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2014 TRIENNIAL SURVEILLANCE REVIEW—EXTERNAL COMMENTARY—SURVEILLANCE IN A WORLD OF VOLATILE CAPITAL FLOWS

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The enormous growth of interconnectedness in the global economy, especially financial interconnectedness, can generate large and sudden volatility. This places a premium on IMF surveillance as a tool for crisis prevention and also as a preparation for crisis management should the need arise. Four innovations are suggested in this note that would make Fund surveillance more effective. First, more needs to be done to allay suspicions that Fund analysis is excessively anchored in the orthodoxy currently favored in the Treasuries of industrialized countries. Second, bilateral surveillance could be used more effectively to help countries manage volatile capital flows with appropriate signaling to markets. Third, surveillance should do more to promote a collective process aimed at getting the major countries to coordinate their macro policies sufficiently to resolve—or at least to lessen—the risk of global instability. Finally, a system of external critiques of IMF surveillance reports could be introduced to open up the process to greater scrutiny.

TAILORING ANALYSIS TO REFLECT STRUCTURAL CONSTRAINTS

1. There is a widespread perception among developing countries that the Fund's analysis is excessively anchored in conventional policy analysis and is not sufficiently open to consider heterodox solutions in developing countries. The case for heterodoxy is usually made on the grounds that developing countries have structural characteristics which are different from industrialized countries, as a result of which interventions that might well be effective in industrialized countries are less effective in developing countries. The structuralist characteristics usually invoked include weak institutions, missing markets (notably forward markets and deep and liquid debt markets), supply side rigidities and information asymmetries. These factors can produce long lags in the impact of policy and generally make it less effective. Neglecting these factors is often cited as a key weakness in Fund analysis, explaining its lack of traction in developing countries in non-crisis situations. It must be emphasized that many heterodox solutions advanced in the policy debate in developing countries are not necessarily valid, even if account is taken of structural factors, but since policy makers face skepticism about conventional policies precisely on these grounds, advice emanating from surveillance can have traction only if these aspects are explicitly taken into account.

2. Fund staff should therefore be specifically tasked to take into account the structural constraints that dominate the debate in the country concerned in making policy recommendations. Acknowledgement of the constraints may not alter the policy recommendation, but it may modify assessments of the expected outcome, avoiding the criticism that the Fund makes unrealistic claims about the effectiveness of their policy recommendations.

THE MERITS OF REGULATING CAPITAL FLOWS

3. The expanded scale and increased volatility of capital flows presents major challenges for exchange rate management for emerging market countries. In earlier days, pressures on the exchange rate came largely from the current account and there was a reasonable presumption that

some exchange rate adjustment, combined with action on aggregate demand, was the appropriate response. The situation has changed dramatically, with exchange rates in many emerging market countries potentially subject to destabilizing pressure from volatile capital flows, often driven by factors unconnected with the domestic economy.

4. The current consensus, to which the Fund also subscribes, recognizes that developing countries may need to intervene in such situations including by imposing capital controls. This represents a clear departure from the days of the "either fully fixed or fully flexible" approach. However, there is no operational clarity on what types of intervention are appropriate and in what circumstances. The Fund typically emphasizes macroeconomic stability, a sound financial sector (including deep and liquid debt markets), greater self insurance through adequate reserves and regional reserve sharing arrangements. It is true that all of this would minimize the likelihood of problems, but action in these areas will take time to mature and meanwhile developing countries under attack need more operationally specific guidance. The Fund's institutional view on liberalization and management of capital flows falls short of being an operational guide for deciding to what extent and in what circumstances should a country resort to Capital controls on inflows or outflows, and what should be the best way of signaling an intention to revers these actions.

5. The issue is potentially controversial because in the mid 1990s, the Fund Management had pushed for amending the *Articles of Agreement* to make liberalization of the capital account an explicit objective of the Fund on the grounds that it would promote efficiency in the international financial system. This was strongly opposed by the developing countries on the grounds that (a) capital account liberalization could not be put on the same plane as trade liberalization in terms of promoting efficiency, and (b) it would lead to measures for capital account liberalization being included in the conditionalities associated with Fund programs.

6. There is no case, and certainly no appetite, for giving the Fund an explicit mandate to promote liberalization of the capital account. However, the present situation, in which countries are entirely free to introduce any type of capital control they want at any time, may not be optimal., While it gives countries an important measure of policy flexibility, it can be argues that it also adds to investor uncertainty. In fact it highlights an imbalance in the system in which trade policy actions are constrained by WTO rules and banking is increasingly governed by internationally agreed rules, while capital flows, which have gained in importance and stable flows are welcomed by most countries, operate without any agreed rules.

