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2014 TRIENNIAL SURVEILLANCE REVIEW—EXTERNAL STUDY—MULTILATERAL SURVEILLANCE: ENSURING A FOCUS ON KEY RISKS TO GLOBAL STABILITY

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EXECUTIVE SUMMARY

The 2007/9 crisis and the ongoing transformation of the global economy call for a rethink of the scope of the Fund's multilateral surveillance. This paper first reviews the reforms already undertaken in response to the crisis as a basis for exploring the case for further initiatives to ensure that the Fund's multilateral surveillance function is equipped to identify the key risks to global stability, within its areas of comparative advantage. The paper offers recommendations for further reforms within the Fund's existing mandate, and more far-reaching changes that might be warranted over the medium term, in particular to ensure that risks from capital flows are adequately addressed.

The crisis brought the weaknesses of Fund surveillance and the need for global cooperation into sharp focus. It demonstrated that the steady transformation of the global economy, characterized by rising capital flows and interconnectedness, had not been fully internalized by the Fund, whose pre-crisis multilateral surveillance focused on global imbalances. Similarly, there was limited cooperation on economic and financial policies until the crisis broke out, when the G20 became the key forum for discussions of financial sector reforms and macroeconomic policies.

The Fund has begun to strengthen its multilateral surveillance. The importance of interconnectedness and spillovers is being addressed through annual Spillover Reports, and the adoption of the Integrated Surveillance Decision (ISD) laying out procedures to further integrate multilateral and bilateral surveillance. Systemic risks are being identified through an Early Warning Exercise (EWE) and the bottom-up Vulnerability Exercise. To better integrate financial stability issues into bilateral and multilateral surveillance, Financial Sector Assessment Programs (FSAPs) have become mandatory for 29 countries with large or highly interconnected financial sectors. Finally, the Fund has upgraded its policies on capital flows, with the formulation of an Institutional View on the liberalization and management of capital flows. Efforts to strengthen the traction of

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multilateral surveillance are also influenced by progress towards finalizing the 2010 quota and voice reforms, which have not yet been approved by U.S. Congress.

Stronger and more systematic international cooperation, informed by Fund surveillance, would support global economic stability. Although incentives for cooperation seem to have waned, and the G20's effectiveness has diminished, there is a strong case for consistent policy cooperation in three areas: macroeconomic policies, particularly by systemically important countries; harmonization of global financial regulation; and the oversight of international capital flows. The Fund could contribute to these efforts by, for example, intensifying work on the drivers of global liquidity, and its impact on non-systemic countries.

The Fund can make further improvements within its existing mandate. In the near term, there is room to gain traction on cooperation by moving towards a *risk-based* multilateral surveillance framework underpinned by an improved analytical framework, with initiatives in the following areas:

- *Analytical capacity.* The EWE should be strengthened, and fully integrated with the IMF's internal vulnerabilities exercises.
- *Diverse Views.* Staff should be empowered to be more proactive and candid in identifying risks, particularly those stemming from large systemic economies and financial centers. In line with IEO advice, resources should be used more flexibly.
- *Integrating FSAPs.* FSAPs should be used to inform multilateral surveillance, in particular on progress towards harmonization of financial regulatory reforms.
- *Risk Unit*. It is essential to define clearly the terms of reference, role, and reporting line of the Fund's new Risk Unit and to put in place arrangements to ensure that staff resources can be reallocated flexibly to address emerging risks.
- *Establishing a track record.* To gain traction, the Fund needs a 'track record' of forward-looking policy advice. The EWEs need to be able to show, through an ex-post analysis, that there were occasions when significant gains would have accrued to the global economy if key systemic countries had followed the Fund's advice.

Looking further ahead, establishing a new governance structure, through a merger of the IMFC and the G20, could help encourage cooperation. The new IMFC would deliver strategic and policy direction, and engage in policy cooperation, including macroeconomic policy, trade policy and issues relating to capital flows. This would help create a more coherent and effective forum to internalize externalities. The IMF would need to play a critical supporting role for this proposal to work.

In the medium term, a strong case can be made for giving the Fund an explicit capital account remit. The Articles of Agreement could be amended to grant the Fund jurisdiction over members' capital accounts. This would represent a clear commitment on the part of Fund members to shift towards a more cooperative approach to global stability; to encourage direct and formal dialogue between source and recipient countries; and strengthen the Fund's position to manage global liquidity. This requires further improvements to the Fund's analytical framework, including empirical measures of systemic risk and indicators for global liquidity to flexibly guide the international community's policy cooperation framework.

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I. INTRODUCTION

1. **The 2007–09 international financial crisis demonstrated that the unchecked build-up of risks in the global economy can culminate in substantial costs to the international community**. In contrast, the policy response implemented by the G20—and supported by the International Monetary Fund (IMF or the Fund)—illustrated the substantial gains that can be achieved through global coordination. The crisis was a massive institutional failure on part of both private and public entities. However, as pertains to the IMF, it served to reveal deep flaws in the Fund's ability to fulfill its surveillance task—that is, the monitoring of individual member countries' economic fundamentals and policies (i.e., bilateral surveillance) and of their interactions with each other (i.e., multilateral surveillance) to identify potential risks to the system's stability and take measures to mitigate them. The purpose of the present study is to analyze how the IMF's multilateral surveillance can be made more effective in order to achieve better global macroeconomic outcomes and a more stable international financial system.

2. **Since the financial crisis the global community and the IMF have rightly developed an ambitious agenda aimed at improving the Fund's surveillance framework to address the pre-crisis flaws.** This is, naturally, a work in progress which is strengthened through periodic reviews on the progress achieved (such as the 2014 Triennial Surveillance Review (TSR)) and frequent consultations about alternative possible enhancements (such as the present study). Here, we explore what further enhancements could be implemented in the IMF's multilateral surveillance framework to gain efficiency and traction in the Fund's ability to identify, analyze and mitigate risks to global stability.

3. **In addressing this general issue, a number of more specific questions arise:** (i) Given the current international financial architecture and the mandate of the Fund, how can the Fund more effectively call attention to the key risks to global economic and financial stability? (ii) How could the Fund work more effectively with other bodies to promote cooperation in international economic and financial policies? (iii) What further analysis should the Fund deliver to support these processes? (iv) Are the Fund's mandate and its *Institutional View* on capital flows adequate to the task of undertaking surveillance of risks in international capital flows, or is a more ambitious framework needed for the Fund to play an effective role in this area?

4. **We consider how the Fund can enhance its multilateral surveillance work on macroeconomic outcomes** (including through advice on the stance of monetary, fiscal, and financial regulatory measures); and whether and how the Fund can assist in enhancing structural conditions (e.g., financial regulation) that impact on the efficiency and stability of the global economy and financial system. The ultimate objective of this study is to provide a set of proposals and guidelines aimed at increasing the traction and effectiveness of the IMF's multilateral surveillance activities in order to mitigate risks in the international economy and financial system, and to put the global economy on a more sustainable and robust growth trajectory. In some instances, these proposals will seem impractical in the short term and politically unpalatable in

current circumstances, but they should nevertheless be spelled out to contribute to the pressing debate concerning the global economy's long-run growth sustainability.

5. **Indeed, one of the overarching arguments we develop is that global economic governance reforms are a necessary condition for strengthening the traction of multilateral surveillance over the longer term.** As the global economic landscape continues to change, the international community should seek to ensure that the IMF's structure remains in tune with members' economic weight and significance while maintaining representativeness and neutrality. A positive step in this direction was taken through the 2010 reform agreement, which reviewed members' quotas and voting rights and increased the financial resources of the Fund. However, the failure of the U.S. Congress to ratify the agreed reforms represents a disappointing setback on the way to a more robust international monetary system (IMS). Thus, it seems appropriate to provide further analysis on what reforms could achieve the goal of enhanced multilateral surveillance and, ultimately, a more stable and balanced global economy.

6. **The remainder of the paper is structured as follows.** Section II provides a brief account of the IMF's surveillance efforts and weaknesses in the years preceding the global financial crisis of 2007-09. Section III reviews the principal changes that have taken place, since the crisis, in the global financial architecture and the Fund's mandate. Section IV sets out the Fund's current multilateral surveillance framework. Section V lays out the arguments that call for a strengthened surveillance role for the IMF. Section VI proposes ways to strengthen the IMF's multilateral surveillance activities under its current mandate. Section VII proposes ambitious long-term reforms to make the Fund's multilateral surveillance tasks more efficient and inclusive while increasing the coherence of the global financial architecture. Section VIII concludes.

II. MULTILATERAL SURVEILLANCE IN THE RUN-UP TO THE CRISIS

7. **This section lays out the context for the Fund's multilateral surveillance in the run-up to the global financial crisis**. It focuses on weaknesses that were revealed in both the Fund's surveillance and the global financial architecture, highlighting how failures of global policy coordination resulted in insufficient efforts to identify threats to global stability or mobilize action once they were detected.

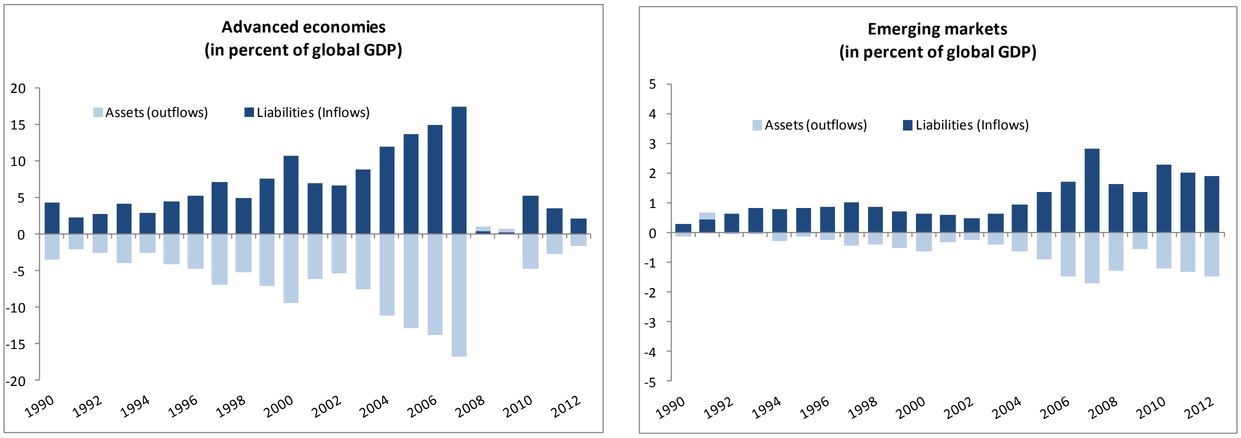
Before the Crisis

8. **The global economy went through major changes in the ten years prior to the crisis**. Gross capital flows increased rapidly (Figure) and much faster than trade flows in the period preceding the global financial crisis.[3] Net capital flows increased as well—a counterpart to growing

[3] Trade flows account for the bulk of international transactions since the Fund was founded, although there has been an unprecedented increase in the volume of capital flows in recent years. In 2007, global capital flows had more than tripled the levels observed in the beginning of the decade.

current account imbalances and reserve accumulation—especially by emerging markets (EMs) seeking to insure themselves against crises. These developments, coupled with rapid growth in financial markets in advanced economies (AEs) and EMs' rising share of global output, changed the way in which shocks would be transmitted.

Figure. Gross Capital Flows to Advanced and Emerging Market Economies



9. Against this backdrop, the Fund's multilateral surveillance focused on the global pattern of external current account imbalances. From 2004 to the start of the crisis in mid-2007, the Fund emphasized the risk of a disorderly unwinding of global imbalances triggering a rapid and sharp depreciation of the dollar, a surge in commodity prices and a rebound in inflation.

10. Risks building in the financial sector and the potential for macro-financial and cross-border linkages to propagate shocks received less attention. The Fund generally viewed the growth and sophistication of financial markets, and economic integration more generally, as benign developments (see paragraph 12). In line with the focus on global imbalances, the Fund examined net capital flows, but paid less attention to rising gross stocks of internationally-held financial assets and capital flows, which were becoming more relevant for financial stability and the cross-border transmission of shocks. Fund surveillance also did not focus effectively on financial regulatory issues or links between monetary policy and global imbalances, and generally did not suggest macro-prudential approaches to address emerging risks (IEO 2011). The Fund's surveillance framework, amended in 2007, emphasized risks to the stability of the system of exchange rates and the operation of the IMS. It left uncertainty about whether staff should assess spillovers from countries that were viewed as stable, or spillovers such as financial contagion that were not transmitted through explicit balance of payment channels.

A. Weaknesses Revealed During the Crisis

11. The crisis brought flaws in the scope of Fund surveillance and the global architecture for policy coordination into sharper focus. An IMF staff review (IMF 2009a) highlighted two areas where existing arrangements failed to respond adequately to growing vulnerabilities:

- *Surveillance of global economic developments and policies* did not give sufficiently pointed warnings about the risks building up in the international financial system. The IEO report (IEO 2011) argued that this was partly due to organizational impediments that created a silo mentality within the Fund and hindered its ability to "connect the dots" in the run-up to the crisis.

