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WHY THE IMF AND THE INTERNATIONAL MONETARY SYSTEM NEED MORE THAN COSMETIC REFORM

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I INTRODUCTION

On its website, the International Monetary Fund (IMF) defines its main purpose as the provision of “the global public good of financial stability”. As spelled out in its Articles of Agreement, this requires a stable system of exchange rates, sustainable current account balances and orderly currency and balance-of-payments adjustments. To achieve this, Fund undertakes economic and financial surveillance at the national and global levels, provides policy advice to its members, and lends to those facing external payment difficulties in order to facilitate adjustment.

The record of the IMF in delivering this global public good leaves much to be desired. The period since the breakdown of the Bretton Woods arrangements has seen repeated gyrations in the exchange rates of major currencies, persistent and growing trade imbalances, recurrent balance-of-payments, debt and financial crises, many of which have reverberated across the global economy. The IMF has been unable to cope with misguided macroeconomic, exchange rate and financial policies in countries with a disproportionately large influence on global monetary and financial conditions as well as autonomous destabilizing impulses generated by financial markets and international capital flows unleashed by rapid and widespread liberalization.

One reason for this poor performance is that the Fund has no teeth vis-à-vis its non-borrowing members. It has little leverage not only over policies in reserve-issuing countries, but also in others enjoying surges in capital flows, including developing and emerging economies (DEEs), since these countries rarely need the Fund during these boom times when the seeds of instability are sown. While the Fund exercises firm direction and surveillance over the policies of those members borrowing from it, obligations are superfluous and non-binding for non-borrowing members and the Fund has no power of enforcement. For non-borrowing countries, the IMF is a “voluntary institution.”¹

But, more importantly, the IMF has generally been unable to identify build-up of financial fragilities, predict instability and crises and issue early warnings in large part because of its blind faith in markets. In the sub-prime turmoil it has missed the biggest crisis of its lifetime. It has persistently failed to warn DEEs against destabilizing capital flows, unsustainable exchange rates, payments and debt positions. Since the mid-1990s several countries working under IMF programs and drawing on its resources experienced severe instability and crises and in some important cases, such as Russia and Argentina, sovereign default could not be avoided. The IMF’s debt sustainability analyses and recommendations have left many poor countries in disarray when they fell back into debt distress after being told that their external debt had reached a sustainable position and they no longer needed debt relief from official creditors.

¹ As remarked by the IMF representative during a UN Working Group Panel on 26 May 2010 on the reform of the financial architecture.

The more the IMF has failed to prevent instability and crises, the more it has become involved in crisis management and lending. Indeed, with the increased frequency of systemic financial shocks, crisis intervention and lending has become the primary activity of the Fund so much so that at times of calm when drawing on the IMF ceased, as was the case during the great global bubble of 2003-08, its own financial viability came in to question. After every major financial crisis the IMF has sought a new role and this has almost always been construed in terms of expansion of its emergency lending instruments and capacity. The current crisis is no exception – it has given rise to new facilities for crisis lending and the tripling of IMF resources.

IMF emergency lending is said to play two main roles. On the one hand, it provides breathing space to countries facing severe liquidity problems and payments crises, allowing them more time to adjust and helping restore confidence. On the other hand, for countries with “strong and sound policies and fundamentals”, rapid access to adequate and upfront financing is expected to play a preventive role, particularly under threats of spillovers and contagion from financial instability originating elsewhere in the global system. Moreover, quasi-automatic access to adequate IMF financing is expected to diminish the need for self insurance in international reserves and the associated costs and trade imbalances.

However, Fund lending has rarely prevented economic downturn in countries facing payments instability and crises. Such lending is often associated with pro-cyclical policy conditionality which serves to deepen the impact of the financial crises on jobs and income. This is still the case with the IMF programs in Europe despite the flexibility claimed. But more importantly, emergency lending could create more problems than it solves. When the scale is large, it can endanger the financial integrity of the IMF. It is not always easy to determine if a crisis is one of liquidity rather than insolvency. Argentina and Russia ended up in default while receiving IMF support on grounds that they were facing liquidity crises, and there is no guarantee that Greece will now be able to avoid default. Since the IMF does not enjoy *de jure* preferred creditor status, when the scale of operations is large, it can get badly hurt in the event of a messy default and asset grab race by creditors.

Since the IMF crisis lending is effectively designed to keep countries current on debt payments to international creditors and to maintain an open capital account, it often leads to an unequal burden-sharing between creditors and debtors. Commercial debt gets replaced by debt to the IMF which is often more difficult to renegotiate. Private debt gets dumped on the public sector – sovereign debt invariably rises after financial crises resulting from excessive build up of debt by the private sector. All these create moral hazard and prevent the operation of market discipline, because they allow investors and creditors to escape without bearing the full consequences of the risks they have assumed.

Because of the problems posed by bailout operations, the primary task of the Fund should be crisis prevention rather than crisis lending. This calls for a significant improvement in the quality of the Fund’s financial and economic surveillance. It also calls for a reform of its members’ obligations so as to bring about a reasonable degree of

multilateral discipline over macroeconomic, exchange rate and financial policies, particularly in its major members. The rationale for multilateral discipline is much stronger in money and finance than in any other area of global economic interdependence, including trade, since adverse external spillovers from monetary and financial policies in systemically important countries tend to be much more damaging.

But even with radical reforms in these areas, financial crises with global ramifications will continue to occur. Emergency lending is not, however, the only and even the best way of dealing with them. Orderly debt work-out procedures based on widely recognized principles of insolvency designed to secure the involvement of private lenders and investors in crisis resolution are more equitable both between debtors and creditors and between private and official lenders, and more effective from the point of view of their impact on the behaviour of lenders and investors and, hence, on financial stability. It is quite astounding that the international community has been unwilling to put in place such mechanisms despite rapidly growing international debtor-creditor relationships, still continuing to address sovereign debt crises in an *ad hoc* manner.

This paper takes up these issues in the reform of the IMF and the international monetary system. Although some specific proposals are discussed, the objective is not to provide blueprints, but to draw attention to main shortcomings of international monetary and financial arrangements in delivering “the global public good of financial stability.” The paper starts with a brief examination of the record of the IMF in early warning and crisis prevention and makes an assessment of whether its recent attempts for soul searching in financial market analysis and policy advice constitute a break from market fundamentalism and the so-called Washington Consensus.

This is followed by a discussion of the main difficulties encountered in securing effective and even-handed surveillance and multilateral discipline over macroeconomic, exchange rates and financial policies of IMF members and possible modifications to existing modalities and obligations. Possible benefits of independent surveillance are assessed and the scope for binding obligations regarding exchange rates and balance-of-payments adjustment are examined. It is argued that not only should IMF members retain the right to exercise control over capital flows, but the Fund should encourage them to do so when and as needed, through its lending programs and Article IV consultations.

