeed, amendment of the Articles to clarify their reach—e.g., over financial sector stability—could certainly galvanize expectations and efforts, but a more expedient way forward would be to focus on a range of practical steps to deliver on the existing mandate to safeguard global economic and financial stability. Clearly, updating the Fund's mandate is a work in progress. Depending on the effectiveness of recent reforms, and any issues highlighted by a still early debate on international monetary stability, the case for amendments can be revisited.

2. ***Priorities***. Three complementary priorities stand out in the post-crisis world:

- *Surveillance to safeguard stability*. Stronger and even-handed bilateral surveillance to uncover vulnerabilities in large advanced economies must undoubtedly become a higher priority, but the crisis has also made the case for a broader perspective that looks at financial inter-linkages and risks to the stability of the system as a whole. The interrelated nature of large global imbalances, capital flows, and rigidities in the adjustment process underscore the importance of strong bilateral surveillance for all member countries. Yet surveillance is also more than just a matter of better analysis with better data, and will require a more substantive dialogue on stresses, risks, and remedies across national boundaries.
- *Lending to prevent and ameliorate crises*. Although crises often result from policy action or inaction over many years, thus requiring adjustment, they can equally threaten countries pursuing relatively sound policies—and especially so when the shock is systemic. The Fund must be able to tailor the size and conditionality of its lending to country circumstances and to act forcefully, and in synergy with regional financing arrangements, when the stability of the system as a whole is threatened.
- *Longer-term effectiveness of the international monetary system*. The system is characterized by a number of structural weaknesses—persistently large external imbalances, volatile capital flows and exchange rates, and high reserve demand but only a narrow range of suppliers. While there are no easy solutions, an initial debate has at least yielded consensus on the questions that any guardian of the international monetary system must find answers before problems come to a head.

II. Surveillance

3. ***Integrating surveillance***. Good surveillance entails asking the right questions, integrating different strands of analysis to yield more than just plausible answers, and

subjecting those answers to robust high-level debate. In hindsight, there were problems in all these areas in the run up to the crisis, when the co-existence of the great (macroeconomic) moderation, rapid financial innovation, and massive cross-border capital flows was not questioned enough or—to the extent it was in the global imbalances debate—failed to garner much traction with policymakers. The crisis has particularly brought home the importance of effective financial sector surveillance, within countries and across borders, of bi-directional linkages between macroeconomic and financial developments, and of the need for a serious dialogue on these matters at the highest level. Indeed, integration of financial and macroeconomic analysis, and of bilateral and multilateral surveillance, has been a consistent theme of numerous internal and external assessments of Fund surveillance over the years. The crisis has merely clarified the cost of failing to act on this advice forcefully.

4. ***Financial sector surveillance***. If the Fund is to effectively promote global financial stability, it—like national authorities—will need to take a more macro-prudential perspective that devotes more attention to the risks and stability of the system as a whole. Collaboration with specialized institutions, as in the Early Warning Exercise, will be important for these initiatives to bear fruit. The building blocks of a macro-prudential perspective include:

- *Integrating financial stability assessments into bilateral surveillance*. Financial sector issues and policies are at the core of the Fund's stability mandate, but the integration of financial stability assessments from FSAPs, the main instrument of such analysis, into bilateral surveillance has been a major challenge. This reflects many factors, including the treatment of FSAPs as a voluntary technical assistance exercise not specifically targeted at systems with the greatest relevance to global risk. The Board therefore recently approved the integration of financial stability assessments into bilateral surveillance on a mandatory basis for countries with systemically important financial systems. These assessments would cover (i) the source, probability, and impact of risks to macro-financial stability; (ii) the financial stability framework; and (iii) capacity to manage and resolve financial crises.

- *Mapping interconnectedness and risks*. The architecture of global finance is highly concentrated, with most flows intermediated by a handful of large complex financial institutions (LCFIs), transacted over a few payments and settlement platforms, and concentrated in a small core of countries. Shocks propagate quickly in such a system, with changes in LCFI funding models (e.g., from deposits to market securities) or asset holdings (e.g., from individual loans to bundled assets) yielding profound effects on the flow—and freeze up—of global capital. to However, important data gaps hinder analysis of these risks A key task for the Fund will be to resolve these data gaps, in conjunction with other international bodies such as the Financial Stability Board (FSB), of which the Fund has become a member. Work is in progress to address a number of data gaps in the context of a G20 initiative endorsed by the IMFC. This includes the IMF-FSB data template for LCFIs expected later this year, which will bring some order to the current scatter of information. Nevertheless, elaborating a risk map will entail access to other data, cross-border derivatives positions, and custodial bank flow of funds. Greater participation in existing data collection efforts, especially by systemically important countries, will be essential to filling data gaps.