- *Coordination of macroeconomic policies across governments* did not produce the international leadership needed for a concerted response to the global risks identified.

12. Prior to the crisis, the IMF frequently endorsed the mainstream view that financial innovation had increased the safety of the financial system. In this sense, the Fund's analysis did not correctly assess the level of risk created by the growing complexity of financial products. For instance, the April 2006 Global Financial Stability Report (GFSR) includes the following statement, which conveys the IMF's stance at the time: "There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient. The improved resilience may be seen in fewer bank failures and more consistent credit provision" (p. 51). Today, a growing body of academic research suggests that the opposite is true. Excessive financial complexity leads to systemic instability, rather than increased safety.

13. Fund surveillance was often not specific or pointed enough to gain traction (IMF 2009a, IEO 2011). It did not provide sufficiently specific warnings, missed inter-linkages, and was too optimistic on AEs and on financial innovation (IMF 2009a). This was especially noticeable in failure to detect risks—particularly financial system risks—in the U.S. and U.K., at the center of the global financial system. Weaknesses in bilateral surveillance over these economies contributed to the shortcomings in multilateral surveillance as there was a complacent mindset which believed that a major financial crisis in the U.S. or Europe simply could not occur. This was clear in the exclusion of all advanced economies from the Vulnerability Exercise launched after the Asian financial crisis of the late 1990s. Similarly, even though the Fund identified some key financial sector risks, multilateral surveillance did not convey clearly the need for urgent action (IEO 2011).[4] It also paid insufficient attention to risks of international spillovers from a crisis in AEs.

14. Weaknesses in the global financial architecture also meant that a coherent, coordinated response did not materialize even when serious concerns were raised:

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[4] The GFSR issues warned repeatedly that abundant liquidity was boosting asset values beyond levels justified by fundamentals and was making investors complacent; that a structural shift in global financial markets—via financial innovations—was reallocating credit risk from banks to nonbanks, with potential implications for financial stability; and that the proliferation of complex, leveraged financial instruments made liquidity risk increasingly relevant. However, the risks flagged in the GFSR did not feature prominently in the IMF's overall messages in part, because of the lack of a coherent macro-financial storyline to underpin the laundry list of risks, and the dominance of the WEO's messages—which at that time were more sanguine than those in the GFSR.

- Repeated warnings from the Fund in the first half of the 2000s about the risks of global current account imbalances eventually led the International Monetary and Financial Committee (IMFC) in 2006 to endorse a broad response—involving fiscal consolidation in the U.S., structural reforms in Europe and Japan, measures to boost domestic demand and currency flexibility in emerging Asia, and increased spending by oil producers. However, the Fund's efforts in 2006-07 under a Multilateral Consultation to obtain more specific policy commitments from the main countries concerned met only limited success—if any at all.[5] G7 *communiqués* at times contained more direct exhortations, primarily toward non-members, but this also led to little concrete action (IMF 2009b).

- **Although the central banks of key systemically important countries coordinated their liquidity provision efforts from the beginning of the crisis in August 2007, the broader macroeconomic policy responses were initially poorly coordinated at the time the crisis reached its worst phase in the fourth quarter of 2008.** Countries protected their own banks with guarantees, at the risk of causing runs elsewhere. Liquidity provision in the U.S. initially focused on home markets, despite strong demand for dollars in other financial centers and the risk of feedback effects back to the U.S.[6] Furthermore, the lack of pre-agreed burden-sharing mechanisms meant that countries were quick to ring-fence assets in their jurisdictions when cross-border entities showed signs of failing (IMF 2009a).

III. EVOLUTION OF THE INTERNATIONAL FINANCIAL ARCHITECTURE AND THE MANDATE OF THE FUND SINCE THE ONSET OF THE GLOBAL FINANCIAL CRISIS

15. The crisis provided a significant impetus to global cooperation on economic and financial policies. The incentives to cooperate, which had been absent during the boom of the 2000s, re-emerged. This section examines the emergence of the G20 as the key forum for cooperation—a reflection of EMs' rising share of global output, the global nature of the crisis, and the fact that AEs' policy frameworks had been discredited because the crisis was triggered in their financial systems. It also discusses international cooperation on financial sector reforms involving the Financial Stability Board (FSB).

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[5] The Multilateral Consultation was unsuccessful in part because the procedures were not formalized, and had to be developed in an *ad hoc* manner. IMF 2010a states that "The experience with this process has generally not been considered a success, however. For example, Edwin Truman noted at the time that 'the content and timetable of these consultations are insufficiently ambitious.' Later, in discussing the staff report on the Multilateral Consultation, several Executive Directors pointed out that the policy package in the Multilateral Consultation report was less ambitious than that recommended in the WEO or Article IV consultations. Other directors raised concerns about the lack of a framework to effectively monitor the implementation of policy commitments made by the five economies in this multilateral consultation." (p. 23)

[6] In October 2008, the Federal Reserve put in place currency swap lines with Banco Central do Brasil, Banco de México, the Bank of Korea, and the Monetary Authority of Singapore, setting an important precedent for dollar funding lines to EMs.

16. Although meetings of G20 finance ministers and central bank governors had taken place regularly since 1999, the role and importance of the G20 in cooperation on international initiatives in macroeconomic policy and financial regulatory reform expanded vastly as a result of the crisis. The Heads of State and Government of the G20 held their first-ever Summit in Washington at the height of the crisis, in November 2008. The *Communiqué* of the Washington G20 Summit set out a remarkably comprehensive and detailed program to reform the global architecture of financial regulation. A few months later, the G20 London Summit of April 2009 supplemented these measures by agreeing on an internationally coordinated program of fiscal stimulus to mitigate the negative impact of the crisis on employment and output throughout the global economy. Thus, the newly-established G20 Summit process laid out a global reform agenda which had major implications for multilateral surveillance and the mechanisms for cooperation on economic policies and the leaders pledged to monitor its successful implementation. Key elements were as follows:

- Closer cooperation on economic policies to avoid economic collapse, restore growth, avoid negative spillovers, and support emerging market and developing economies.

- A comprehensive program of reforms to strengthen financial markets and regulatory regimes so as to avoid future crises. The Financial Stability Forum (FSF) was to be expanded to include a broader membership of EMs.

- Reforms to the international financial institutions (IFIs), including additional resources and steps to strengthen their governance and membership.

In retrospect, this was a remarkable outcome. The fiscal stimulus and the actions of central banks, although not coordinated by the G20, probably avoided a great depression.

17. The G20's agenda has expanded significantly since 2008-09 and economic cooperation has become just one of many priorities. New areas of focus include tax evasion and avoidance, climate change, corruption and energy policy, which largely fall outside the Fund's areas of expertise. Commentators have expressed concern at the broadening of the G20's agenda, and that G20 *communiqués* have become longer and more reliant on extensive background material, with less in the way of substance.[7] This process began shortly after G20 meetings were elevated to Heads of State level. When the agenda was transferred from central bank Governors and Ministers of Finance to Foreign Relations Ministries, it took on a more political tone and since then the G20 has almost ceased to be an effective mechanism for economic cooperation. The Australian presidency has taken steps to refocus on key priorities. Nevertheless, concerns persist about the G20's capacity to coordinate macroeconomic policies effectively over the long term, and its ability to continue to act effectively as a forum for economic cooperation now that EMs are growing in size and importance relative to AEs in the global economy, and the strong crisis-induced incentives to cooperate have shown signs of weakening.

[7] See, for example, Callaghan, 2013, The St. Petersburg G-20 Blues.

A. Cooperation on Financial Sector Reforms

18. In 2008–09, the G20 leaders developed an action plan for international financial sector reform. It was designed to respond to the stresses that had emerged during the crisis with the following measures: (i) strengthening transparency and accountability; (ii) enhancing sound regulation, in particular by strengthening banks' capital requirements and risk-management practices, reducing systemic risk in derivatives markets and reforming credit rating agencies; (iii) promoting integrity in financial markets; (iv) reinforcing international cooperation to strengthen surveillance and resolution of cross-border firms; and (v) reforming the IFIs, including by strengthening collaboration between the IMF and the FSF/FSB to better integrate regulatory and supervisory responses into the macro-prudential policy framework.

19. In 2009 the FSF was transformed into the FSB and given a broader mandate. It became the main forum for coordinating the reform and strengthening of financial regulation and supervision at a global level, in the context of the comprehensive G20 economic cooperation program**.** A number of EMs were invited to join the FSB in order to broaden its membership, and members committed to pursue the maintenance of financial stability, enhance the openness and transparency of the financial sector, and implement international financial standards. It also agreed to undergo periodic peer reviews, using IMF/World Bank Financial Sector Assessment Program (FSAP) reports. In its FSAP work the Fund staff, in cooperation with the World Bank, reviews the structure and regulation of the financial system and assesses key financial risks and vulnerabilities of each of its member countries, and provides recommendations on how those elements can be made consistent with international regulatory best practice. The FSB was tasked to elaborate and report on these commitments and the evaluation process.

20. The division of labor between the Fund and the FSF/FSB was defined in a joint letter of November 13, 2008 from the Managing Director (MD) of the IMF and the Chairman of the FSF to Ministers and Governors. The letter lays out how the FSB and the IMF should work together. It notes that the shared goal of the FSB and the IMF is to strengthen the international financial system by supporting the work of the G20. To accomplish this goal, the letter establishes a division of responsibilities. In particular, it asserts that "surveillance of the global financial system is the responsibility of the IMF" and specifies that "the IMF assesses macro-financial risks and systemic vulnerabilities." It states that the principal task of the FSB is "elaboration of international financial sector supervisory and regulatory policies and standards, and coordination across various standard setting bodies;" and it notes that "the IMF participates in this work and provides relevant inputs as a member of the FSB." In contrast, "implementation of policies in the financial sector is the responsibility of national authorities, who are accountable to national legislatures and governments." The IMF "assesses authorities' implementation of policies through FSAPs, ROSCs and Article IVs." The letter also emphasizes that "the IMF and the FS[B] will cooperate in conducting early warning exercises" (see Section IV and Box 1) and that the FSB assesses financial system vulnerabilities drawing on the analyses of a number of bodies, including the IMF.

21. While these arrangements are relatively clear, there are obviously still some gray areas. In effect, the division of labor between the IMF and the FSB continues to be unclear. For example, overall responsibility for examining the macroeconomic consequences of regulatory reforms, which are often non-trivial in nature and have unintended consequences, has not been explicitly defined. The Fund has periodically covered this issue in its surveillance work, but has not established a systematic process or products to cover this issue; the coverage has been more *ad hoc* in nature. For example, the Staff Discussion Note and Staff Position Note series discussed the impact of regulatory reforms on bank lending rates and on large and complex financial institutions (IMF 2010b, 2012a). Several GFSRs have also covered topics related to the design and implications of regulatory reforms.[8]

22. Further, the issue of who is to oversee and encourage the harmonization of financial regulation across jurisdictions remains a significant "blind spot" in the global financial system. This has been a matter of significant debate in recent years but no agreed arrangement has been achieved within the G20. In this regard, there is a strong case for the IMF to pursue this objective, but it lacks a clear mandate to do so. So far, the IMF has mainly provided assessments on the implementation of global regulatory reforms through the GFSR (IMF 2012b, 2012c, 2013a, 2014a). It has also produced Staff Discussion Notes on the potential effects of country-specific reform proposals, such as the Volcker, Vickers, and Liikanen measures to address too-important-to-fail problems (IMF 2013b).

B. Reviving Cooperation on Global Macroeconomic Policies

23. In 2009, the G20 launched a new surveillance process with the aim of ensuring that global policies are consistent and supportive of growth. Referred to as the "Framework for Strong, Sustainable, and Balanced Growth," it involved a mutual assessment process (MAP) of G20 countries' goals and supporting economic policies.

24. The MAP has been led by members and supported by the Fund. This set-up was designed to secure buy-in from the members, while drawing on the Fund's technical expertise. The Fund assesses whether members' policies are consistent, and likely to deliver sustainable and balanced trajectories for the global economy.[9] The Fund was also expected to make recommendations for policy adjustments to improve the global outlook. From a legal perspective, the Fund's involvement constitutes technical advice provided under Article V, Section 2(b) which authorizes the Fund to provide technical or financial services "upon request," and should not constrain Fund's bilateral and multilateral surveillance work. Instead, this was expected to be an opportunity for the Fund staff to deepen its policy discussions and reinforce traction by opening up new communication channels and helping generate greater buy-in for needed reforms. To help preserve G20 ownership, staff's assessments are provided directly to the G20, and sent at the same

[8] See IMF 2010c (chapter 2); IMF 2011a (chapter 3); IMF 2011b (chapter 3); IMF 2012c (chapter 3); and IMF 2014a (chapter 3).

[9] The FSB was to provide advice on financial policies; the ILO on labor market policies; the WTO on trade policies; and OECD and UNCTAD, where appropriate. The World Bank has been asked to advise on progress in promoting development and poverty reduction as part of the rebalancing of global growth.

time to the IMF Board. Staff was to present its contributions to the Board in informal briefings ahead of each Ministerial Meeting, and to brief the Fund's Board after the G20 meetings.