Section IV looks at the problems resulting from the international reserves system based on the dollar and discusses possible alternatives, notably the role that could be played by the Specials Drawing Rights (SDRs). It is argued that a move away from the dollar-based reserves system towards SDRs could help reduce global imbalances and improve international monetary stability by providing a certain degree of policy discipline on the US. It would also help DEEs, *inter alia*, by reducing the need for self insurance and the associated costs.

Section V follows with a discussion of crisis intervention by the IMF, its objectives and impact on financial stability. It is argued that if instability and crises

cannot be prevented, it would be better to respond to them by combining mandatory mechanisms to involve private creditors and investors in crisis resolution with emergency lending designed to maintain a high level of income and employment than by large scale lending to bail them out. This is one of the most important ingredients of the reforms needed to strengthen the capacity of the IMF in crisis prevention. Otherwise, the IMF may increasingly become a quasi-international lender-of-last-resort without the requisite capacity and power of oversight and this will likely do more harm than good.

The paper concludes that the international monetary system needs to be restructured with the primary objective of *preventing* instability and crises, including through greater involvement of private lenders and investors in crisis resolution. A genuine reform along these lines will require considerable reflection and debate in the international community. It also presupposes recognition of the problems. However, some of the most important issues such as enforceable exchange rate and adjustment obligations, the international reserves system and orderly sovereign debt workout mechanisms are not squarely on the agenda of the G20 and the IMF. Developing countries have a particular stake in this endeavour given their vulnerability to shocks and limited capacity to respond. If major countries do not support establishment of an orderly and equitable international monetary and financial system, DEEs should find ways and means of protecting themselves and looking after their interests through regional mechanisms.

II IMF'S FAILURES IN FINANCIAL ANALYSIS AND EARLY WARNING

A key task of the Fund in securing stability is to keep track of economic and financial developments at the national, regional and global levels in order to identify the build up of potentially damaging macroeconomic imbalances such as excess savings or investment, chronic fiscal and balance-of-payments disequilibria or strong inflationary or deflationary pressures, and financial fragilities including excessive liquidity creation and credit expansion, debt accumulation and asset bubbles, and provide early warning and policy advice to governments for corrective action. In this endeavour the Fund naturally relies on a theoretical framework for identifying macroeconomic and financial imbalances, their interactions, proximate causes and possible consequences and the policies needed to address them.

This is an inherently difficult undertaking given the state of art of macroeconomics (White 2009). Predicting the timing of a crisis is an almost impossible task. There are also serious difficulties in correctly identifying whether asset price increases or credit expansions represent a speculative bubble rather than improved fundamentals or if a surge in capital flows is sustainable. However, as noted by two BIS economists, “**identifying in a timely way** the developments of financial imbalances with potential unwelcome implications for output and inflation, while very hard, is not impossible” (Borio and Lowe 2004: 18).

The failure of the IMF in identifying potentially damaging imbalances and issuing early warnings has its origin not so much in the inherent shortcomings of economic theory or imperfect knowledge and information as its faith in free markets. The Fund has traditionally adopted a crude neoclassical-cum-monetarist framework premised on efficient markets and rational expectations almost to the total neglect of accumulated knowledge and insight provided by alternative thinking, believing that disequilibria and imbalances generated by freely functioning markets are self correcting without entailing severe social and economic costs. Despite mounting evidence from crises in emerging and mature markets alike, the Fund has maintained an obsession with budget deficits and inflation, ignoring that asset price inflation driven by speculative lending and investment could pose even greater threats to stability and growth.

After recurrent crises in DEEs during the 1990s, the Fund intensified the surveillance of financial markets and capital flows, but this has not been effective in preventing further crises, including in countries working under IMF programs such as Russia, Argentina and Turkey, in large part because of its failure to diagnose and act on the root causes of the problem. The Fund has generally been highly optimistic about the sustainability of capital inflows to emerging market economies. While it should have been obvious that preventing unsustainable surges in capital inflows, rapid deterioration of net external asset positions, sharp currency appreciations and mounting trade deficits was essential for avoiding future problems, the Fund remained averse to any form of control over such flows, including market-friendly measures such as unremunerated

reserve requirements recommending, instead, monetary and fiscal tightening and greater exchange rate flexibility, which, in the view of its Independent Evaluation Office, proved to be highly ineffective (IMF/IEO 2005: 60).

The Fund has also been lukewarm against interventions in foreign exchange markets that many DEEs have used during the surge in capital inflows after 2003 in order to avoid currency appreciations and current account deficits, arguing that they were ineffective (see, e.g., IMF WEO October 2007: 122-24). It has favoured, instead, fiscal contraction as a remedy despite growing evidence from the BIS and elsewhere that currency market interventions have generally been quite successful in emerging economies, particularly where the banking sector is closely scrutinized (Akyüz 2009). Its insistence on the ineffectiveness of interventions in conditions of sustained capital inflows is particularly inconsistent with its pronouncement that the Chinese RMB is undervalued – a country which has been heavily and successfully intervening in order to sterilize the impact of its growing current account surpluses and net private capital inflows on the RMB/dollar rate.²

The IMF's debt sustainability assessments have been as equally problematic as its external sustainability analyses. For emerging economies they often yield highly optimistic debt projections while its sensitivity tests have been ineffective in providing early warning signals (Akyüz 2007). These are not simply harmless academic exercises for prediction. The errors in debt sustainability analyses are often carried over both to the policy advice that the IMF provides in the context of Article IV consultations or conditionalities, and to official debt relief initiatives, thereby affecting the outcome.

Much the same holds for the analyses of debt of Highly Indebted Poor Countries where sustainability is relatively easier to assess because the terms and conditions of their official debt do not vary much with market conditions. Several poor countries have seen their debt ratios rise significantly above the IMF-determined sustainability thresholds after reaching completion points and receiving debt relief at the rate deemed necessary to make their debt sustainable (Kitabire and Kabanda 2007).

In the subprime debacle the Fund missed the biggest crisis of its lifetime. In the run up to the crisis it failed to identify the nature and extent of a potentially destabilizing speculative build-up and to provide adequate early warning. According to the Fund report on 2006 Article IV Consultations with the United States: "Mortgage securitization had helped channel foreign savings into the U.S. housing market while allowing mortgage originators greater flexibility to diversify credit exposure and *reduce systemic risk.*" (IMF 2006: 7-8; italics added). The Fund staff was preoccupied with reducing fiscal and external deficits and maintaining control over inflation as the main policy challenges facing the United States economy, while reassuring that the "U.S. financial sector has proven exceptionally resilient in recent years." IMF (2005: p. 31; and 2006: p. 23). Even a month before the beginning of the credit crunch, they argued that "the most

² For the most recent pronouncement of undervaluation of the RMB, see IMF (2010f).

likely scenario is a soft landing as growth recovers and inflation falls, although both are subject to risks” (IMF 2007: p. 26).