5. ***Multilateral surveillance***. The Fund's mandate in its Articles to "oversee the international monetary system to ensure its effective operation" is a broad one, and the Fund's flagship publications, the World Economic Outlook (WEO) and the Global Financial Stability Report (GFSR), articulate advice that informs policy debate and cooperation. The broad mandate is good from the standpoint of flexibility and discretion but leaves open how— and how pointedly—its policy messages in this area are conveyed and acted upon. Two sets of initiatives warrant attention:

- *Macro-financial analysis*. The WEO and GFSR provide a wealth of analysis on macroeconomic and financial trends, respectively. However, discerning the bottom-line message of the two is made difficult by the baseline forecast emphasis of the WEO and the downside-risk sensibility of the GFSR. To bridge this gap, a new synthesis of the two documents will be prepared, targeted at senior policymakers and leaders. This is in addition to on-going efforts to bring pointed risk assessments to the IMFC via the Early Warning Exercise, and the new impetus given to the Fund's analysis and advice on fiscal issues by the Fiscal Monitor. Finally, there is the related—and far from settled—question of whether the Fund should put in place a Board decision that sets out a comprehensive framework for multilateral surveillance and that clarifies what is required of the Fund, and its members, in this regard. (Unlike bilateral surveillance, there is no Board decision spelling out expectations for the two sides.) The Board will return to this matter at the time of next year's Triennial Review of Surveillance and the Review of the 2007 Bilateral Surveillance Decision.
- *Spillover analysis*. Priority must be given to bridging the gap between multilateral and bilateral surveillance. In this regard, spillover analysis—brought together in focused reports—is an important innovation under consideration that will look into the cross-border implications of policies of the most systemic economies. The analysis would then be discussed with policymakers on both sides, the originating and the affected. The goal is a more open and pointed discussion of cross-border effects than has been possible to date in either the bilateral or multilateral context. Such analysis holds the potential of informing not only the Fund's own multilateral and bilateral surveillance but also the IMFC's deliberations of global issues, as well as the Fund's input to the G20 Mutual Assessment Process. It could also increase the traction of surveillance by engaging policymakers at the most senior levels. After a trial with five major economies (China, Euro Area, Japan, U.K., and U.S.), to be completed with their Article IVs by July 2011, the Board will take stock of the desirability of, and modalities for, future work.

6. ***Bilateral surveillance***. Article IV consultations with all members is a cornerstone of the Fund's mandate. Beyond its role as independent external assessments, its most valuable

characteristic from members' own standpoint is the cross-country perspective that the Fund brings. In an effort to enhance this component, the Fund has been experimenting with cross-country/thematic reports that draw policy lessons for small groups of countries facing similar issues. In the years ahead, the scope for such reports, without compromising the detailed assessment that characterizes country surveillance reports, is expected to be enhanced. In addition, the Board has approved greater flexibility in the determination of the cycles for Article IV consultations, and will discuss in the coming months whether and how to strengthen the framework for timely consultations.

III. Lending

7. ***Global financial safety net***. The crisis has highlighted that an adequate global financial safety net has several dimensions—sound policy frameworks, adequate risk management and supervisory structures, adequate resources, including currency reserves, speed of response, conditionality tailored to country circumstances, and a capacity to pull all these together to respond to systemic events. Many of these points were addressed in early 2009, when members tripled Fund resources and the Board approved an increase in members' potential access, streamlined its lending toolkit, modernized conditionality, and adjusted charges. The Fund also overhauled its concessional lending toolkit for low-income countries to enable the institution to better serve these members. A major element of the reform package was the new Flexible Credit Line (FCL) that allowed ex-ante qualification based on the strength of fundamentals, policies and policy frameworks in lieu of traditional ex-post policy conditionality.

8. ***Broadening crisis prevention***. Last month, the Board approved two further reforms:

- *Refining the FCL*. Although the FCL was successfully tapped by three countries to ensure continued market access, and reduced spreads for countries merely presumed to qualify for it, discussions and surveys revealed that a number of design features limited its appeal. In response, the duration of purchase rights has been doubled to a year, and allowance made for two-year arrangements (with a mid-term review). The implicit cap on access of 1000 percent of quota also has been removed, allowing arrangements to be better tailored to financing needs. At the same time, safeguards for Fund resources have been strengthened, including procedures for early Board involvement in assessing the access levels and their impact on Fund liquidity.

- *Introduction of the PCL*. The Precautionary Credit Line aims to provide effective crisis prevention to members with sound fundamentals and policy frameworks but also moderate vulnerabilities that preclude FCL eligibility. The PCL relies on FCL-style qualification rooted in surveillance to send positive signals about the strength of policies. Other conditions are focused on remaining vulnerabilities identified during qualification, and include semi-annual reviews and possible prior actions and performance criteria. Access is frontloaded, phased, capped at 1000 percent of quota, and requires that there not be any actual financing need at the time of approval. The

PCL would facilitate the extension of the global financial safety net to more members, with due regard to safeguarding Fund resources and limiting moral hazard.