25. The MAP has required significant Fund input, particularly in early years. In its first year, Fund staff produced three main inputs, in April (Analysis and Perspectives, deriving a base case scenario), June (Alternative Scenarios) and November 2010 (Staff's Assessment of G20 Policies), in addition to informal notes and presentations shared with the G20 at the working level (see Table).

Table. Building Blocks for the G20 MAP Framework

Summit	Key steps	Description
Pittsburgh September 2009	**Policy and macroeconomic frameworks**	All G20 members to share information—with each other and the IMF—about their policy plans and expected performance over next 3–5 years. IMF to examine global implications.
Toronto June 2010	**Assessment of members' policies**	IMF assessed the consistency of G20 members' policies with growth objectives and simulated an "upside" scenario in which well-designed, collective action produces better outcomes for all countries and contributes to global rebalancing.
Seoul November 2010	**Enhanced MAP with indicative guidelines**	G20 leaders to gauge progress toward Framework goals via *indicative guidelines* to identify and assess imbalances. IMF was tasked to conduct in-depth assessment of members with large imbalances.
	Policy commitments	Each G20 member identified policy actions it would take to help achieve the common growth objectives.
Cannes November 2011 ***(Cannes Action Plan for Growth and Jobs)***	**Near-term actions**	G20 leaders reiterated importance of expeditiously implementing measures announced by euro area leaders just before the G20 Summit. The G20 also committed to take significant strides toward a more stable and resilient international monetary system.
	Medium-term policy imperatives	G20 leaders endorsed policy actions to correct imbalances over the medium term and ensure progress toward strong, sustainable, and balanced growth. They committed to working with greater resolve on social issues, such as unemployment and social safety nets.
	Analysis of large imbalances	For seven countries identified as having large imbalances, *sustainability reports* by IMF staff provided in-depth analysis of the nature of countries' imbalances, root causes, and impediments to adjustment.
Los Cabos June 2012 ***(Los Cabos Growth and Jobs Action Plan)***	**Policy actions**	G20 leaders committed to adopting policy measures to strengthen demand, support global growth, and restore confidence, address short- and medium-term risks, enhance job creation, and reduce unemployment.
	Accountability framework	G20 leaders agreed on enhancing an *Accountability Assessment Framework* to assess progress in meeting commitments toward the shared goal of strong, sustainable, and balanced growth, and conducted the first assessment under this framework.
Saint Petersburg September 2013 ***(St. Petersburg Action Plan)***	**Policy actions**	G20 leaders agreed on an Action Plan to cooperatively boost global growth, jobs, and financial stability. They acknowledged the need for fiscal consolidation to reflect economic conditions; for advancing financial oversight and regulation; and for structural reforms to support growth. Leaders also expressed support for completion of the IMF's 2010 quota reform.

26. The MAP has produced some benefits and has evolved over time. Member-country 'ownership' has remained high (Faruqee and Srinivasan 2012). The Fund's multilateral surveillance, particularly the World Economic Outlook (WEO), has helped identify global inconsistencies resulting from country submissions to the MAP. It has also opened up new channels of communication between the Fund and top policy-makers. As the MAP exercise has evolved, the analyses provided by staff have supported the process designed by G20 members to help them elaborate their policies in the areas of correcting global imbalances, designing a more stable and resilient IMS, strengthening demand and supporting global growth, addressing short- and medium-term risks, and enhancing job creation. Efforts to raise global growth are receiving a renewed push under the Australian presidency. The most recent G20 meeting committed to developing new structural measures to lift the collective GDP of G20 countries by more than 2 percent (over US$2 trillion more in real terms) above the trajectory implied by current policies over the coming five years.

27. However, in general, cooperation has ebbed somewhat in recent years. As the deep initial concerns of the crisis have gradually faded, incentives for cooperation among G20 countries have declined. Following on the 2008 and 2009 Summits, subsequent G20 meetings set ambitious goals for global policies and members agreed to adjust their policies to achieve better global economic outcomes, but members' response to these commitments varied. A change in the goal of the G20 MAP to include sustainability considerations as well as growth seems to have eroded the trust of some members (Faruqee and Srinivasan 2012).

IV. THE IMF'S MULTILATERAL SURVEILLANCE FRAMEWORK

28. The Fund has made major changes to its multilateral surveillance framework to address the weaknesses that emerged during the crisis. This section discusses the Fund's new approach in terms of the legal framework, processes and products the Fund has used to improve its multilateral surveillance. In particular, the Fund has taken steps to better integrate bilateral and multilateral surveillance through the adoption of an Integrated Surveillance Decision (ISD) that guides the Fund and members in terms of their responsibilities under Article IV. Finally, new procedures have been put in place for formal multilateral consultations, should the Fund want to initiate them.

A. Fund's Mandate and Legal Framework

29. The crisis triggered a rich discussion of the Fund's surveillance mandate.[10] A key conclusion was that as a guardian of economic stability the Fund has tended to emphasize bilateral surveillance. The Fund has also tended to focus more on macroeconomic policies in both its bilateral and multilateral surveillance, while placing less emphasis on the potential gains from international cooperation in harmonizing financial regulation across jurisdictions and strengthening financial system structures. While its FSAP recommendations have generally helped to enhance and harmonize financial regulation across member country jurisdictions, these recommendations have not been consistently and systematically integrated into the multilateral surveillance process. Furthermore, as the larger risks in a globalized world are systemic, the Fund needs to have a more systemic perspective in order for members to support this with dialogue. This led to calls for a new

[10] The documents produced are informally referred to as the "mandate papers"; these include IMF 2010a, 2010d, and 2010e.

surveillance decision that would lay out, for the first time, the Fund's responsibility to oversee the IMS and the engagement of members. It was also seen as important for the Fund's remit over domestic policies, particularly the financial sector, to be clarified, and that the institution could do more to monitor capital flows and provide guidance on related policies.

30. In 2012 the Fund amended its key decision governing surveillance in order to address these concerns:

- ***Problem***. The Fund's legal framework for surveillance, Article IV and the 2007 surveillance decision, was seen as out of tune with the goal of modernizing surveillance. The framework for bilateral surveillance had an exchange rate bias, did not adequately address the interaction between financial, fiscal and macro-stability, and was unable to capture outwards spillovers well.[11] Surveillance also lacked a clearly defined framework to tackle global issues requiring collective action.

- ***Goal.*** The needed approach was to provide the basis for more effective and relevant surveillance in an integrated world, by focusing surveillance on *economic and financial stability*; ensuring that the views taken on global and local issues are fully integrated; recognizing that all economic and financial policies matter for stability and may have a global impact; and providing a framework to foster policy coordination.

- ***Approach.*** As there was little appetite among the membership for amending the Fund's Articles of Agreement, it was decided to modify the Board decision by introducing an ISD. The Decision is intended to fill the gaps in bilateral surveillance by bringing in multilateral surveillance and bridging the two activities. For the purposes of its policy discussions with individual members, the Fund can thus rely on its multilateral surveillance authority as well its legal authority under bilateral surveillance.

31. The adoption of the ISD enhances the Fund's surveillance role as follows: It has established the *conceptual* link between the Fund's responsibility for multilateral surveillance and its mandate for bilateral surveillance under Article IV of the Fund's Articles of Agreement, and bridged the two activities at the *operational* level.[12] The Decision clarifies the importance of global economic and financial stability in achieving the objectives of multilateral surveillance. It establishes the Fund's role in providing guidance to members regarding their domestic economic and financial policies—reducing the exchange rate bias in the previous surveillance framework. It clarifies the discussion of

[11] While bilateral surveillance assesses how members' policies promote systemic stability, its perspective on spillovers is limited in two important respects. First, the current legal framework for bilateral surveillance requires the Fund to examine outward spillovers arising from a member's policies only when they are transmitted through the member's balance of payments, implicitly leaving outward spillovers transmitted through other channels outside of its scope. Second, with respect to members' domestic policies, each member is required to promote systemic stability only by promoting its own domestic stability (IMF 2010a).

[12] It meant that Article IV consultation would become a vehicle for both bilateral and multilateral surveillance, allowing the Fund to discuss with a member the full range of spillovers arising from a country's policies.

outward spillovers from member policies. The decision also fills in the missing framework for the discussion of issues regarding collective action by allowing for the MD to call for formal multilateral consultations.

32. The ISD does not, directly or indirectly, change the nature of members' obligations under the Articles of Agreement, including the obligations set out in Articles IV, VI and VIII. The decision is designed to give guidance to the Fund in its conduct of bilateral and multilateral surveillance. The principles for the guidance of members' exchange rate and domestic economic and financial policies set forth in the Decision respect the social and political policies of members and are to be applied in a manner that pays due regard to the circumstances of members, and the need for evenhandedness in surveillance.

33. To address the problems that emerged in the 2006 multilateral consultation, the ISD also laid out procedures for future multilateral consultations. It confirmed that the Fund has the prerogative under Article IV, Section III (a) to hold multilateral consultations, and clarified the procedures for doing so. It clarified, in particular, that the Fund's role is to act as a *facilitator* rather than to *broker* a particular solution. Key elements of such a consultation are the following:

- **Informal discussions.** If the MD considers that an issue may significantly influence the effective operation of the IMS and requires collaboration among members that is not already effectively taking place, then the MD shall discuss the issue confidentially with the relevant members. The Fund should avoid duplication of a similar consultation process with another forum such as the G20. In addition, if members would like to initiate an IMF multilateral consultation, they should first approach management rather than bringing the issue to the Board.

- **Board decision.** When the MD considers that a multilateral consultation is necessary, he or she may recommend this to the Board, which may decide whether a consultation will be held. So far, consultations of this type have not yet been held, in part because multilateral surveillance issues that have come up in recent years—such as the lack of macroeconomic policy coordination within the euro area—are being taken up in other fora in which the Fund is a party.

- **Formal consultations**. A multilateral consultation will consist of discussions between Fund staff and management and officials of relevant members. The Fund will facilitate discussions among participating members. However, agreement on specific policy actions would be left to the members. As in the case of informal consultations, the Fund would act as a *facilitator* as opposed to trying to broker a particular solution. The Fund's role in trying to foster agreement on collective action would be to facilitate discussions among members by providing analytical input and identifying policy options. However, the discussion on how best to share the policy adjustments among members would be led by participating members.

- **Reporting to the Board**. After the conclusion of these discussions, the MD will report to the Executive Board the proceedings of the multilateral consultation and the Board will conclude the process with the formal consideration of this report. This is potentially an important innovation in the surveillance processes: the question mark that hangs over it is whether and when it will actually be used. Will it become an effective element of the Fund's surveillance 'tool kit,' or will it be stillborn like the special consultation provision of an earlier Surveillance Decision?

B. Products and Processes

34. Since the crisis, the Fund has put in place a multilaterally consistent risk-based surveillance framework. Risk-based surveillance involves designing processes to ensure that the institution identifies the major risks to global economic and financial stability, and directing surveillance resources to where the risks are most severe. It has been built around the priorities of the 2011 TSR, which included: expanding coverage of ***interconnectedness and spillovers***; strengthening ***risk assessments***; and enhancing the scope of ***external and financial stability assessments***. This has been achieved by strengthening processes, revamping existing products, including the WEO and GFSR,[13] and introducing new ones where needed—including the **Spillover Report** and the **Pilot External Sector Report (Pilot ESR)**.[14] In addition, in response to the financial crisis the IMF is working with members, the FSB and other organizations to fill gaps in the data that are important to monitor global stability.

35. The Fund has also proposed steps—through the quota and governance reforms—to strengthen the credibility and effectiveness of its ongoing efforts towards greater global financial stability.[15] On December 15, 2010 the Executive Board approved proposals that will lead to a major overhaul of the Fund's quotas and governance—representing the biggest-ever shift of influence in favor of emerging market and developing countries to recognize their growing role in the global economy. Members' quotas, the Fund's principal source of financial resources, will double under the 14th General Review of Quotas to SDR 476.8 billion, from SDR 238.4 billion. This will result in a shift of more than 6 percent of quota shares to dynamic emerging market and developing countries, while protecting the quota shares and voting power of the poorest members. The proposals also include a shift to a more representative, all-elected Executive Board.[16] As of

[13] The WEO and GFSR have enhanced their coverage and analyses of risk scenarios, including considering pertinent tail risks—such as a severe deepening of the euro area crisis or breakup of the euro area.

[14] Spillover and external sector reports are discussed by the board. There have been three rounds of pilot Spillover Reports (see 2011c, 2012d, and 2013c). The reports assess the impact of economic policies in the world's five largest economies—China, the euro area, Japan, United Kingdom, and the United States—on partner economies. So far, two pilot external sector reports have been produced annually since 2012 (see IMF 2012e and IMF 2013d). The reports present a multilaterally consistent assessment of the largest economies' external sector positions and policies. The report integrates the analysis from the Fund's bilateral and multilateral surveillance to provide a coherent assessment of exchange rates, current accounts, reserves, capital flows, and external balance sheets. The report is part of a continuous effort to ensure the Fund is in a good position to address the possible effects of spillovers from members' policies on global stability and monitor the stability of members' external sectors in a comprehensive manner.