Even as the depth and the extent of the problem became increasingly obvious to many independent observers, the Fund’s Global Financial Stability Report downplayed the difficulties faced: “The weakness has been contained in certain portions of the subprime market ... and is not likely to pose a serious systemic threat. Stress tests conducted by investment banks show that, even under scenarios of nationwide house price declines that are historically unprecedented, most investors with exposure to subprime mortgages through securitized structures will not face losses” (IMF GFSR April 2007: 7). This misjudgement of prevailing conditions in financial markets continued throughout the year even as banks started reporting large losses: “Although the dislocations, especially to short-term funding markets, have been large and in some cases unexpected ... systemically important financial institutions began this episode with more than adequate capital to absorb the likely level of credit losses.” (IMF GFSR October 2007: 10).³

More recently there has been some soul searching at the Fund, in an attempt to understand why it failed to warn of the most severe post-war financial turmoil. It issued two papers in 2009 focussing on the initial lessons of the crisis (IMF 2009b and 2009c), followed by two authored working papers “Rethinking Macroeconomic Policy” (Blanchard *et al.* 2010) and “Capital Inflows: The Role of Controls” (Ostry *et al.* 2010), discussing the IMF’s positions on macroeconomic, foreign exchange and financial policies.

The IMF now recognizes that “*surveillance of global economic developments and policies* did not give sufficiently pointed warnings about the risks building up in the international financial system. ... Fund surveillance echoed the conventional view that advanced countries with relatively low and stable inflation together with highly profitable and well capitalized banking sectors could withstand the unwinding of any froth in housing and capital markets.” While some other institutions and independent commentators were strongly warning of downside risks from mid-2000s, by the time the “Fund defied conventional wisdom by offering a prescient warning ... it was too late” (IMF 2009c: 2, 5). Systemic risks were underestimated because of its focus on inflation targeting to the neglect of asset bubbles, the assumption that the possible adverse effects of a reversal of asset bubbles on the real economy could be counteracted by lower interest rates, and the failure to adequately account for financial sector feedbacks and spillovers (IMF 2009b). Thus, the Fund now advises central banks to abandon the single target (inflation) – single tool (the policy rate) approach to monetary policy, to tolerate higher rates of inflation and to adopt a broader macro-prudential view, taking into account asset price movements, credit booms, leverage and the build up of systemic risks (IMF 2009b and Blanchard *et al.* 2010).

³ For a discussion of the IMF’s failure to correctly identify the nature of financial imbalances leading to the subprime crisis and its inadequate appreciation of contagion, see Rakshit (2009).

On capital control too the IMF appears to be breaking away from the orthodox single-minded opposition to restrictions, arguing that for “both macroeconomic and prudential reasons ... there may be circumstances in which capital controls are a legitimate component of the policy response to surges in capital inflows.” (Ostry *et al.* 2010: 15). These controls are now considered among the toolkit of policy measures for dealing with adverse macroeconomic and financial consequences of surges in capital inflows, comprising fiscal, monetary and exchange rate policies and prudential regulations. Currency market interventions are also included in this toolkit and viewed in a much more positive light. It is conceded that not only price stability but also exchange rate stability should be part of the objective function of central banks in small open economies (Blanchard *et al.* 2010: 13).

However, the Fund’s thinking on capital controls is still ambivalent. Restrictions over inflows are seen as justified only if a number of conditions are met – that is, if the economy is operating near potential, reserves are inadequate, the currency is undervalued and the flows are likely to be transitory. Economic benefits of free international mobility of capital are reaffirmed, and controls are considered as exceptions, only a temporary countercyclical response to surges in inflows in countries that already have largely open capital accounts. While it is recognized that “controls seem to be quite effective in countries that maintain extensive system of restrictions on most categories of flows”, those with “largely open capital accounts” are not advised to go in that direction but use such controls as last resort (Ostry *et al.* 2010: 5).

The policies advocated by the IMF as alternatives to capital controls and the conditions under which capital controls are said to be useful are contentious.⁴ Operation of the economy below capacity does not justify a hands-off approach to capital inflows. Short-term inflows at such times may bring income gains, but experience suggests that such gains tend to be more than offset by contractions that could result from a possible reversal. Again, because of the large carry costs involved, allowing short-term arbitrage capital to enter the economy and using them to accumulate (borrowed) reserves as self insurance against their exit is not necessarily a better option than restricting their entry. Lowering interest rates may not be an effective alternative to capital controls since interest rate differentials are not the only reason for short-term inflows. When they are attracted by quick windfalls from bubbles in asset markets, lower rates could simply add fuel to the fire. Finally, there is always uncertainty if and to what extent a currency is appropriately aligned with the underlying fundamentals. Thus, DEEs with large and persistent current account deficits are well advised to approach capital inflows with extreme caution and focus on building a sound payments position rather than financing them with foreign capital.

The unorthodox messages contained in these IMF discharges, notably the call for greater tolerance for inflation, attention to asset and credit bubbles, and use of controls over capital inflows as legitimate tools of policy are carefully worded and qualified with

⁴ See the description in Ostry *et al.* (2010, Figure 1). For discussion of many of the issues taken up in this paragraph, see Akyüz (2008).

several caveats. As such, the turnaround in IMF pronouncements on these matters appears to be triggered not so much by thoughtful reflection of its staff as by the need to respond to growing challenges to its technical and intellectual competence and integrity. Therefore, the jury is still out on whether the lessons learned from this crisis will move the IMF away from the Washington Consensus and produce a fundamental improvement in the quality of the IMF's economic and financial monitoring and policy advice to its members.

III IMF SURVEILLANCE AND MEMBERS' OBLIGATIONS

III.1 The Bretton Woods System

Policies almost always play an important part in financial instability and crises. Misguided deregulation of financial markets and liberalization of the capital account and unsustainable macroeconomic and exchange rate policies are often the proximate causes of financial crises and currency and balance-of-payments instability. This is true both for DEEs and advanced economies (AEs). However, global repercussions of financial crises and currency instability in systemically important countries, notably those enjoying reserve-currency status, are much more profound and widespread than those in DEEs. Adverse external spillovers constitute the rationale for multilateral disciplines in national policy making, the more so the greater the degree of global economic integration.