7. Countries that want to attract stable capital flows may wish to subscribe to some discipline in which they retain the flexibility to introduce controls in exceptional situations while signaling a positive attitude in general. The discipline for capital flows could be similar to the system for choosing a particular exchange rate regime. Countries would be totally free to choose and even change the degree of capital controls they operate, while only informing the Fund of this decision, thus fully preserving sovereignty in this area. However, a country that wishes to signal that it is resorting to temporary intensification of capital controls, could inform the Fund of this fact and follow this up with consultations indicating its intentions to return to the status quo when normalcy is restored. This need not involve a fixed time table for the unwinding of controls, which may be

impractical, but it could involve specification of objective circumstances that would trigger the reversal of exceptional action.

8. The above arrangements would not limit what countries can do in the area of capital controls. They would only provide an option for countries that are keen to signal to foreign investors that the action taken is exceptional and the country remains committed to stable capital flows. Consultations with the Fund and its monitoring of progress would increase credibility compared to a merely unilateral statement by the authorities.

9. Jose Ocampo has pointed out that the term "controls on capital flows", implies arbitrary interventions to control an inherently undesirable phenomenon. It should be replaced, by "regulations on capital flows" which treat capital flows as normal, but requiring regulation guided by transparent objectives. There is merit in this suggestion.

THE MERITS OF POLICY COORDINATION

10. Diagnosing the nature of global imbalances is a critical first step in multilateral surveillance, and the Fund is extensively engaged in this activity. Its failure to anticipate the crisis of 2008 dented its reputation, but it is worth noting that the Fund was not alone in that failure. The reason for the failure has been extensively studied and there is no need to revisit well trodden ground. Hopefully some important lessons have been learnt which will improve performance in future.

11. The more critical—and more difficult—challenge is to be able to use surveillance to achieve sufficient coordination of policies among the major countries to improve global outcomes. There is no satisfactory mechanism in place to meet this challenge. Policy coordination goes beyond surveillance, but it is worth considering what can be dome since in the absence of an effective mechanism for coordination, multilateral surveillance is little more than a ritual.

12. There are three essential components of successful policy coordination.

- First, there must be sufficient agreement on the nature of the underlying imbalance to give broad directions of the corrective policies to be followed by different groups of countries. This is something that can be done at the multilateral surveillance stage.

- The second stage must be to achieve sufficient agreement on the relative size of the effort to be made by each major country. Agreement on broad directions is not very helpful if here are significant disagreements on how much has to be done by each country.

- Finally, each major country must be convinced that its action, in concert with others, will not only produce an outcome that is better for the global economy, but is also better for itself than could be obtained if it acted alone.

13. Success in the second and third stages is very difficult to achieve and it is also not clear that it can be achieved through a purely Fund led process. The Fund tried to achieve policy coordination

through a series of synchronized bilateral consultations on current account imbalances with major countries in 2006. The effort was spectacularly unsuccessful. As Raghuram Rajan reported, all the countries consulted agreed that there was a problem, but each felt the solution should come from corrective steps to be taken by other countries![2]

14. Policy coordination among countries inevitably involves some voluntary sacrifice of sovereignty. This is an essential requirement for global governance to be meaningful, but there is little to suggest that countries are ready to do this. There are two logical ways in which to proceed and they correspond broadly to what IMF Managing Director Christine Lagarde, in her Dimbleby lecture,[3] characterized as the "hard" and "soft" forms of global governance.

A. The "Hard" Approach: Amending the *Articles of Agreement*

15. The first approach is grounded in empowered institutional structures and would involve giving teeth to the multilateral surveillance process by amending the *Articles of Agreement* to empower the Fund to enforce compliance with a Fund-determined solution. This is not a practical option at present, but it is worth reflecting on what might be needed if we are to rely on a "hard approach" to global governance. We can glean some sense of this from a proposal outlined by Edwin Truman.[4]

16. Truman recommends amending the Articles to clarify that the obligations of each member should include not only achieving internal and external stability, but also ensuring effective operation of the international monetary system to achieve global economic and financial stability. To this end, the Fund would prescribe performance parameters across the full range of monetary, fiscal, foreign exchange, financial and structural policies for a group of "significant" countries. The proposed amendment would also establish a basis for punitive action against countries that violate their performance parameters and do not heed the Fund's recommendations for corrective action.