[15] Quota subscriptions are a central component of the IMF's financial resources. Each member country of the IMF is assigned a quota, based broadly on its relative position in the world economy. A member country's quota determines its maximum financial commitment to the IMF, its voting power, and has a bearing on its access to IMF financing.

[16] Members committed to make best efforts to complete their domestic approval processes of these reforms by the Annual Meeting of the Board of Governors in October 2012.

spring 2014, the U.S. Congress—the member with both the largest voting rights and a veto for this proposal—had not ratified the proposals.

Interconnections and Spillovers

36. The overarching theme of the 2011 TSR was to make surveillance as interconnected as the global economy. Surveillance was seen as too fragmented. Specifically, there was a need to better leverage the Fund's cross-country expertise and macro and financial expertise into a more integrated view. This was to be achieved by regular analysis of spillovers and interconnectedness and channels of transmission, as well as improved coverage of cross-country issues.[17] Consequently:

- **Systemic Article IV consultations post-ISD.** Since the ISD came into force in January 2013, Article IV consultations for large systemic economies have included discussions of the outward spillovers from their policies, including transmission channels and possible impacts on countries. Such Article IVs have presented alternative policies where staff sees this as necessary.

- **The staff report for clustered Article IVs.** Cluster reports examine the policies of groups of countries with strong interlinkages or facing common shocks. Cluster reports have been discussed by the Board as background to the Article IV consultations of some or all of the associated countries, whose Board discussions also take place in clusters.

- **Spillover Reports** examining outward spillovers, from five systemic economies (U.S., Japan, China, euro area and the U.K.) whose policies may significantly affect the stability of the system, have been undertaken since 2011.[18]

37. This is supported by analytical work to understand global liquidity and financial interconnections. Significant progress has been made on developing indicators of global liquidity. Furthermore, several multilateral surveillance papers have examined macroeconomic and financial inter-linkages and have sought to apply the lessons across countries.

- **Global liquidity indicators:** A variety of indicators pertaining to global (private and official) liquidity that can be monitored for Fund surveillance were proposed in a recent board paper (IMF 2014b). Examples of such measures are the M2 and policy rates of the U.S., Japan and the

[17] IMF staff has also intensified efforts to incorporate regional surveillance and cross-country analysis in country work. The most prominent of these initiatives is the publications of regional outlooks by some area departments which includes an overview of the regional economic picture and also thematic issues in multilateral surveillance that are of regional relevance. Regional Economic Outlooks (REOs) effectively serve a regional surveillance function—which requires a focus on regional economic interlinkages and policy spillovers (IEO 2006).

[18] Similarly, cluster analysis—mapping out key financial and trading links—has examined analytical frameworks and channels for the propagation of financial shocks (IMF 2012f). Furthermore, the Fund has made good progress on building an analytical base on interconnections. In addition to including systematic coverage of spillovers relevant for REO and in the WEO (since April 2012), the overall analytical base on interconnectedness has been strengthened (see Box 1 IMF 2012f for details).

euro area. In many cases these indicators are already being monitored in various Fund surveillance products.

Risk Assessments

38. The Fund has also taken several steps to strengthen systemic risk assessments, recognizing transmission channels, and to discuss possible policy responses. The 2011 TSR called for more in-depth risk analysis in Article IV reports, including through the use of a risk assessment matrix (RAM);[19] drawing more from risk assessments in multilateral surveillance products; and taking up analyses from the vulnerabilities, and Early Warning Exercises (EWE) in policy discussions with country authorities.[20] With increasing fiscal challenges in the aftermath of the crisis, a new flagship product—the Fiscal Monitor—was launched in 2009 to enhance the multilateral surveillance of fiscal developments.

Box 1. The Early Warning Exercise

To help gain traction with senior policymakers, a confidential EWE was introduced in 2008. Its main focus is to assess low-probability but high-impact risks to the global economy and identifies policies to mitigate them. Recent EWEs have also included an assessment of a set of likely (rather than low-probability) events that pose systemic risks to global growth and financial stability. Given the sensitive nature of this material, it is presented only to a small audience, IMFC Ministers/Governors, and is not published, with the aim of fostering a candid discussion. The EWE brings together macroeconomic, cross-sectoral and cross-border spillovers and financial perspectives on systemic tail risks, drawing on a range of quantitative tools and broad-based consultations. The Fund takes the lead on economic, macro-financial, and sovereign risk concerns, and the FSB on the financial system regulatory and supervisory issues (IMF 2013a).

39. The Fund has also made major changes to internal analysis and processes to ensure that its multilateral (and bilateral) surveillance is based on a coherent view of global risks:

- The EWE was launched to stimulate a candid discussion among senior policy makers on tail risks (see Box 1).
- A new organizing framework, based around an interdepartmental risk group, has been introduced to ensure that the Fund's surveillance is based on a coherent view of global risks. It prepares and updates periodically a global risk assessment matrix (G-RAM) which forms the basis for risk assessments in bilateral surveillance products.
- Under the auspices of the risk group, the Fund's vulnerability exercises have been revamped. To add to the longstanding vulnerability exercise for emerging markets (VEE), the vulnerability

[19] The RAM lists key global and regional risks relevant for a particular country, and associates a broad probability of realization and assessment of impact to each (low-medium-high). The RAM should be integrated into the discussion of risks in the main text of the Staff Report. Recent examples of risk assessments include the Kuwait, Singapore, Botswana and Chile 2013 Article IV reports.

[20] The EWE's main focus is on tail risks in comparison to the WEO, GFSR, and Fiscal Monitor which cover more mainstream risks.

exercise for advanced economies (VEA) was launched in 2009 to identify risks and vulnerabilities in industrial high-income countries, typically OECD members. The vulnerability exercise is now structured around the following three pillars: (i) underlying/intrinsic vulnerabilities; (ii) crisis/event risks (effectively external vulnerabilities); and (iii) policy capacity (effectively political risk). For each country, the model outcomes are aggregated first by sector (e.g., external, fiscal, etc.), and then across sectors to arrive at an overall country risk rating. Area departments also weigh in on the determination of the sectorial risk rating. A similar exercise (VE-LIC) was launched in 2011 for low-income countries (LICs) (IMF 2010a). Staff now prepares a consolidated note covering all three vulnerability exercises, to provide a comprehensive assessment of vulnerabilities.

Financial Stability

40. Several measures have been taken to systematically integrate financial stability issues into bilateral and multilateral surveillance. In 2010, the Financial Stability Assessments (FSA) under the FSAP was made a mandatory element of surveillance for 25 countries with large and highly interconnected financial sectors, with FSAs to be held at least once every five years. The group of countries with systemic financial sectors was recently increased to 29, and where relevant these FSAPs will cover spillovers, including outward spillovers, in line with the ISD.[21]

41. The IMF's Financial Surveillance Strategy (FSS) was adopted by the Executive Board in September 2012 in line with a recommendation of the 2011 TSR.[22] The strategy sets out concrete and prioritized actions over three to five years to strengthen financial surveillance to help the Fund fulfill its mandate of ensuring the effective operation of the IMS and supporting global financial stability. It is built on three pillars: (i) improving risk identification and policy analysis; (ii) fostering an integrated view of financial sector risks in products and instruments; and (iii) engaging more effectively with stakeholders.

External Stability and Capital Flows

42. The Fund has introduced new techniques and products to help ensure that its surveillance of external stability is multilaterally consistent. In line with the recommendations of the 2011 TSR, a Pilot ESR has been developed, which draws upon the External Balance Assessment (EBA), a new analytical technique. There was also a need for assessments to take a broad view of external stability, encompassing an analysis of balance sheets and including coverage of exchange rates, capital flows, and reserve policies. Emphasis was also placed on discussing the overall policy mix, including the external assessment, rather than discussing it separately.

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[21] The list of jurisdictions for these mandatory assessments is based on the size and interconnectedness of their financial sectors.

[22] Other TSR recommendations include: strengthening the coverage of financial issues in Article IVs; mobilizing financial expertise for Fund mission teams working on systemically important financial sectors and vulnerable economies; stepping up training and disseminating analytical tools and good practices (including cross-country lessons from FSAPs); and preparing cross-country thematic studies.

43. The Fund has also clarified its view on capital flows, with the formulation of an Institutional View (IV) on the liberalization and management of capital flows (see Appendix 1). Given the integration of global capital markets, the rising importance of the capital account relative to the current account, and the Fund's role in stepping in when sudden stops and reversals in capital flows threaten the IMS, it seems appropriate that Fund surveillance covers more effectively capital flows and related policies. In November 2012, the Fund adopted its IV on the liberalization and management of capital flows. The IV clarifies that capital flows indeed are an integral part of the remit of surveillance and that the Fund may advise members on related policies. It also provides guidance for Fund's advice to both source and recipient countries. Specifically, the IV provides guidance on: (a) the best approach to liberalization of the capital account; and (b) policies for the management of large inflows and disruptive outflows including the use of Capital Flow Management measures (CFMs). The IV draws on earlier Fund policy papers, analytical work, and Board discussions on capital flows. The IV is meant to guide Fund advice to members and, where relevant, Fund assessments in the context of surveillance. It does not, however, alter members' rights and obligations including in other international agreements, as this would require an amendment of the Articles of Agreement (IMF 2012g).

V. SHOULD THE IMF DO MORE TO STRENGTHEN ITS MULTILATERAL SURVEILLANCE?

44. The intent of the Articles of Agreement, to which all 188 Fund member countries have pledged to adhere, is for the IMF to be the central focus of international macroeconomic policy cooperation on a consistent and permanent basis. In particular, each member accepts certain obligations with regard to the conduct of its economic and financial policies, including the obligation to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The Fund is charged under Article IV with exercising 'firm surveillance' to ensure that members fulfill their obligations. In this framework the IMF is seen as the appropriate body within which all member countries undertake systematic international cooperation in implementing their economic policies. The Fund's work on *multilateral surveillance* is potentially the key vehicle for achieving this ongoing cooperation. The scope for the Fund to undertake multilateral surveillance is defined by its general mandate under the Articles and by decisions of the Executive Board, particularly the 2012 ISD. The multilateral surveillance framework has been developed further since the ISD was approved in July 2012, and has included new analyses, products and processes, as described in Section IV above. Yet it is not obvious that this framework and the Fund's current multilateral surveillance activities will be sufficient to address adequately the challenges of the rapidly evolving global economic and financial architecture. This is particularly true with respect to the risks posed by the vastly increased size and importance of capital flows in the global economy, the role of wealth effects in transmitting financial shocks, the new emphasis on the use of macro-prudential policies to address financial system vulnerabilities, and the continued recourse to unconventional monetary policies by several AEs.

45. Prior to 2007 the G7 Group of systemic 'advanced' countries, together with the Fund, was the main focus of international cooperation in economic policies. But, as indicated in the preceding sections, there were weaknesses in the Fund's bilateral and multilateral surveillance work before the crisis that contributed to the widespread failure to identify the key downside risks in advance. The present section assesses the effectiveness and coherence of the Fund's current multilateral surveillance framework in the context of this new global economic and financial architecture.

46. Given the high degree of interconnectedness of countries, markets and institutions in the international economy and financial system, as well as the gradual convergence in the economic weights of EMs relative to AEs, there is a compelling case for policy cooperation at the global level not just in terms of gains for individual countries but also from a systemic standpoint. This is especially so when coordination is undertaken proactively on a continuous basis, and has clear and attainable objectives. However, in order to achieve such cooperation the building blocks have to be in place for countries to view the operational arrangements for cooperation as beneficial in the long run. Although self-selected groups of countries such as the G10, the G7 and the G20 have shown themselves to be willing to intensify their *ad hoc* policy cooperation at times when they face large *downside* risks, it is clear that the current global structure does not provide strong incentives for these groups to engage in *sustained and consistent cooperation*, and that the current analytical framework is far from providing the comprehensive understanding of all the interactions in the global economy that would be needed to have an 'independent assessor' that could effectively direct policy coordination on an ongoing basis. **Three areas where enhanced coordination may be considered desirable are examined in this section: implementation of macroeconomic policies, particularly by systemically important countries; reform of the global architecture of financial regulation; and oversight of international capital flows.**

47. Cooperation in Macroeconomic Policy: It is obvious that in an interconnected world macroeconomic policy actions by individual countries, particularly systemically important ones, can exert substantial spillover effects that will be either positive or negative for individual economies and for the global economy as a whole. Nevertheless, the degree to which such systemically important countries have focused on cooperating in macroeconomic policy has been episodic.[23] Only rarely have systemic countries been prepared to alter macroeconomic policies that they have seen as appropriate to their own domestic circumstances in order to increase the possibility of achieving the uncertain prospect of a superior global macroeconomic outcome. Nor have they shown a consistent willingness to accept Fund advice in this direction—the Louvre and Plaza Accords could be cited as exceptions. This reticence is hardly surprising, given the large uncertainties that exist about the size of the potential gains from cooperation, the fact that some or most of the gains may accrue to other

[23] The Fund staff view that systemic countries lack a strong incentive to engage in macroeconomic policy coordination on a consistent and continuous basis is clearly stated in the Ostry and Ghosh 2013, who note that "examples of international macro policy coordination have been few. The most successful examples have been when the world seemed on the brink of collapse." Ostry and Ghosh 2013 see the key obstacles to international policy coordination as: "asymmetries in country size; disagreements about the economic situation and cross-border transmission effects of policies, and often policymakers' failure to recognize that they face important trade-offs across various objections."

countries, the acknowledged weaknesses in the Fund's past advice on the cooperative macroeconomic policy measures to be taken, and reservations about whether the Fund's longstanding governance structure assures that its advice is neutral and unbiased. In sum, except in times of crisis the gains from engaging in macroeconomic policy coordination are seen as small and uncertain—particularly by policymakers in systemic countries—relative to the perceived costs.