The architects of the Bretton Woods system recognized that multilateral discipline over national policies would call for enforceable obligations. A gold-exchange standard was established for the dollar, which in effect restricted the ability of the US, as the country enjoying the reserve-currency status, to run deficits without limit. Other countries were required to maintain their exchange rates within a narrow range of multilaterally negotiated par values. They were allowed to change them only on authorization from the Fund. An unauthorized change in par values would have enabled the Fund to withhold the member's access to its resources and even to force the member to withdraw (Dam 1982: 90-93). A scarce currency clause (Article VII) was introduced to secure symmetry in adjustment between surplus and deficit countries. Thus, the currencies of surplus countries could be declared scarce, thereby allowing others to use discriminatory trade, exchange and capital measures against them.

However, none of these obligations were strictly enforced under the Bretton Woods System (Bird and Willett 2007). IMF oversight of exchange rate adjustments was effectively abandoned in 1949 when Britain undertook a unilateral devaluation in order to gain competitive advantage and write down its wartime debt without facing punishment. The US ignored the limits set by the gold-exchange standard on its deficits and flooded the world economy with dollars, which eventually made it impossible to maintain gold convertibility. The scarce currency clause was never used. True that it had been introduced by the British as a protection against a possible dollar shortage, and in the event it was not needed because of rapid expansion of US deficits and dollar supply. However, it was still not invoked for Germany and Japan whose persistent surpluses made an important contribution to the collapse of the exchange rate arrangements.

The par value arrangements collapsed with the unilateral suspension by the US of gold convertibility in 1971 – the first and the most significant post-war default of international obligations by any country without facing a penalty. Floating was adopted without any credible commitment to exchange rate stability. Indeed the new “obligations

regarding exchange arrangements” established with the Second Amendment of the Articles in 1978 amounted to no more than the recognition that the stability of the international monetary system depended on the extent to which domestic policies sustained orderly underlying conditions. As pointed out by Triffin (1976: 47–48), the obligations were “so general and obvious as to appear rather superfluous” and the system “essentially proposed to legalize ... the widespread and illegal repudiation of Bretton Woods commitments, without putting any other binding commitments in their place.”

III.2 Bilateral and multilateral surveillance

With the abrogation of the par value system the IMF surveillance gained critical importance. At the same time as members were allowed the right to choose their own exchange rate arrangements, the Fund was charged to exercise firm surveillance over members’ exchange rate policies. Over time the scope of bilateral surveillance has expanded into a number of other areas. In the 1980s it was recognized that “to be effective surveillance over exchange rates must concern itself with the assessment of all the policies that affect trade, capital movements, external adjustment, and the effective functioning of the international monetary system.”⁵ After a series of crises in emerging economies it was agreed in April 1998 that the Fund should intensify its surveillance of financial sector issues and capital flows, giving particular attention to policy interdependence and risks of contagion, and ensure that it is fully aware of market views and perspectives.⁶ Various codes and standards have been established for macroeconomic policy, institutional and market structure, and financial regulation and supervision have become important components of the surveillance process. The 2007 Surveillance Decision delineated the full scope of surveillance, including all areas of policy that impinge directly and indirectly on external stability (IMF 2009e).

As recognized by the IMF (2010c: 5), unlike bilateral surveillance – the so-called Article IV consultations – the meaning and scope of multilateral surveillance are not well articulated. The Fund was charged by the Second Amendment to “oversee the international monetary system in order to ensure its effective operation” but no “substantive obligations of the members are identified” and “the Fund has never spelled out what its systemic oversight ... entails by way of process, substance, and data – either for itself or for its members” (IMF 2010a: 4). And “in contrast to bilateral surveillance, there is no comprehensive Executive Board Decision providing guidance for this half sentence reference to multilateral surveillance” (IMF 2010g: 5).

The focus of multilateral surveillance should, in principle, be the global spillovers and systemic interactions of national policies. In discharging this function, the Fund should be able to request its members to make policy adjustments when their policies lead to global imbalances or produce external destabilizing spillovers transmitted through

⁵ Group of Ten (1985: para 40). For further discussion, see Akyüz and Dell (1987).

⁶ IMF Interim Committee Communiqué of 16 April 1998; Washington, D.C.

balance of payments or other channels. However, from a legal point of view there are no obligations of Fund members to undertake policy actions to enhance systemic stability unless they are also necessary for their own stability. In other words, each member is required to promote systemic stability only by promoting its own domestic stability and “for the Fund to have a power to require changes in members’ domestic policies when these negatively affect the system as a whole but not their own domestic stability, a change in the Articles of Agreement would be required.” (IMF 2010c: 16).

This effectively implies there are no legal grounds for the Fund to request surplus countries – such as Germany, Japan and China – to make policy adjustments. Similarly, financial shocks transmitted to other countries cannot come under the Fund’s bilateral surveillance if they do not endanger domestic and external stability of the country taking the policy action. Thus, a hike in US interest rates or a rapid expansion of liquidity would be quite legitimate if it is compatible with the domestic and external stability of the US even if these wreak havoc in other countries.

The contrast with the international trading system is striking. Obligations in the trading system generally restrict beggar-my-neighbour policies that could inflict damage on other countries, regardless of their domestic consequences. This is not the case with IMF obligations despite the wide recognition that adverse international spillovers from monetary and financial policies in systemically important economies tend to be much more damaging than those from trade policies. Even the obligation to “avoid manipulating exchange rates” has no practical value in view of the freedom granted to members to choose whatever exchange regimes they wished.

In practice the IMF has paid little attention to international spillovers from policies in systemically important countries even as it encouraged the DEEs to rapidly integrate into the international financial system, increasing their susceptibility to external shocks. Nor has it been effective in bringing about coordinated policy adjustments in major deficit and surplus countries. During 2006-07 it initiated a process of “multilateral consultations” with systemically important countries to address global imbalances, but this did not produce the policy coordination needed. The G20 launched a Mutual Assessment Process in 2009 to secure economic policy collaboration and to complement Fund surveillance. The first report based on policy scenarios by the IMF was discussed in the Toronto Summit in June 2010, and a general agreement was reached on the need for AEs to communicate growth-friendly fiscal consolidation plans, for surplus countries to focus more on domestic sources of growth and for deficit AEs to take action for boosting national savings. It is now also agreed that IMF reports and Article IV consultations would address global spillovers from national policies of the US, EU, China, Japan and the UK, the issuers of five major currencies. However, no mechanism has been proposed to secure that policy action would be taken to mitigate adverse global spillovers.

While the IMF members have the same obligations to maintain orderly macroeconomic and balance-of-payments conditions and stable exchange rates, the Fund’s policy oversight is confined primarily to its poorest members who need to draw

on its resources because of their lack of access to private finance and, occasionally, to emerging economies experiencing interruptions in their access to international financial markets. For its borrowers the policy advice given by the IMF in Article IV consultations often provide the framework for the conditionality to be attached to any future Fund program (IMF/GIE 1999: 20). But its surveillance of the policies of the most important players in the global system has no real meaning.