9. ***Multi-country arrangements and regional cooperation***. A staff technical note, to be discussed ahead of the November G20 Leaders Summit, is expected to clarify that current decisions governing the FCL and PCL are sufficiently flexible as to permit simultaneous and multiple arrangements upon members' request. Insofar as such coordinated action can have significant market effect in times of crises, this could greatly strengthen the Fund's crisis toolkit. In addition, the scope for greater synergies between the Fund and regional financing arrangements—e.g., as with the European Stabilization Mechanism—will be explored in a high-level seminar during the Annual Meetings and in other on-going efforts.

10. ***Global Stabilization Mechanism (GSM)***. Staff's proposal for the GSM, which remains controversial, represents a more ambitious and far-reaching mechanism to enhance the Fund's capacity to respond to the kind of systemic crises brought about by increased inter-connectedness and complexity is also under consideration. However, further work is required to assess whether concerns that a formalized procedure may stoke moral hazard can be overcome. The GSM is designed to be used only in a systemic crisis, in close cooperation with relevant institutions, to trigger Board consideration of an array of institutional responses, including simultaneous offers by the Fund of access to the FCL and other means of meeting systemic liquidity needs.

11. ***Low-Income Countries (LICs)***. The Fund remains committed to assisting LICs in an uncertain economic environment. Since the beginning of 2009, it has committed roughly $5 billion in new concessional financing and demand is likely to remain high. The Fund has also delivered on its commitment to overhaul its lending facilities for LICs, established a Post-Catastrophe Debt Relief Trust, and cancelled all of Haiti's debt to the IMF. Looking ahead, mobilizing contributions from members to ensure adequate funding of the Fund's concessional facilities will be a priority. The Fund also looks forward to working with development partners to assist LICs in implementing sound strategies to scale-up critical infrastructure investment, and enhancing support for fragile states.

IV. International Monetary System

12. ***Long-term challenges***. The Fund's Articles require it to promote long-term global stability and proper functioning of the international monetary system (IMS)—a mandate that would certainly include a better understanding and mitigation of many long-lived problems in the global economy. These include an unprecedented accumulation of international reserves, their concentration in a narrow set of currencies, persistent global imbalances, and large and volatile capital flows and exchange rates—all against the background of uncertain access to international liquidity in times of crisis. These issues are interrelated, with progress in one area alleviating pressure on the others. They reflect in large part the transition challenges of a world where emerging markets grow much faster than advanced economies,

often with export-oriented growth strategies, but where financial markets in the former typically need further deepening. While the transition is bound to be a long-term process, further work in this area will need to focus on pragmatic steps that the Fund and members could jointly take to strengthen the stability of the IMS, with emphasis on the following areas:

- *Capital flows*. Work is proceeding toward improving the understanding of cross border capital flows (through enhanced data and analysis), including on how financial conditions in the systemic financial centers affect economic outcomes elsewhere. The scope for a multilateral approach to reducing capital flow volatility will be explored through, for example, identifying policy options for capital flow recipient or source countries, and the merits of developing guiding principles to help frame policy recommendations tailored to specific country circumstances for the Fund's bilateral advice on managing flows. This strand of work intersects with efforts to strengthen global financial regulation and links between the two will need to be considered.
- *Reserve adequacy*. Analytical work is underway to provide guidance on appropriate levels of precautionary reserves in a financially integrated world, given the costs and benefits of holding reserves and available alternatives.
- *Role of the SDR*. The scope for a greater role for the SDR (both in the official and private sector) to strengthen the resilience and effectiveness of the IMS will be considered further, with due regard for the realism, implications and potential costs of fostering demand for an alternative reserve asset.

V. CONCLUSION

13. ***Next steps***. Much has been achieved in response to the crisis in terms of living up to the Fund's mandate to promote global stability. Nevertheless, more can and should be done. In the immediate period ahead, progress is not so much a matter of rewriting the Fund's Articles as it is of getting on with pragmatic steps of the kind outlined above. The Board's year long reflection has been an occasion for important action, but also for an appreciation of the need to continue to build a consensus around further reforms, especially regarding macro-financial and cross-border surveillance, instruments to tackle systemic crises, and the stability of the international monetary system.

14. ***Further work.*** Updating the Fund's mandate is a work in progress. Many of the innovations described in this Progress Report are untested, and while they did require substantial consensus building among the membership, it remains an open question whether they will succeed in addressing previously identified weaknesses in the Fund's surveillance and lending toolkit. Likewise, Fund engagement in issues pertaining to the smooth functioning of the IMS will evolve and require ongoing consultation with members. In the near term, the 2011 Triennial Review of Surveillance and Review of the 2007 Bilateral Surveillance Decision will present opportunities to take stock of recent reforms and ask if additional changes are needed and if they can be accommodated within the existing Articles.

Developments in other key areas also merit continued and close evaluation, including the Fund’s role in shaping the new financial system and in issues related to sovereign debt sustainability and fiscal space.