48. Since the outbreak of the crisis in 2007–08, the impetus for international cooperation in macroeconomic policy has been provided mainly by the G20 Summits and Finance Ministers' Meetings, with the Fund playing a supporting role. During the crisis, G20 policy cooperation was effective in several instances. Cases in point are the international coordination of liquidity provision by key central banks during 2007–09; the internationally-coordinated fiscal stimulus measures implemented by a number of G20 countries starting in 2009; and the G20's comprehensive program to reform global financial regulation.[24] However, the G20 is an informal arrangement with no enforcing mechanisms, as well as limited representativeness. This raises the question of whether a formal institutional arrangement is needed to assure ongoing and effective economic and financial policy coordination towards the goal of "strong, balanced and sustainable growth" on a global level. Part of the intractability of this question lies in the fact that it is hard to demonstrate analytically that clear global gains will result when countries adjust their policies from what they see as best in their own interests in order to achieve a 'better' global economic outcome. This suggests that the impetus for systemic Fund member countries to cooperate actively in implementing macroeconomic policies typically is weak in normal times, when coordinated policy adjustments are seen only to give the uncertain prospect of modest positive effects on global economic performance.

49. To counter the perception that macroeconomic policy coordination requires that countries subordinate their domestic stability objectives to the goal of improved global macroeconomic performance, the ISD recommends that "members should consider alternative policies that, while promoting the member's own stability, better promote effective operation of the international monetary system" and that the Fund "may not and will not require a member to change its policies in the interest of the effective operation of the international monetary system." These strictures place clear limits on the degree to which the Fund's multilateral surveillance can expand the scope of macroeconomic policy coordination. Thus, it appears still to be the case that a strong impetus to coordinate macroeconomic policies only comes at times of crisis—such as 2007–09—when political leaders face the imminent prospect of catastrophic risks and losses from *non*-cooperation.[25] Reflecting this asymmetry, the regular G20 Summit Meetings that began in November 2008 were initially focused on a comprehensive program

[24] Ostry and Ghosh 2013 observe, however, that "while there is a broad consensus that these policies helped avert a potentially catastrophic great depression and a seizing up of the financial systems, there is also concern they generated spillovers in many dimensions, including output, external balances, capital flows, currency values, and asset prices." However, they provide no evaluation of whether these spillovers detracted from or enhanced global macroeconomic performance.

[25] In these circumstances, it could be the case that certain cooperative efforts undertaken in times of crisis are seen as "one-shot deals," thus hindering the realization of gains which may arise from a "repeated game approach."

to reform the global architecture of financial regulation as well as on the fiscal and monetary policy coordination that was needed to mitigate the 'Great Recession.' But more recent G20 Summits have reflected a less focused agenda as well as 'mandate creep' to issues beyond cooperation in economic and financial policies (see paragraph 17). This is a concern, since it is now relatively well accepted among policy officials that prolonged periods of stability can breed serious bouts of instability by fostering complacency and increased risk-taking. Recognizing this lacuna, the G20 countries now rely on the Fund/FSB EWEs as a basis for their assessment of the need for proactive cooperation in their macroeconomic policy settings. Thus the G20—as a self-selected group—has not established a permanent secretariat for macroeconomic policy implementation and tacitly recognizes that it is appropriate to delegate this responsibility to the IMF. At the same time, however, the IMF's capacity to "steer" official discussions on coordination is somewhat limited by the G20 (see paragraph 33).

50. In order to encourage 'mindfulness' of the externalities from large countries' economic policy actions the IMF has increasingly flagged global risks through the concept of 'policy spillovers.' However, there is a tension between this concept and the idea that there are aggregate long-term gains to be had from policy coordination. Several commentators have observed that the Fund might be able to achieve more traction if it could demonstrate feedback effects from policy spillovers—particularly policies implemented in large systemic countries (commonly referred to as "spillbacks.")[26] In this context, some have called for a greater understanding of the determinants of global liquidity, as possibly a better-fitted framework for fostering coordination (see Box 2).

51. Coordinated Reform and Harmonization of the Global Architecture of Financial Regulation: The arguments in support of international cooperation to harmonize financial regulatory rules across jurisdictions are different from those for macroeconomic policy coordination, and in our view more compelling. Unlike macroeconomic policy, where the case for cooperation is conjunctural and depends on expectations about the size and direction of spillover effects, financial regulation provides the framework within which financial transactions are conducted both domestically and across national borders. It is a long-run structural policy, analogous to trade liberalization. Regulatory measures that strengthen the robustness of financial institutions, markets, and infrastructures should always be closely harmonized internationally. Otherwise, strengthened financial regulation in one country will be undermined by regulatory arbitrage that shifts risky activities to more tolerant jurisdictions, creating an un-level international competitive playing field and intensifying pressures to weaken discipline in risk management. Therefore, key enhancements to financial regulation through a cooperative approach are, at present, likely to result in a significant marginal reduction to systemic global risk. In sum, harmonization of key measures of financial regulation is unambiguously Pareto-improving for the global economy and financial system as a whole.

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[26] See the Managing Director's Global Policy Agenda (IMF 2014c).

Box 2. Could a Better Grasp on Global Liquidity Contribute to the Fund's Multilateral Surveillance Task?

Since the global financial crisis, the concept of global liquidity has been a key issue in public debate regarding the international financial system. However, there is still no unanimous agreement regarding its analytical definition or precise empirical counterpart. Here, we do not aim to settle such a longstanding debate, but rather to flesh out some ways in which a more robust treatment of the concept of global liquidity could serve to enhance the IMF's multilateral surveillance framework.

The Committee on the Global Financial System Report[1] notes that, while the concept of liquidity generally relates to "ease of financing," it is useful to distinguish between official and private liquidity. The former comprises all the funding that is made available through monetary authorities and its global distribution can be highly influenced but the Fund's through various arrangements. The latter refers to funding provided by the private sector and has become increasingly important in the international financial system—as exhibited by the rising volume of cross-border capital flows. It is not clear that the IMF's current surveillance framework can meaningfully impact the distribution of private liquidity towards a more stable global economy.

Rey 2013, for instance, re-states that the dominant concept in international finance, which is made clear by the Mundell-Fleming model, is the policy "trilemma": "with free capital mobility, independent monetary policies are feasible if and only if exchange rates are floating." This view, which was clearly imbedded in the IMF's pre-crisis surveillance framework by focusing excessively on exchange rate policy and favoring open capital accounts, remains to some degree present in the Fund's current surveillance framework. The underlying assumption is that free-floating exchange rate regimes guarantee that optimal domestic liquidity conditions translate into an optimal global level of liquidity and that exchange rates will not deviate from their fundamental values for long. However, the validity of this view in guiding the IMF's surveillance activities has been called into question.

Rey 2013 finds evidence of a global financial cycle which, through cross-border capital flows, disrupts countries' local financial conditions and may—if left unmanaged—lead to instability. Thus, the international components of liquidity (whose monitoring lacks a systematic approach) may warrant as close scrutiny as do domestic conditions (closely monitored through Article IV consultations)—flexible currencies notwithstanding. In a similar vein, Bruno and Shin 2013 develop a model of international banking in which global lending conditions translate into local lending conditions via the risk-taking of global banks. They find that currency appreciation is associated with a larger volume of capital inflows and higher leverage in the banking sector; suggesting a link between global liquidity and financial stability. Both studies identify U.S. monetary policy as the principal determinant of global financial conditions.

In this setting, the IMF has developed a guidance framework through the IV on capital flows for countries that are experiencing capital outflows as well as countries that are recipients of inflows on managing their capital accounts. However, in seeking to foster greater international policy coordination, the situation could also arise where action in receptor countries is not optimal from a global perspective. Here, the IMF could benefit from a better understanding of the dynamics of global liquidity and its channels of transmission in order to advise on a coordinated response to such circumstances to mitigate systemic risk—rather than give disparate advice to source and receptor countries. Additionally, the IMF might be able to gain greater traction with source countries if its analytical surveillance tools clearly identify the aggregate benefits from their policy adjustments.

1/ See BIS 2011.

52. The importance of achieving internationally harmonized reform of financial regulation was clearly recognized by the G20 leaders in the depths of the crisis in 2008 when they transformed the FSF into the FSB and charged it with ensuring international consistency in the main elements for enhancing the regulation of financial institutions and markets to strengthen financial system stability. However, while the Fund has a central role in fostering *macroeconomic* policy cooperation, its Articles of Agreement contain no specific mandate to oversee the development of an internationally harmonized system of financial regulation (see paragraphs 20-22). Nevertheless, the fact that the international financial crisis that began in 2007 led to the 'Great Recession' demonstrated that global reform of financial regulation is highly relevant to the Fund's capacity to perform its multilateral surveillance role. The FSAP is not a formal tool for fostering international harmonization of financial regulation. Nevertheless, the FSAP exercise in each member country includes an assessment of whether the authorities are in compliance with international financial sector standards (such as the Basel Core Principles for effective bank supervision, etc.) Since the Fund's assessments are based on best-practice international standards and the Fund focuses on uniformity of treatment across members, the FSAP assessments can help to foster the international harmonization of key international financial regulatory standards over the longer-term. Since the onset of the financial crisis the FSAP reviews and their recommendations have gradually been integrated more deeply into the multilateral surveillance process, as well as into the bilateral Article IV surveillance missions with each member country. They provide the Fund and the international community with a useful means of reviewing whether the measures endorsed by the FSB are being implemented in a consistent manner internationally. With its virtually global membership the Fund is in a unique position to assess the degree of international harmonization of financial regulation that the G20 program will eventually achieve. FSAPs, therefore, can help to foster international harmonization of financial regulation. International coordination of financial regulatory standards, in turn, will limit both the scope and the incentives for regulatory arbitrage, thereby enhancing global financial stability.

53. Cooperation in the Oversight of International Capital Flows: Perhaps the most challenging area for achieving acceptance of the need for international cooperation is in the oversight of international capital flows. Previous sections have indicated that given the highly integrated nature of the global financial system, this is an area of fundamental interest and concern to the Fund's work in multilateral surveillance. However, the Articles of Agreement do not give the Fund a specific mandate for oversight of international capital transactions that corresponds to its responsibility to oversee current transactions.[27] This asymmetry in the Fund's mandate limits its scope to press its advice on individual governments' policies on capital transactions. Thus the Fund's ability to coordinate policies that directly impact international capital flows depends on the confidence that the members place in its analysis of the effects of such flows and what, if anything, should be done to influence them by policy action.

[27] Specifically, Article VIII Section 2 states that a member country "may not impose restrictions on the making of payments and transfers for current international transactions without the approval of the Fund." But the Articles do not contain a corresponding provision requiring Fund approval of restrictions on payments and transfers that constitute international capital flows.

54. Prior to the onset of the financial crisis the general consensus was that gradual and sequenced capital account liberalization was desirable for all Fund member countries. It was considered that the dominant issues related to how to sequence a gradual opening up of the capital account. The general view was that these capital account liberalization measures constituted a one-way move to full convertibility that should not be subsequently reversed. During and since the financial crisis, however, many countries have found that the highly accommodative monetary policies being implemented by major systemic countries, combined with other structural elements of the international economy, have not only caused substantial volatility in exchange rates but have sometimes produced situations in which their real exchange rates (or asset prices) have moved for protracted periods to levels not considered sustainable or desirable from a macroeconomic perspective in the longer term, thus increasing the risk of abrupt adjustments with substantial welfare costs and the potential to cause major adverse macroeconomic developments. As a result, a number of countries have resorted to CFM measures to control volatile capital movements into and out of their economies. At present, despite the importance of these issues, no consensus exists on the degree of harmonization that should exist in the rules governing international capital flows, or on how much of the Fund's multilateral surveillance work should be focused on these issues and their systemic implications (see Box 2 for further commentary). The Fund has taken a useful step in this direction by developing its 'Institutional View' on capital flows. Nevertheless, greater clarification on this issue—both by the Fund and systemic Fund members—will be essential to strengthening the Fund's multilateral surveillance.