III.3 Reform of IMF surveillance and members' obligations

III.3.1 Independent surveillance

A key question is, therefore, how to improve the quality, effectiveness and evenhandedness of IMF surveillance. The London Summit of the G20 (2009; para 12) expressed its support for “candid, even-handed, and independent IMF surveillance”, but without specific recommendations as to how to achieve these. Subsequently the International Monetary and Financial Committee (IMFC) reaffirmed the emphasis on “candor, evenhandedness, and independence” and the need “to enhance the effectiveness of surveillance” (IMF 2009d: para 11). However these undertakings have little credibility since the IMFC is known to have come up with similar pronouncements in almost every other meeting, particularly those held after episodes of instability in international currency and financial markets.⁷

There can be little doubt that problems regarding the quality, effectiveness and evenhandedness of IMF surveillance cannot be resolved without addressing its governance related shortcomings. On one view, considerable progress can be made by overhauling and downsizing the Board to make it more representative and effective, and giving greater independence to Executive Directors vis-à-vis their capitals and to the IMF secretariat vis-à-vis its governing bodies.⁸

This view has been taken further by a senior British Treasury official who proposed a formal separation of surveillance from decisions about program lending (Balls 2003). It is argued that the current structure of the IMF treats program design as an extension of surveillance, but the lack of a clear distinction between lending and

⁷ For instance, in September 2000 the Committee emphasized “enhancing Fund surveillance, and promoting stability and transparency in the financial sector”: in April 2002 it encouraged the Fund “to press ahead with the range of recent initiatives designed to enhance the effectiveness of surveillance and crisis prevention, including the Financial Sector Assessment Program”: in October 2004 it allocated four paragraphs on “making surveillance more effective and strengthening crisis prevention”; and in April 2006 it proposed a “new framework for IMF surveillance” which included, *inter alia*, making the staff “accountable for the quality of surveillance”.

⁸ For a discussion of these issues see Cottarelli (2005); van Houtven (2004); and Kelkar *et al.* (2005). Some of these elements of governance reform have also been emphasized, to varying degrees, by the three former Managing Directors of the Fund, De Larosière, Camdessus and Köhler in IMF (2004).

surveillance activities creates the wrong incentives and diminishes the effectiveness of surveillance. Moreover, there is currently no formal regular mechanism for assessing whether the Fund is providing objective, rigorous, and consistent standards of surveillance across all member countries. While responsible for ensuring the effectiveness of the Fund's activities, Executive Directors also have responsibilities to their authorities. This creates a conflict of interest where Executive Directors tend to collude in surveillance in defence of the countries they represent, turning peer pressure into peer protection. Surveillance should thus rest with authorities who are independent of their governments and who are not involved in lending decisions. This would also have the advantage of protecting the Board and IMF management from being dragged into decisions, which – on the basis of objective evidence – they would not want to take or publicly justify.⁹

Such a step could indeed help improve the quality of surveillance. Publication of independent surveillance reports and a wider debate over policy could help prevent build up of fragilities and vulnerabilities by providing signals to market participants and creating public pressure on governments in need of corrective action. However, in the absence of binding commitments, it would still be difficult to encourage major non-borrowing governments to heed the policy advice emerging from the surveillance process. Credible commitments and enforceable obligations regarding exchange rates and international adjustment appear indispensable for a reasonable degree of international monetary and financial stability.

III.3.2 Exchange rate obligations

While a return to the par value system of the Bretton Woods is not feasible, there are ways and means of establishing more flexible but stable international regimes. One such proposal is target zones for the three major reserve currencies, namely the dollar, the euro and the yen, advocated during the 1980s and 1990s by several people, including former chairman of the Federal Reserve Board, Paul Volcker.¹⁰ While there are differences among specific proposals for target zones, including the width of the bands, adjustment and intervention rules and policy assignments, they generally envisage an agreement among the G3 on a set of exchange rate ranges compatible with sustainable external payment positions. The agreed target zones should be wide enough to accommodate moderately divergent policies and adjusted as warranted by changes in underlying fundamentals. Targets would be defended by individual or joint interventions and monetary policy actions as and when necessary.

⁹ Stern (2009) makes a similar proposal for an institution run by politically independent technocrats, as an unbiased risk assessor to provide early warning about systemically important economies.

¹⁰ For various target zones proposals see, Williamson (1985, 1998), Williamson and Miller (1987), Volcker (1995) and McKinnon (1997). For an assessment and comparison, see Clarida (1999).

While there would be technical difficulties in estimating exchange rate bands compatible with sustained external positions, such judgments are often expressed by the IMF regarding exchange rates of members drawing on its resources as well as during bilateral consultations as called for by the 2007 Decision (IMF 2009e). The main difficulty is whether a reasonable degree of exchange rate stability could be reached under a regime of free capital movements while retaining policy autonomy for achieving objectives such as price stability, rapid growth and high employment. By virtue of the so-called impossible trinity, it is widely agreed that even if major governments commit themselves to maintaining relative stable exchange rates within multilaterally agreed bands and are prepared to undertake joint interventions to prevent instability and misalignments, they may be overwhelmed by the size and speed of international capital movements.¹¹ Retaining policy autonomy may require the bands to be too wide to secure meaningful exchange rate stability while too narrow bands may not stand market pressures if the degree of policy coordination needed is not forthcoming, as seen during 1992–93 in the European Monetary System.¹² Therefore, any multilateral commitments for exchange rates may need to be accompanied by control over short-term, arbitrage capital flows in order to broaden the space for policy to address domestic policy objectives while attaining exchange rate stability.¹³ This would be quite in line with Article VI which specifically recognizes that members may exercise such controls as are necessary to regulate international capital movements and that regulation of capital flows is an important element of the international monetary system (IMF 2010b: 14).

Since swings in major currencies have often been an important source of instability for DEEs, a credible and effective regime of target zones would certainly be beneficial to them. However, the benefits of increased stability of these currencies may come at the cost of increased instability of interest rates and this could create difficulties for DEEs in managing capital flows, debt and exchange rates of their own currencies (Reinhart and Reinhart 2002). Interest rate fluctuations needed to maintain exchange rates within target zones can be significantly reduced by controls over short-term flows, thereby widening the policy space in the AEs concerned and helping create a stable environment for DEEs.