17. Truman's proposal implies subjecting the identified group of significant countries to very strict surveillance—tantamount to having a permanent Fund program! This is unlikely to be politically acceptable to either developed or developing countries. Apart from the political problem, there are also technical problems in getting agreement on the quantified performance parameters against which surveillance would have to be conducted, especially if non performance could trigger corrective action.

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[2] See Rajan, Raghuram (2010), *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press, Press.princeton.edu.

[3] *A New Multilateralism for the 21st Century: the Richard Dimbleby Lecture*, February 3, 2014.

[4] Truman, Edwin. M. (2010), "Strengthening IMF Surveillance: A Comprehensive Proposal," Policy Brief 10-29, Washington, D.C.: Peterson Institute for International Economics.

18. An additional hurdle for the proposal is that it greatly increases the power of the Fund for intensive surveillance, but without any comparable improvement in its governance. Moving towards harder governance, without a credible governance structure is surely a non starter.

B. "Soft" Governance: The G-20 MAP Exercise

19. If "harder" governance is ruled out, the logical alternative is a "soft" approach as exemplified by the G-20 MAP. It is not a "Fund-led" process, but relies on the systemically important countries themselves engaging directly in consultations to achieve policy coordination, with the Fund providing analytical support.

20. The "country led" nature of the process eliminates concerns about loss of sovereignty, but the task remains formidable, as shown by the component steps listed below.

a) Each country must first define its own national objectives, which are expected to be broadly consistent with an agreed global objective, and also define the national policy actions it will take to achieve its stated objective..

b) The Fund then examines whether each country's policy choices are consistent with the improved performance projected. Initially, most countries did not specify additional policy actions commensurate with the improvement being targeted. The extent of policy specification has improved over time, but it is very difficult to judge whether the actions indicated will actually lead to the outcomes expected. Much is often expected from positive investor responses to structural reforms intended to be implemented, and there can be vastly different assessments about their impact and the time lags involved. The Fund's assessment can be critical here.

c) The Fund is also expected to check whether the sum of individual country projections is consistent with global constraints. For example, are too many countries assuming that they can export their way out of a recession, or out of current account deficits, implying a growth of global trade which exceeds what is feasible? If the export projections are not feasible, what alternative policy combinations can countries follow? Answers to these questions have to be found through consultations among the countries themselves, with the Fund playing a technical support role.

21. The G-20 MAP exercise is far from reaching credible agreement on these issues, consistent with the objective of resuming robust growth. However, the process has certainly generated a better understanding of the problem, and perhaps even some consensus on the broad direction in which countries must move. To be fair, there is probably more understanding and commonality beneath the surface than is reflected in the public positions that countries take for the simple reason that Government's cannot agree to anything which they may not be able to deliver due to domestic dissension.

22. The G 20 MAP is clearly still a work in progress. However, although it does not lend itself to quick decisions with firm commitments, it does provide a potentially useful framework for

continuous direct consultations at a high level among the major countries, creating an environment in which it will be easier to collaborate effectively in the face of a crisis, should that become necessary.

23. The Fund's multilateral surveillance activity could strengthen the outcome of the "soft" approach if it is integrated more effectively with the G-20 MAP. The G 20 does not have any formal legitimacy within the Fund's governance structure even though the G 20 countries command a dominant share of votes. However this difference could be bridged by the Fund reporting on the results of the G-20 MAP to the IMFC, with its own candid assessment of the outcome which could be discussed by the more representative forum.

A FINAL THOUGHT: EXTERNAL CRITIQUES OF SURVEILLANCE REPORTS

24. An important limitation of the present system is that surveillance reports are sent to the Management and the Board without any formal mechanism of external professional criticism. Board Members are of course free to raise whatever issues they wish at Board meetings, but that is not equivalent to subjecting the staff's analysis to external and possibly adversarial professional scrutiny.

25. The Fund could consider introducing a system of review by up to two external reviewers, chosen by the country under review, who might comment on the report keeping in mind the official response of the country. These comments should go to Management and the Board. The reviewers should be chosen from a panel maintained by the Fund and should be of a nationality different from the country. The Fund should pay the reviewers an appropriate consulting fee.

26. The practice would be particularly useful for developing countries that may have reservations on the Fund's analysis, but either lack the capacity to take on the Management and staff, or prefer not to do so for tactical reasons. This will not be as burdensome because many countries may not want to have their country reports subjected to professional review, especially if they find them broadly acceptable.

2014 Triennial Surveillance Review—External Commentary: Surveillance In A World Of Volatile Capital Flows