VI. MEASURES TO IMPROVE MULTILATERAL SURVEILLANCE UNDER THE IMF'S CURRENT MANDATE

55. As noted in Sections II–IV, the IMF has taken a number of steps to strengthen multilateral surveillance since the onset of the financial crisis in 2007. In our view, the measures outlined in these sections are appropriate and important steps. Nevertheless, to continue to gain credibility in this area the Fund needs to make further improvements to its analysis and advice on the international coordination of economic and financial policies. This section outlines our recommendations on the enhancements the Fund could make in the near term under its current mandate. Section VII will discuss, in a more 'out-of-the-box' fashion, the ways in which member countries might consider changing the Fund's mandate over the longer term to make its multilateral surveillance the central focus of a continuous process of economic policy coordination. In extending this work Fund staff will need to have cooperation from national authorities to obtain the data it needs to make these assessments, particularly data on balance sheet and off-balance sheet positions that have not been provided to the Fund on a regular basis in the past. This will prove to be a challenge, but the gains to be achieved in the analysis of the risks in the financial sector and their linkages to adverse macroeconomic developments will be worth the effort in increasing the Fund's ability to connect financial and real sector risks.

56. Implementation of IEO recommendations. In 2011 the Fund's Independent Evaluation Office (IEO) published a Report on "IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–2007." The IEO Report (see its Chapter V) made recommendations for strengthening multilateral surveillance by changing the Fund's internal working environment to encourage diverse/dissenting views in staff analyses, enhancing incentives for candor in the staff's policy discussions with national authorities, better integrating financial sector issues into macroeconomic assessments, and overcoming the 'silo mentality' that limits the effectiveness of staff cooperation across its regional and functional departments (see paragraphs 11-14). The Fund has followed up on a number of the IEO's recommendations through organizational changes and Board decisions. Nevertheless, it appears to us that other important IEO recommendations have not yet been fully implemented. As detailed in a recent staff study,[28] the main IEO recommendations that still require further effort are those to "better integrate financial sector issues into macroeconomic assessments" and to "deliver a clear, consistent message to the membership on the global outlook and risks." Thus the immediate next steps in strengthening multilateral surveillance should be to complete implementation of these recommendations. In this section we first focus on the most pressing areas for further enhancements before turning to the additional actions we recommend to strengthen multilateral surveillance further under the Fund's current mandate.

57. Measures to strengthen the EWE. Development of the EWE as a joint responsibility of the IMF and the FSB was one of the first major actions taken by the G20 to strengthen the capacity to identify emerging risks and vulnerabilities in the global economy and financial system (see the G20 Communiqué, November 15, 2008). Since that time the EWE has been implemented through confidential semiannual presentations by the IMF and FSB staffs to the IMFC. Thus it is the most direct means by which the Fund can succinctly communicate the most important systemic risks it identifies in its multilateral surveillance and its most important policy recommendations to a key group of systemic-country policymakers. It is therefore essential for the Fund to ensure that these messages are actionable, clearly prioritized, and unambiguous. In these exercises the Fund has a leading role in identifying macroeconomic and macro-financial vulnerabilities, while the FSB takes the lead on those vulnerabilities that need to be addressed by initiatives in financial regulation.

58. In preparing the EWEs the IMF and FSB staffs recognize that "crises result from the collision of vulnerabilities of an economic or financial nature with essentially unpredictable developments that can serve as a specific trigger." Thus the purpose of the EWE is *not* to predict the outbreak of a crisis at a specific time in the future, but rather to present IMF/FSB views on key emerging downside risks and vulnerabilities that may need to be addressed to make the global economic and financial system more robust. These semi-annual assessments are also supposed to make recommendations that provide policymakers in the member countries with actionable

[28] See IMF 2014d, especially Paragraphs 35-46.

warnings on tail risks, thereby making the outbreak of crises less likely, or their consequences less severe when they occur.[29]

59. An essential key to continuing to enhance the EWE will be Fund Management's commitment to strengthen the analytical capacity of the Fund staff in the three areas discussed in Section V: macroeconomic policy coordination, international harmonization of regulatory reform, and oversight of capital flows. The IEO Report recognized that in order to achieve this Fund Management must encourage a working environment where staff can be increasingly proactive and candid in identifying risks—particularly those arising in large systemic economies and financial jurisdictions—that have the potential to create vulnerabilities from large spillovers. This analysis also needs, by definition, to be forward-looking, rather than reactive.

60. Further Enhancements to the EWEs. We believe that the EWE could gain in effectiveness if staff analysis and IMFC discussions were focused not only on how macroeconomic policies should respond to counter emerging downside risks, but also how macro-prudential policies should be adjusted to mitigate major buildups of financial risks, particularly in key jurisdictions. The Global Financial Stability Reports have taken a useful step in this direction by highlighting major financial system-wide risks and the avenues for their mitigation. This element should now be hardwired into the EWE process, particularly since the newly established macro-prudential agencies in the key financial jurisdictions have until recently been more focused on regulatory rule-making than on identifying and countering rising system-wide risks in the macro-financial conjuncture. To help ensure that diverse views are aired the staff could on occasion invite external experts to EWE sessions to comment on the risks they see in the conjuncture and discuss their implications for policy coordination. Such discussions could represent an important "learning process" for cooperation among member countries.[30] An important case in point is the implementation of the G20's comprehensive financial regulatory reform program, where we see international harmonization of key measures as crucial to avoiding down-side risks from regulatory arbitrage across jurisdictions that can camouflage risks and create perverse incentives. The IMF and the FSB should cooperate closely in this area to establish a shared view of the key regulatory measures that it is most important to implement in an internationally-harmonized way to strengthen the resilience of the global financial system.

[29] In identifying these risks and making recommendations on how to address them the Fund staff obviously confronts the challenge of balancing the tension between identifying an increasing set of potential risks and the credibility loss that could ensue from 'crying wolf' too often. In our view, the way to confront this issue is for the staff to give an indication of the likelihood of a risk materializing. For example, if a risk of major financial system stress over the next twelve months is viewed by the staff as having a relatively low probability of occurring but would have a very high adverse impact if it did occur, it should make this low probability clear but still provide recommendations on how the risk should be addressed if it did arise.

[30] The Fund's Research Department hosts a semiannual teleconference on global macro-financial risks that serves as background for the EWE. Participants include representatives from the financial markets, academia, think tanks, and the official sector.

61. A Fund-wide Risk Management Unit. We recommend that Management use its newly established Risk Unit—in line with the recommendations of external experts engaged to prepare a review of the Fund's risk management framework back in 2011[31]—to proactively develop a forward-looking, institution-wide view of emerging risks. Specifically, the Unit should assist Management and the Executive Board in articulating a clear view of the Fund's overall risk appetite/risk tolerance in both its lending activities and its policy work; overseeing Fund-wide risk management, and allocating staff resources flexibly to emerging risks as they are identified.

62. Increasing Management's Capacity to Direct Staff Resources to address the key risks. The establishment of the Risk Unit alone will not be enough to strengthen the Fund's ability to respond flexibly to newly identified risks. As the IEO has recognized in several of its reports, the Fund continues to have a relatively rigid internal organizational structure in which functional and area departments exercise essentially exclusive control over their assigned staff. This could mean that staff resources are not reallocated flexibly or quickly enough across departments to address unforeseen down-side risks when they arise. Such a rigidity in the Fund's organizational structure could limit the effectiveness of its multilateral surveillance at times of heightened uncertainty—the very times when both responsiveness and analytical clarity are most needed in order for the Fund to provide credible, concrete advice on needed policy responses and their coordination. To strengthen the Fund's capacity to respond quickly in assigning staff resources to key risks identified by the new Fund-wide risk-management framework, we recommend that Fund Management consider establishing a Committee composed of directors of the departments engaged in multilateral surveillance. This Committee could be chaired by a member of Management and would have the authority to redirect the appropriate staff resources temporarily among departments as needed to discharge the Fund's multilateral surveillance responsibilities. The increased flexibility this could provide could also have the benefit of reducing the problems of structural inflexibility, 'silo mentality,' and lack of forward-looking analysis noted in IEO reports and staff surveys, thereby contributing positively to staff morale.

63. Establishing a 'track record' for the Fund staff's forward-looking policy advice in the context of multilateral surveillance. In order for the Fund gradually to earn credibility as a 'trusted advisor' when it advocates measures of policy coordination that would not occur spontaneously, the Fund needs to establish a 'track record' showing that things turn out better when its recommendations on policy coordination are followed. This involves the difficult problem of the 'counter-factual.' In order to gain credibility as a key element of the Fund's multilateral surveillance the EWEs need to be able to show convincingly, through an *ex post* analysis of outcomes, that there were occasions when significant gains would have accrued to the global economy and financial system if key systemic countries had altered their policies in response to IMF/FSB advice given in *past* EWE sessions. To move forward in achieving this goal, we recommend that prior to each EWE presentation to the IMFC the Fund staff should regularly provide senior officials in the finance ministries and central banks of IMFC member countries with its *retrospective* analysis of the advice it

[31] The team consisted of Jacob A. Frenkel, Malcolm D. Knight, Thomas O'Neil, and Guillermo Ortiz (Chair).

had given to the IMFC in the recent past, an assessment of the degree to which the staff's advice had been followed, and—if so—whether the outcomes did indeed broadly result in a better performance than would have occurred without policy adjustments. Conversely, in cases where the staff judged that the recommended policies had not been taken, they would give their judgment as to whether the resulting weaknesses in performance had exacerbated vulnerabilities.[32] Such an exercise could also be used to enhance the analytical depth of Spillover Reports. As the Fund's analysis gained credibility the multilateral surveillance process would become more widely accepted. Clearly, when major unexpected events occur the Fund cannot be expected to have foreseen all the low-probability 'tail risks.' Nevertheless, it is essential for the staff to investigate these in the context of the vulnerabilities exercises. even though they often generate 'false positives.'

64. Measures to enhance the IMF staff's internal "Vulnerabilities Exercise" and integrate it more tightly into the EWE. As a key element of its preparations for the EWE exercise the Fund staff operates an internal "Vulnerabilities Exercise" to underpin its forward-looking effort to identify emerging risks. The Vulnerabilities Exercise has encouraged the Fund staff to undertake deeper analytical work on international macroeconomic and macro-financial linkages and on their impact on capital flows, which has informed the Spillover Report's capacity to identify vulnerabilities that could lead to contagion. This was complemented in 2010 by the decision to require that the financial stability assessments made in the FSAP reports for the 25 (expanded to 29 in 2013) most 'systemic' financial jurisdictions be a mandatory component of the Article IV bilateral surveillance discussions for each of these economies. The IEO report noted that Fund Management and staff have not yet implemented a full process for the staff to: (i) monitor the measures taken by national authorities to remediate these weaknesses; (ii) evaluate their effectiveness; and (iii) consider further steps to be discussed with the authorities. We recommend that these essential follow-up actions should be a high priority for Management and senior staff. Such analysis would support key financial sector recommendations made by staff in bilateral surveillance discussions, and would also serve to strengthen the analysis of the Spillover Reports. Implementing this recommendation will require strong impetus from Fund Management to clarify the multilateral surveillance responsibilities of departments across the institution and to foster further enhancements to area departments' cooperation with functional departments most involved in multilateral surveillance. It would also help to create the necessary incentives for staff to provide candid assessments to Fund Management and national policy makers. These processes should also be integrated into the institution-wide Risk Management Framework proposed above. In this context as well, the IEO recommendation that the Fund Management and Board should more actively seek views from independent outside analysts on a regular basis should also be acted upon.

65. Further integration of FSAPs into the Fund's multilateral surveillance. It is commendable that the timing of FSAP assessments is now being coordinated more closely with that of the staff Article IV missions, since this element of bilateral surveillance forms an essential "bottom

[32] Such ex post analysis would be challenging given the unpredictability of policy responses and a multitude of possible counterfactuals.

up" foundation upon which the aggregate view of what is needed for effective multilateral surveillance is built.[33] Therefore, we believe it is desirable that this process becomes more targeted, particularly for those countries that are judged to have significant weaknesses in their financial systems, structures, or regulations that could give rise to financial system vulnerabilities. When a country has had a recent FSAP assessment in the run-up to a regular Article IV consultation the staff participating in the Article IV can have a deeper appreciation of the strengths and weaknesses of its domestic financial system and regulation that feeds into multilateral surveillance. Consistent with this view, the Article IV missions to countries that have had recent FSAPs are now required to follow up on the FSAP recommendations, and this work is closely reviewed by the Money and Capital Markets Department (MCM). The Fund should continue to integrate financial sector surveillance into its multilateral surveillance framework by encouraging area department staff and country authorities to proactively anticipate and address emerging financial system risks in the period between FSAPs. In addition, the Fund also needs to communicate its findings on weaknesses that it sees in systemic countries or groups of countries promptly to the FSB, particularly in cases where the Fund staff identifies groups of countries that need to make more progress in resolving similar weaknesses in their financial system structures. This process could be made more systematic through the development of a business plan to strengthen coordination among the relevant area departments and MCM. It would obviously involve an increased staff resource commitment—again, efforts to improve the Fund's capacity to allocate staff resources more flexibly in the short term are crucial.