The target zones proposals, as originally formulated in the 1980s and 1990s, were confined primarily to the G3 currencies, leaving other countries free to pursue their own exchange rate regimes as they felt fit. This was based on an implicit assumption that

¹¹ According to impossible trinity, it is not possible to pursue simultaneously an independent monetary policy, control the exchange rate, and maintain an open capital account. All three are *potentially* feasible, but only two of them could be chosen as *actual* policy. For a discussion that this trilemma is not absolute, see Akyüz (2009).

¹² On the degree of coordination needed and the consequent loss of policy autonomy under target zones, see Akyüz and Dell (1987) and Clarida (1999).

¹³ In order to counter arbitrage flows interest equalization taxes were used in the US in the early 1960s and negative interest rates on foreign deposits were used in Switzerland in the early 1970s; see Swoboda (1976). The more recent equivalent of such measures is the unremunerated reserve requirements.

other countries taken individually, or as a group if they acted collectively, were sufficiently small not to disrupt the fundamental equilibrium exchange rates among the three reserve currencies. Since then, however, China has emerged as a major player, the number one exporter and the largest surplus economy. Moreover, because of the central role that China plays in the East Asian production network, its exchange rate policies exert a wider influence. For this reason, any multilateral discipline with respect to exchange rates cannot exclude China.

III.3.3 Removing the asymmetry in adjustment

The second area where effective multilateral discipline is needed concerns adjustment by surplus and deficit countries. Under the current arrangements surplus countries as well as reserve-issuer deficit countries, notably the US, do not face any pressure for adjustment and there are no enforceable multilateral obligations in this area. An agreement on target zone among major economies would not by itself resolve the issue of who should adjust in the event of large current account imbalances. Moreover, asymmetry in adjustment is also a central concern to other countries, notably the DEEs.

One way of inducing surplus countries to adjust is by activating the scarce currency clause and authorizing the others to apply restrictive trade and capital account measures. However, this would not only run against insurmountable political opposition but also serious practical difficulties regarding the nature and extent of the sanctions each and every country would be entitled to apply. A softer alternative is provided by Keynes' International Clearing Union proposal. According to this scheme the countries running large deficits would pay interest on their drawings (overdrafts) on the Clearing Union while at the same time undertaking adjustment, including currency devaluations. Similarly, large surplus countries would be subject to a charge on their balances in the Clearing Union and required to appreciate their currencies. This latter feature of Keynes' proposal can be adapted to current conditions in that countries running persistent surpluses in excess of a certain threshold in terms of GDP could be required to pay taxes into a fund.¹⁴

In setting such thresholds for surplus countries attention should be paid to a number of factors since causes and effects of surpluses can differ considerably.¹⁵ The details would thus require considerable attention, but perhaps the most important objective that should govern such an arrangement is to discourage surpluses that constitute a major source of deflation and instability for the world economy.

In the October 2010 meeting of the G20 Finance Ministers the US Treasury Secretary made a proposal along these lines, to limit the G20 countries' surpluses and

¹⁴ This proposal is revisited by Eichengreen (2009) who suggests that such a tax can be paid to the IMF.

¹⁵ This is pointed out by the IMF Managing Director in relation to the US proposal discussed below – see IMF (2010h).

deficits to 4 per cent of their GDPs. This is a clear recognition that current global imbalances cannot be resolved simply by activating the scarce currency clause and compelling the three largest surplus economies, China, Germany and Japan, to adjust while leaving the US off the hook. An orderly international adjustment would no doubt require Germany and Japan to grow faster by expanding domestic demand and China to substitute domestic consumption for exports (Akyuz 2010). However, current global trade imbalances result as much from the behaviour of the largest deficit economy, the US, which has been exploiting its “exorbitant privilege” as the issuer of the dominant reserve currency. As long as the US continues to live beyond its means, the rest of the world as a whole would need to run a trade surplus, and policy adjustments outside the US would simply determine the distribution of that surplus among countries.

The US proposal envisages no mechanisms for encouraging or compelling countries to undertake necessary adjustments to comply with the limits, but only voluntary cooperation. Even if it is agreed by all the parties concerned, without an enforcement mechanism its chances of producing tangible results would be slim. For surplus countries a tax-based scarce currency clause may provide a market-friendly incentive for adjustment. However, since the dominant reserve issuer, the US, does not face any significant pressure for adjustment, restricting its deficits would depend very much on removing its exorbitant privilege by reforming the international reserves system. In other words, a central objective of the reform of the reserves system would be to facilitate international adjustment.

III.3.4 Capital account obligations and surveillance

The Articles do not give an explicit mandate to the IMF on capital account policies of its members. In the 1990s there were attempts to extend the mandate of the Fund to capital account transactions by establishing obligations for members to liberalize capital movements subject to some safeguards. Now that controls over inflows are recognized by the IMF as a legitimate component of policy response to capital surges, an issue raised is the role that the IMF could play in the regulation of capital flows.

The IMF (2010b: 15) argues for a broad mandate: “Given the fact that the Fund is charged with providing financing to address crises that may be caused by premature liberalization, it may be particularly appropriate for the Fund to play a central role in determining when liberalization supports—or undermines—stability of members and the overall system.” One way of ensuring this is by giving the IMF the power to authorize both liberalization and controls. However, this carries significant risks given the IMF’s continued inclination towards open capital account regimes noted above. Other ways and means should be found for the Fund to promote controls over destabilizing capital surges in the context of Article IV consultations as a way of preventing exchange rate and balance of payments instability, rather than giving it a broad mandate that could restrict the ability of DEEs to exercise control.

The Articles of the IMF not only recognize the right of members to regulate international capital flows but also authorize the Fund to request them to exercise control. The 1977 surveillance decision mentions, among the developments that might indicate the need for discussion with a member, the behaviour of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements. The 1995 amendment explicitly refers to “unsustainable flows of private capital” as an event triggering such discussion.

These require that surveillance should include sustainability of a country’s external balance sheet and hence effective management of external liabilities. As discussed in Section E, restrictions over capital outflows should become legitimate tools of policy at times of crises as part of orderly debt workout mechanisms. In the same vein, guidelines for IMF surveillance should specify circumstances in which the Fund should actually request the imposition or strengthening of controls over inflows.

For countries operating under Fund programs, conditionality should include control over destabilizing capital surges. In the past the Fund not only refrained from doing this, but in fact supported exchange-based stabilization programs relying on short-term capital inflows. The key issue is, however, how to increase the leverage of the Fund on capital account policies in non-program countries relying on destabilizing surges in capital flows and reduce the likelihood of costly crises and bailouts. While many countries are now approaching such surges with greater caution, there are several which still continue to rely on them, allowing sharp appreciations and mounting trade imbalances. One option would be to restrict future access to IMF resources under Exceptional Access Policy for countries not heeding the advice for control over surges during Article IV consultations. This could also help slowdown the surge in capital inflows and discourage moral hazard associated with bailout operations.

IV THE INTERNATIONAL RESERVES SYSTEM

IV.1 Instability and imbalances

An international reserves system based on a national currency as a means of international settlement and a reserve asset faces serious dilemmas irrespective of exchange rate arrangements and the regime for international capital movements accompanying such a system. Triffin (1960) pointed to a paradox in the Bretton Woods system, which could bring its viability in to question: that is, it would be impossible to rely on the dollar for the provision of international liquidity and at the same time fix its value in terms of gold when the global economy and demand for liquidity are expanding rapidly. In such a system the net holding of dollar assets by the rest of the world would depend on the US running current account deficits. If the US stopped running deficits, the shortage of international liquidity would stifle growth and make it difficult for other countries to maintain parity. If, on the other hand, the US runs growing deficits and supplies adequate international liquidity to the rest of the world, the accumulation of liabilities could eventually undermine the confidence in the dollar, making it difficult to maintain its value vis-à-vis gold.

In a world of free international capital mobility, net dollar holdings by the rest of the world no longer depend on US current account deficits. The rest of the world can increase its net holding of dollar assets as long as the US is willing to increase its holding of foreign-currency assets through investment abroad. In such a case the accumulation of dollar liabilities will be matched by increases in US holding of foreign assets. There would be no deterioration of the net asset position of the US or increases in the global stock of dollar liabilities relative to other currencies. However, for the rest of the world to acquire safe U.S. Treasuries, the US government would need to run budget deficits or should be willing to acquire foreign assets in exchange for Treasury bills and bonds. Otherwise, reserves would have to be kept in risky securities of US corporations, exposing reserve holders to default.

The Triffin paradox, as it was originally formulated, disappeared with the move to floating exchange rates and free capital movements, but the problem of instability did not. This is because the US deficits are no longer constrained by the obligation to maintain gold convertibility, and floating cannot restrict its ability and temptation to live beyond its means as long as demand for reserves by the rest of the world continues to expand, particularly as a result of faster growth in lesser developed economies.

Dollar domination has continued after the move to floating exchange rates, rapid growth of international financial markets and capital flows. The share of the dollar in non-gold official reserves has remained far above the share of the US in the global economy, falling only from 70 per cent at the time of the suspension of gold convertibility to some 65 per cent at present. The rise of Germany and Japan as industrial

powers did not challenge the dominance of the dollar. As explained by the IMF historian Boughton (2001: 937) Germany and Japan “were reluctant to see their currencies ‘internationalized’ and used as reserves ... Moreover, the prospect of a system of multiple reserve currencies was widely viewed, both inside and outside the Fund, as a potentially destabilizing development that was to be avoided if possible.”

After the demise of the par values the US has continued to run its policies in pursuit of domestic objectives of growth and price stability, to the benign neglect of the external value of the dollar. As a result, its current account has been highly unstable, and the dollar has gone through several gyrations vis-à-vis other reserve currencies. These have produced considerable swings in international capital flows and instability in the exchange rates and balance-of-payments of DEEs.

With the Second Amendment the IMF was given the responsibility of conducting surveillance over its members’ policies on reserve assets (Article VII). While each member was required to collaborate with the Fund to ensure that its reserve policies are “consistent with the objectives of promoting better international surveillance of international liquidity and making the special drawing right the principle reserve asset in the international monetary system”, this provision is devoid of any content with respect to the scope of obligations of IMF members (IMF 2010b).

IV.2 Reserve costs

After the collapse of the par value system, the need for reserves was expected to ease as countries gained access to international financial markets and became more willing to respond to external shocks by adjustments in exchange rates. However, greater access to international finance and capital account liberalization in DEEs have produced exactly the opposite result by giving rise to accumulation of large stocks of external liabilities and growing presence of foreigners in domestic securities markets, thereby making them highly vulnerable to sudden stops and reversals of capital flows. This has necessitated self insurance, particularly after the 1997 Asian crisis when it became clear that the only collective insurance available, namely IMF lending, was highly unreliable and orderly debt workout mechanisms that could prevent meltdown were unlikely to develop.

While traditionally reserves covering three months of imports were considered adequate for addressing the liquidity problems arising from time lags between payments for imports and receipts from exports, it has become a common wisdom that in order to avoid a liquidity crisis, international reserves in DEEs should at least meet their short-term external liabilities.¹⁶ At the end of 2009 total international reserves of DEEs reached

¹⁶ This is known as Guidotti-Greenspan rule. ESCAP (2010: 20) argues that a “more precise yardstick of vulnerability encompasses the measurement of overall gross external liabilities of a country that are most clearly reversible and measurable. The components of such an approach are short-term debt, the stock of portfolio inflows and the magnitude of imports over three months.”

some \$5.5 trillion, exceeding 12 months of imports. About half of these are earned from current account surpluses, mainly by China and Fuel Exporters, and the rest came from capital inflows – that is, they are borrowed reserves.¹⁷ In a few countries such as China, current account surpluses and reserve accumulation have been associated with rapid growth. But in a large number of DEEs additional reserves were built from capital inflows as governments intervened to prevent currency appreciations and weakening of payments positions. Similarly, many commodity exporters have put aside part of the growing export proceeds and restricted domestic spending and growth for fear that, in the absence of self-insurance, an eventual downturn in commodity prices could lead to virulent crises.

These reserves are invested in low-yielding assets, mainly the US Treasury bills and bonds. On the basis of average historical spreads between the borrowing rate and return earned on reserves, the annual carry cost of borrowed reserves alone to DEEs can be estimated to be in the order of some \$130 billion. This constitutes a net transfer of resources to reserve issuers, notably the US, and exceeds total official development assistance to developing countries.¹⁸ The cost borne by DEEs would be greater if allowance is made for foregone growth by putting export surpluses into US Treasuries rather than investment and imports.

IV.3 Reducing reserve needs

There are several ways of reducing reserve needs of DEEs and hence costs in resource transfer to reserve-issuers and foregone growth. First, measures that reduce the volatility of capital flows would also help diminish the need for self insurance. They include effective surveillance over monetary and financial policies of systemically important countries which exert a significant influence on the size and direction of international capital flows. They also include regulation of capital flows, particularly control over short-term surges; as noted, it may be better to stop them entering the economy than to cover them with costly reserves. There is no multilateral obligation preventing countries from using such controls. As discussed, the Fund should also encourage them to control surges through conditionality and Article IV consultations.

Second, orderly debt workout mechanisms including internationally sanctioned temporary debt standstills and exchange controls would reduce the need for international liquidity at times of sudden stops and exits.

¹⁷ Borrowed” in the sense that they accompany increased claims by non-residents in one form or another, including direct and portfolio equity investment, which entail outward income transfers.