66. The Fund needs to clearly communicate a consistent set of policy recommendations from its regular multilateral surveillance exercises that integrates its analysis of likely financial system developments with those in the broader macroeconomy, identifies the key downside risks, and outlines the policy initiatives that may need to be implemented to avoid those risks or mitigate them if they materialize. Since the financial crisis the Fund has initiated such a large number of new analytical analyses and reports that even seasoned policy analysts can be left uncertain about the 'bottom line' policy recommendations emanating from the Fund's multilateral surveillance work. Since the financial crisis the Fund has initiated such a large number of new reports that there is a risk that its basic policy recommendations will be obscured. It appears to us that the Fund now needs to send a clear message to policymakers and markets of what its policy recommendations are for the case where the global economy evolves in line with the central forecast of the WEO, as well as cases where downside risks occur. Since experience suggests that problems arising in the financial sector can lead to major adverse macroeconomic developments, we recommend that Management give consideration to merging the GFSR and the WEO into a single concise document that would provide policymakers, market participants and the informed public with the Fund's overall view of the most likely scenario for the coming twelve to eighteen months, its policy recommendations for this central scenario, the key downside risks, and the actions it would recommend if any of those risks materialized.

[33] Our understanding of the Fund's new practice is that after every FSAP, a member of the FSAP team joins the next Article IV mission and is tasked with ensuring that there is a follow-up on the FSAP recommendation. Furthermore, MCM economists are now allocated to missions to systemic countries for two success Article IV missions to enhance the medium-term follow-up.

VII. A CASE FOR EXTENDING THE FUND'S MANDATE

67. As discussed in the preceding section, there is room for improvement both in enhancing the analytical framework of the IMF's multilateral surveillance task and in gaining traction on cooperation through this process. This section addresses two interrelated but separate issues—the need to: (i) further strengthen multilateral surveillance; and (ii) achieve traction of multilateral surveillance especially with key stakeholders. Since the 2008 crisis, the Fund's progress in establishing traction in its multilateral surveillance advice has been somewhat slower than the progress it has achieved in enhancing its multilateral surveillance framework. From a longer-term perspective, however, the Fund's ability to effectively promote global economic and financial stability is limited by the architecture of the global financial system and its mandate. The asymmetry in the IMF's mandate creates a tension: it has jurisdiction over the current account but not over the capital account. The IMS is only a part of the global economy.[34] Standing outside the realm of the IMF's conventional (i.e., pre-crisis) oversight activities are several global economic and financial factors which have the potential to produce a build-up of systemic risk and are transmitted through channels not typically scrutinized by regular IMF surveillance before the crisis.

68. Since the IMF's inception, the emphasis on open current accounts and appropriate exchange rate policies has guided much of the Fund's surveillance work. The basis of this framework was the relatively unimportant role capital flows played in the global economy in the early years of the Fund's activity. Their magnitude was significantly less than it is today since at the time virtually all Fund members exercised broad capital controls. International trade, which was the main economic link between countries, was understood to be strictly welfare-increasing and so the natural direction of the Fund's work was to facilitate trade liberalization by limiting current account restrictions. The promotion of exchange rate policies that led currency prices to reflect their fundamental values helped to limit the need for macroeconomic policy coordination as exchange rate adjustments could be used to reduce the persistence of imbalances—thus limiting the potential for significant abrupt adjustments. However, as capital flows have grown in importance on a global scale (see Section II) and their economic impacts and sensitivity to macro policies and global factors have increased, their potentially destabilizing effects have become clearer, as well as more complex (see Box 2). In effect, they have become a crucial source of risk to the global economy that needs to be more closely monitored and managed.

[34] In speaking of the IMS we adopt the definition laid out in IMF 2012h: the IMS "comprises official arrangements that directly control the balance of payments of members (both official and private flows). It consists of four elements: (i) the rules governing exchange arrangements between countries and the rates at which foreign exchange is purchased and sold; (ii) the rules governing the making of payments and transfers for current international transactions between countries; (iii) the rules governing the regulation of international capital movements; and (iv) the arrangements under which international reserves are held, including official arrangements through which countries have access to liquidity through purchases from the Fund or under official currency swap arrangements." (pp. 23-24) Thus, the global economy and the international financial system are broader concepts which encompass the IMS. However, as noted in IMF 2012h, "while global economic and financial stability is a broader concept than the effective operation of the IMS, the fact that the former is also a necessary condition for the latter implies that in order to discharge of its responsibility to ensure the effective operation of the IMS, the Fund needs to promote global economic and financial stability." (p. 26)

69. The 2007–09 global financial crisis demonstrated how international imbalances (current account and liquidity-wise)[35] can have dire global effects and brought to the forefront of the international policy agenda the need to make the IMF's surveillance framework more comprehensive in *risk-identification* and more effective in *risk-mitigation* through coordination (see Sections II and VI). Systemic risk is now an a par with other sources of instability and thus the multilateral approach to surveillance, including over new transmission channels such as capital flows and wealth effects, is being made more robust and comprehensive. However, it is clear that traction in this area can only go so far without a general revision of members' obligations and the Fund's mandate. In this regard the IMF is currently faced with the challenge of trying to achieve a stable distribution of global liquidity with only its power of persuasion to do so.[36]

70. Although the 2012 ISD provides clear guidance in the correct direction by emphasizing that the IMF should monitor any source of risk that may lead to the ineffective operation of the IMS, including all potential sources of economic and financial instability, it does not grant additional tools with which to effectively mitigate them. To bring about a more stable global economy, significant reforms to the international financial architecture are warranted. Additionally, in order to achieve stronger global economic performance—an objective also set out by the G20—the institutions that undertake high-level policy coordination need to reflect the world's interconnected relations in a more balanced way than is currently the case. We argue that these goals could feasibly be realized through reforms that re-allocate (or institutionalize) the mechanism of coordination under the purview of the Fund and endow it with tools to effectively induce and enforce agreements.

A. Governance in Line with the Global Financial Architecture

71. In light of the growing interconnectedness of the global economy, there is good reason to believe that sustained policy cooperation would be effective in reducing tail-risks to the global economy and bringing about a more sustainable longer-term growth path (see Section V and Ostry and Ghosh 2013). This provides a compelling case for amending the IMF's Articles of Agreement in order to give it the necessary mandate and tools with which to deliver greater cooperation. However, the international institutions need to be in place to maintain a cooperative approach to policy—rather than episodic and reactive instances of cooperation. Here

[35] See Gourinchas 2011 for an analysis of how "global liquidity imbalances" played a central role in the global financial crisis.

[36] We continue to employ the concept of "global liquidity," after having mentioned in Box 2 that no there is no consensus around its precise empirical counterpart, because the 2012 ISD integrates the concept into its guidance to the Fund to procure the effective operation of the IMS when it states that "the international monetary system is considered to be operating effectively when the areas it governs do not exhibit symptoms of malfunction such as, for example, persistent significant current account imbalances, an unstable system of exchange rates including foreign exchange rate misalignment, volatile capital flows, the excessive build up or depletion of reserves, or imbalances arising from excessive or insufficient *global liquidity*." (p. 7, emphasis added) Also see Shin 2013.

we propose a set of global governance reforms which could substantially increase the stability and robustness of the global economy.

72. Several of the reforms proposed are ostensibly impractical in the short and medium term, given the incentives—both private and public—that limit the degree of feasible international reform. Indeed, the following discussion is closely intertwined with the broader issue of how global liquidity is distributed in a unipolar, USD-centered, monetary system. Several commentators have argued that there is a genuine need to move toward a multi-polar system in order to achieve greater stability (see, for instance, Farhi, Gourinchas and Rey 2011). However, both the global financial crisis and the ensuing developments have served to strengthen the U.S. dollar's exclusivity as the world's reserve asset (see Prasad 2014). At present, there is no institution that can singlehandedly alter the status quo and, understandably, very little appetite in the U.S. to relinquish such an "exorbitant privilege." Although not directly addressed, this fact does not escape the present discussion.

73. Nevertheless, even while acknowledging the short- to medium-term limits to reform, clearly laying out long-term goals can aid in gaining traction towards their realization. In this sense, consistent with the proposed medium-term enhancements to the effectiveness of the Fund's work in multilateral surveillance under its current mandate as discussed in Section VI, the following proposal is better understood as constituting the possible culmination of a broader reform of the IMS,[37] rather than the starting point. It is geared toward redefining the IMF's role as leader of policy cooperation. Specifically:

- **At a global level of governance the potential duality between the G20 and the IMFC should be resolved by merging these two institutions into a unified committee (a "new" IMFC) of finance ministers and central bank governors to deal with particular aspects of economic cooperation, whether it be macroeconomic policy, trade policy, issues relating to capital flows, or financial regulation.**[38] These would include establishing *rules of the road* for macroeconomic policies, coordinating fiscal and/or monetary policy when necessary, implementing financing lines as needed, and agreeing on new financial regulations, among others.

74. Only in this way would the IMFC have the authority to recommend a major initiative of international cooperation in economic policymaking, particularly if the proposal was unpopular in some quarters. The new IMFC would be a decision-making body that delivered strategic and policy direction and dealt with macroeconomic and financial policy coordination. The IMFC would have legal powers, such as the adoption of Surveillance Decisions or the establishment of new financial facilities. It would—among other functions— engage in policy coordination and

[37] On this subject, there is already a rich literature; prominent examples are the UN (Stiglitz Report) 2009, the Palais-Royal Initiative 2011 and Farhi, Gourinchas and Rey 2011.

[38] Past proposals in a similar vein are the 2009 IMF Governance Report (a.k.a. "the Manuel Report"), Group of Thirty 2009 and Mistral 2011.

react to emerging risks in all three areas discussed in section V; namely, macroeconomic policy coordination, international harmonization of financial regulation and oversight of capital movements to ensure there global consistency and effectiveness.

75. Currently, there is a sense that the post-crisis cooperative thrust has seriously waned and the IMF does not have the appropriate mechanisms to promote the optimal level of global cooperation. The Fund can flag spillovers and risks, but consultations do not have much traction. Although the ISD does provide new modalities for multilateral consultations to take place, the dominance of the G20 as the principal forum for policy coordination seriously limits the Fund's capacity to lead in this process—especially since it is stated that multilateral consultations are only warranted if the relevant parties are not already engaged in discussions in alternative fora (see paragraph 33).[39] Furthermore, the elevation of the G20 to the Heads of State level and its ever-growing agenda have meant that both focus and efficiency have been diminished with regard to economic and financial objectives.

76. Instituting a standing IMFC committee similar in structure to the G20 would provide a forum for continuous dialogue in dynamic (rather than periodic) fashion in order to constructively discuss countries' policy interactions and align goals and means. It would also establish an efficient mechanism for policy coordination through the production of actionable items, and would establish the IMF as the leader in this process. Concrete institutions towards this end could include formal voting rules, periodically published *communiqués* about the committee's assessment of the global economy and members' policies, some degree of agenda-setting power by the IMF MD, and technical assessments by IMF staff on policy proposals, among others. A mandate to promote economic and financial stability is important in this regard as it would avoid the Committee's agenda from becoming overburdened—as the G20's has become in recent years (see paragraph 17).

77. The resulting constituencies of the IMFC would have to be re-delineated to ensure that all Fund members were appropriately represented and that the Committee was in tune with economic realities. The current structure of the IMFC (at present 24 members) reflects the Executive Board's composition. However, as the global landscape shifts in terms of Fund members' output/growth contributions and relationships—largely influencing their policies' externalities—so do their economic interests and vulnerability to spillovers. To enhance legitimacy, representation and facilitate an optimal internalization of spillovers, IMFC membership should be much more flexible and move toward constituencies that reflect more equilibrium in economic importance, geographical representation and aligned interests—something clearly missing from the G20.[40]

[39] In the absence of multilateral consultations, the sole instance where the Fund manages (or facilitates) discussion between affected parties is the EWE. However this vehicle is designed to address low-probability but high impact events and so misses less profitable but (likely) more recurrent opportunities for realizing gains from cooperation.

[40] In this vein, a longstanding proposal has been for the European Union, or at least the Eurozone, to have a single representative. This would serve both to reduce the IMFC in size and facilitate a reshuffling of its membership. But, more importantly, it would be consistent with the fiscal, banking and structural reforms toward greater integration which are actively being pursued in the Eurozone.

78. The Executive Board of the IMF would be redesigned as an advisor to the IMFC (see the *Manuel Report*).[41] The Board would continue to legislate in ordinary areas of Fund policy review and implementation, decide on financing arrangements, and formulate the medium term budget. A clear delineation of the responsibilities of the Board and management in the area of surveillance is necessary to facilitate efficient and unbiased supervision of management's performance by the Board. The restructuring would aim to take advantage of the IMF Governors' experience and knowledge by creating a formal link between them and the IMFC in order to provide strategic counsel.

- **Representation/voting issues within the IMF would likely have to be frequently reassessed to ensure governance structures adequately reflected economic realities. In the Executive Board this could be facilitated by eliminating the requirement of appointing the five chairs for the largest quota-holders.**

B. An Extended Mandate

79. The latter reforms aim at building a more coherent and effective international forum through which to internalize economic externalities that pose risks to the global economy. Most reforms of the type outlined above would necessitate an amendment of the Articles of Agreement and so seem plausible as a means to build on the enhanced role of the Fund obtained through the 2012 ISD and the IV on capital flows. However, dialogue alone may not always suffice to generate the broad agreement on collective action that is necessary for sustainable and robust global growth. Thus, if the IMF were to persuasively develop the proper framework for identifying and mitigating global risks, its members could view it as being in their interest to extend the Fund's jurisdiction in order to grant it all the necessary instruments with which to manage the global economy. In this regard:

- **The Articles of Agreement could be amended to explicitly entrust the Fund with achieving global economic and financial stability through a combined strengthening of multilateral surveillance procedures and reform of the Fund's governance structures along the lines recommended in this paper.**

80. As noted above, the 2012 ISD gives clear and constructive guidance on this theme. However, it seriously limits the traction that the IMF can achieve by noting that no new obligations are imposed on the Fund's members beyond their existing obligations under Article IV.

- **The Articles of Agreement could be amended to grant the Fund jurisdiction over members' capital accounts.**[42]

[41] The *Manuel Report* was presented to the Executive Board of the IMF on June 2009. Naturally, it was not well received by the Board, as it entailed a significant loss of faculties for the Executive Board.

[42] See the Palais-Royal Initiative 2011.

81. Such an amendment would represent a clear commitment on the part of Fund members to support a shift towards a more cooperative approach to global growth and risk management. This amendment would by no means constitute a directive for the IMF to encourage all members to liberalize their capital accounts—as the benefits from doing so vary widely depending on country-specific factors. Rather, it would seek to endow the Fund with the capacity to achieve a sustainable level and distribution of liquidity worldwide. It is important to stress this point as there have been past efforts on part of the IMF to extend its jurisdiction. Although not exclusively for this reason, part of the reason past attempts have been unsuccessful is that they largely represented a campaign to move all Fund members toward open capital accounts. Today, it is no longer a mainstream view to consider such arrangements as unequivocally welfare-enhancing. Thus, the present proposal should be understood as aimed at: (i) enabling the Fund to promote a coordinated response to mitigate any potential risk to the global economy which arose from 'liquidity imbalances'[43] by influencing the combination of counties' policies; and (ii) granting the Fund additional tools to address risks due to volatile capital flows that threatened the stability of the IMS.

82. The current approach of developing an IV to guide advice concerning CFM measures, along with research agenda set out in the Fund's *Financial Surveillance Strategy*, represents an important step in building a coherent stance from which to influence members' spillovers via capital flows. However, some limitations (in terms of potential cooperative gains) may arise from the absence of direct and formal dialogue between source and recipient countries and the economic asymmetries between them. In order to gain traction in this area, formal cooperative mechanisms should be set in place to facilitate collective responses which are unlikely to occur spontaneously—i.e. when significant gains/losses are not evident.[44]

83. With an extended mandate, changes to countries' capital account policies would then be pursued within a multilateral framework and be supported by the IMF's technical assistance and guidance from the IMFC.[45] The aim would be to have an *ex ante* assessment of risks and potential spillovers and to give the IMF the instruments it would need in order to manage the implementation in an orderly manner—employing its new prerogatives where warranted.

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[43] Such as of the type analyzed in Gourinchas 2011.

[44] One of the themes which motivated the adoption of the 2012 ISD is the growing relevance of cross-border capital flows for global economic and financial stability. While this Decision, to some extent reflects a fragile consensus around the appropriate means to address risks emanating from cross-border capital flows, over the medium term the IMF should seek to institute a more cooperative approach to risk mitigation. It is in this sense that the Fund's IV could be leveraged by practicing its prerogative to hold multilateral consultations as set out in paragraphs 31 & 32 of the 2012 ISD. The essential point on capital flows is not that the IV is defective in meeting its objectives, but rather that these issues could be better addressed through collective action of the type envisioned in the 2012 ISD. Unfortunately, this mechanism has yet to be tested and it is not clear why. Granting the Fund jurisdiction over the capital account could potentially generate the incentives to cooperate on a sustained basis.

[45] This proposal can be understood as a natural extension to the 2012 ISD's encouragement to members to "to be mindful of the impact of [their] policies on the international monetary system." (p. 4)

84. Additionally, extending the Fund's jurisdiction over the capital account would strengthen its position to manage global liquidity by acting on source countries, if warranted. This would greatly increase the Fund's capacity to impact the distribution and dynamics of private liquidity—if a compelling case to do so existed—to reduce systemic risks.[46] Finally, with an expanded mandate and enhanced tools to impose sanctions it is likely that the IMF's role as facilitator of cooperation would substantially gain in traction, as it could assume the responsibility of enforcing agreements when necessary.

85. Of course, the idea of extending the IMF's jurisdiction over members' capital accounts has long been an issue of heated debated given the political tension commonly associated with it. However, it must be stressed that published commentary in this area tends to be very general or vague in practical considerations. Without a clearer description of the operational details such a reform would imply it is unlikely to garner much support. Thus, from a shorter-term perspective, the Fund could constructively steer the debate by publicly fleshing out the specifics of what a capital account remit would involve through institutional papers, sequentially developed.[47] This approach would be similar to that adopted in the "mandate papers" which set in place the building blocks for the 2012 ISD. Clearly, the IMF is the institution best situated to develop this analysis, which would provide considerable value towards enhancing the IMS.

86. In practice the issue of properly sequencing the proposed reforms is important. It is clear that countries whose currencies are seen as safe havens and function as reserve currencies will have little incentive to endorse an expansion of the IMF's jurisdiction over their capital accounts unless a CFM framework is in place that credibly serves to reduce systemic risks. Only when such a framework was in place would the international community be in a position to grant the IMF this level of authority and responsibility. Since significant uncertainty surrounds the potential gains to be had from international cooperation, countries would be unlikely to institutionalize a mechanism for cooperation unless this uncertainty could be dealt with to some degree. The IMF is the only international institution capable of building the technical elements with which to support continuous cooperation. In this sense a consistent analytical framework, endorsed by the Fund's full membership, is a necessary condition.[48]

87. A promising arrangement to build consensus in the international community could be an agreement on numerical thresholds for macroeconomic and financial indicators aimed at limiting potential global imbalances and enhancing symmetry of adjustment. Since it is becoming increasingly accepted that large macroeconomic asymmetries between countries tend to reflect a buildup of aggregate risk, the IMF—within the context of a consensual analytical

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[46] For a specific proposal of how this could be implemented in a rules-based fashion, see Goodhart, Peiris and Tsomocos 2013.

[47] An initial discussion on the subject is provided in IMF 2010b, but a more detailed argument on the merits and operational nuances of granting the IMF jurisdiction over members' capital accounts has yet to be developed.

[48] Additionally, is must be noted that for such a scheme to be effective, all Fund members should make it a priority to bridge the data gaps that limit the institution's surveillance work.

framework—could build support for new cooperative efforts by promoting an agreement among relevant officials to adopt *rules of the road* in this regard. Such an arraignment could vary from strict limits which set off macro-prudential measures determined by the Fund, to triggers that automatically call on the Fund to carry out a multilateral consultation. In the long term, traction would best be enhanced by pushing forward the governance reforms outlined above to ensure broad representation and legitimacy.

VIII. CONCLUSION

88. As the global financial system becomes more interconnected and complex, the need to constantly enhance the Fund's multilateral surveillance and risk mitigation framework increases. Evolving patterns in international economic relations and policy frameworks—such as large and generalized macroeconomic effects from capital flows, the widespread use of unconventional monetary policies, and the growing popularity of macro-prudential and CFM measures—have created new channels of transmission for financial and economic shocks and increased the role of cross-border spillovers in policy makers' reaction functions. Further, this trend is expected to persist for the coming decades as EM growth will likely continue to outpace that of AEs—albeit to a lesser degree than during the first decade of this century.

89. In these circumstances, the IMF must seek to improve its multilateral surveillance framework in line with its mandate to safeguard global economic and financial stability and the guidance outlined in the 2012 ISD. Recognizing that substantial progress has been achieved since the 2007–09 crisis, in the short- to medium-term there is room for further betterment. Specifically, large potential benefits are likely to be gained from inducing consistent international cooperation in (i) the implementation of macroeconomic policies—particularly by systemically important countries, (ii) the reform of the global architecture of financial regulation, and (iii) the oversight of international capital flows. Operationally, to implement these recommendations efficiently the Fund could strengthen the EWE and integrate it with the internal vulnerabilities exercises, empower the staff to be more proactive and candid in identifying risks, and enhance FSAPs to inform multilateral surveillance, in particular on progress towards harmonization of financial regulatory reforms.

90. From a longer-term perspective, the Fund's multilateral surveillance could be improved toward fostering policy cooperation to efficiently mitigate global risks that require collective action by amending its Articles of Agreement. In particular, establishing a new governance structure, through a merger of the IMFC and the G20, could help encourage cooperation. The new IMFC would deliver strategic and policy direction and engage in policy cooperation, including macroeconomic policy, trade policy and issues relating to capital flows. This would help create a more coherent and effective forum to internalize externalities. Further, there is a compelling case for giving the Fund an explicit capital account remit. This would represent a clear commitment on the part of Fund members to shift towards a more cooperative approach to global stability; to encourage direct and formal dialogue between source and recipient countries; and to strengthen the Fund's capacity to manage global liquidity in order to help internalize cross-border spillovers.

91. Without some degree of reform, the international financial architecture (absent a real threat of severe instability) is unlikely to generate the incentives geared toward sustained policy cooperation. Spillovers are a natural part of an interconnected economy, but they are not necessarily—in themselves—a strong basis for cooperation. Global economic and financial stability is a public good and, as such, tends to be under-produced. At present, few incentives exist for large economies to adjust their policies to align them with the interests of smaller parties, which individually do not offer high benefits from cooperation. Therefore, the internal structure of the IMF could be reformed to create the institutional mechanisms necessary for cooperation among all Fund members.

92. Ultimately, the degree to which the Fund is seen as capable of delivering global policy cooperation will depend on whether it is seen as a 'trusted advisor' to the international economic policymaking community. Thus, through enhancements in the quality of its analysis and policy recommendations, in the near-term the Fund must continue to improve its track record in giving advice on the modalities of enhanced policy cooperation and the resulting salutary effects along the lines outlined in Sections V and VI. Much progress has already been made in building the Fund's analytical capacity to identify emerging risks in the global economy, but this remains a work in progress and the complete interactions of countries' policies are yet to be understood. Without such a framework the appropriate guidelines for CFM measures will continue to be absent and the case for an extension of the Fund's mandate will remain tenuous. Improving the Fund's analytical framework is thus necessary to lay the groundwork for broader reforms to its mandate—especially as this pertains to its remit over capital flows following the 2012 ISD and the Fund's 'Institutional View' on capital flows.

Appendix 1. Capital Flows: the Fund's Institutional View

Capital flows offer potential benefits to countries, but their size and volatility can also pose policy challenges. The IMF has developed a comprehensive, flexible, and balanced view on the management of global capital flows to give countries clear and consistent policy advice. Discussed by the IMF Executive Board in November 2012, this Institutional View (IV) reflects a broad consensus of the IMF's membership and synthesizes previous IMF policy papers, analytical work, and Board discussions on capital flows. The IV will remain flexible and evolve over time to incorporate new country experience, empirical evidence, and analytical insights. The key features of the IV are the following:

Liberalization

Capital flows can have substantial benefits for countries. But they also carry risks, which can be magnified by gaps in countries' financial and institutional infrastructure. Capital flow liberalization is generally more beneficial and less risky if countries have reached certain levels of financial and institutional development. Liberalization needs to be well planned, timed, and sequenced in order to ensure that its benefits outweigh the costs. Countries with extensive and long-standing measures to limit capital flows are likely to benefit from further liberalization in an orderly manner. There is, however, no presumption that full liberalization is an appropriate goal for all countries at all times.

Managing Capital Flows

Rapid capital inflow surges or disruptive outflows can create policy challenges. Appropriate policy responses comprise a range of measures, and involve both countries that are recipients of capital flows and those from which flows originate. For countries that have to manage the macroeconomic and financial stability risks associated with inflow surges or disruptive outflows, a key role needs to be played by macroeconomic policies, including monetary, fiscal, and exchange rate management, as well as by sound financial supervision and regulation and strong institutions. In certain circumstances, capital flow management measures can be useful. They should not, however, substitute for warranted macroeconomic adjustment.

Multilateral Aspects

Policymakers in all countries, including countries that generate large capital flows, should take into account how their policies may affect global economic and financial stability. Cross-border coordination of policies would help to mitigate the riskiness of capital flows. The IV guides Fund advice to members and, where relevant, Fund assessments in the context of surveillance. It does not, however, alter members' rights and obligations as this would require an amendment of the Articles of Agreement. Members' rights and obligations under other international agreements also remain unaffected.

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