¹⁸ The method used here to estimate reserve costs differs from that in the literature in that a distinction is made here between borrowed and earned reserves. Polak and Clark (2006) also refer to borrowed reserves in their estimation of the cost to poorest developing countries.

Third, pooling of reserves at the regional level could reduce total reserves held by the participating countries while providing adequate collective insurance. A recent example is the Chiang Mai Initiative with a reserve pool of \$120 billion for meeting the temporary liquidity needs of the ASEAN+3 countries.

Finally, more reliable and adequate official financing at times of instability will reduce the need for self insurance. However, as discussed in the next section, such lending should aim primarily at financing current account transactions rather than capital outflows and debt payments to international private creditors – the latter should be tackled mainly by mechanisms designed to involve the private sector in crisis resolution. In any case, as recognized by the staff of the IMF (Mateos y Lago *et al.* 2009), even if the IMF's lending capacity is significantly increased and tailored to instability in global economic conditions, the Fund is unlikely to elicit greater confidence among DEEs and persuade them to give up self insurance unless its governance structure becomes significantly more dependable.

IV.4 Moving away from the dollar towards the SDRs

The solution to many of the problems associated with a reserves system dominated by a national currency should be sought primarily on the supply side. Going back to the gold standard is not an attractive and politically feasible option. Nor is a single global currency replacing all national currencies or the currencies of “rich democracies” (Cooper 2006).

That leaves two alternatives. The first one is to end the dominance of the dollar by promoting some other national currencies as perfectly substitutable reserve currencies. This has been happening to a limited extent with the euro and the Chinese yuan may soon emerge as a serious competitor to the dollar. However, while policies can promote the internationalization of a currency, the emergence of a currency as a perfectly substitutable reserve asset depends on a host of conditions that cannot be readily changed by policy, including deep and liquid financial and foreign exchange markets, macroeconomic stability and large share of the country in question in international trade.

Besides, it is not clear if a multi-currency system would be more stable than a reserves system dominated by a single national currency. On one view, it could promote better stability by imposing policy discipline over the dominant reserve issuer. On another, it could result in greater instability by allowing central banks to shift the composition of their portfolios to optimize expected return. In any case a multiple reserve currency system would not eliminate the problems of deflationary bias and resources transfers from DEEs.

The second alternative is to establish a global reserve currency to exist side by side with national currencies. This could be arranged in several different ways, as elucidated by United Nations (2009). One option is to introduce a new global reserve currency, like Keynes's *bancor*, exchangeable with national currencies at fixed rates,

issued by a global central bank to provide countries liquidity for international payments clearance as well as overdraft facilities.¹⁹ However, building on existing mechanisms and institutions and a gradual move towards the SDRs (or expanded SDRs) appears to be a more practical solution to several, if not all, problems of the dollar-based system.

SDRs no doubt present a more stable alternative to dollar holdings for DEEs by allowing diversification even though their expanded role in the system may not reduce instability among reserve currencies much more than that could be achieved by moving to a multi-currency solution. Moreover, unlike dollar reserves, holding SDRs does not entail costs; cost is incurred only when they are used. Under present arrangements SDRs are allocated to members in proportion to their quotas. Members obtain or use SDRs through voluntary exchanges or by the Fund designating members with strong external positions to purchase SDRs from those wishing to use SDRs allocated to them. When members' holdings rise above or fall below their allocation, they earn or pay interest respectively, with the interest rate being determined as the weighted average of interest rates in money markets in the currencies constituting the SDRs.

The cost advantage of SDRs has given rise to calls for regular distribution to poor countries to ease the burden of holding reserves. Indeed, a former Director of Research of the IMF, Jacques Polak, argued that the only principle that should now guide the allocation of SDRs should be “the benefits of permitting low-income countries to acquire and hold reserves at a much lower interest rate than they would have to pay in the market and a reduced dependence of the system on borrowed reserves that are liable to be recalled when they are most needed” (Polak and Clark 2006: 553).

Regular substantial allocations of SDRs are certainly the most straightforward way to raise their share in reserve assets and help address the inequities in the current system. Allocations should be on a predetermined basis, linked to growth in world income and/or trade. It could also be adjusted counter-cyclically, accelerated at times of global slowdown. Using current quotas as the basis of allocation among countries would not raise the share of SDRs in reserve assets since a large portion would go to countries that do not need and use them. Given their external vulnerability, developing countries have much greater need and demand for reserves and this should be taken into consideration in reaching a formula for the allocation of SDRs among countries. On some proposals, all allocations could be given to developing countries (UN 2009: 116).

Another way forward is to make the IMF an SDRs-based organization; that is, to have SDRs to replace quotas and GAB and NAB as the single source of funding for the IMF. The Fund could be permitted to issue SDRs to itself on a regular basis, to be used

¹⁹ For a recent discussion of this proposal in relation to the current crisis see, Monbiot (2008). Ironically this proposal is now revisited for addressing the problems associated with the dollar-based reserve system and the United States indebtedness while at the Bretton Woods it was opposed by the very same country because it was the biggest creditor at the time and Keynes was proposing taxing current account surpluses. In contrast, in a recent speech on *Reform of the International Monetary System*, proposing adoption of the SDRs as a global reserve currency, the governor of China, the country with the largest surplus, referred to Keynes's bancor proposal as “farsighted”; see, Zhou (2009).

in lending operations. Again, this could be linked to growth in world income and/or trade. Several issues of detail would still need to be worked out, but once an agreement is reached to replace traditional sources of funding with SDRs, the IMF could in fact be translated into a technocratic institution of the kind advocated by Keynes during the Bretton Woods negotiations. Its funding would no longer be subjected to arduous and politically charged negotiations dominated by major industrial countries. Nor would it need to borrow from some of its members in order to lend to others. Such an arrangement could thus bring a considerable improvement to the governance of the IMF, allowing it to stay at equal distance to all its members and help to perform policy surveillance even-handedly and effectively.

It is also possible to supplement these with a mechanism to remove the dollar overhang by allowing countries to replace their existing stocks of dollar reserves with SDRs without causing disruption in currency markets. This is the proposal made by the Governor of the People's Bank of China whereby the IMF would "set up an open-ended SDR-denominated fund based on the market practice, allowing subscription and redemption in the existing reserve currencies by various investors as desired" (Zhou 2009).

This proposal corresponds to what came to be known as the substitution account, extensively discussed in the IMF in two previous episodes of considerable dollar weaknesses, but abandoned for several reasons; first, in the early 1970s in the Committee of 20 in an effort to replace the Bretton Woods system by something more viable and then in the late 1970s and early 1980s as the dollar weakened considerably.²⁰ Under such an arrangement the IMF would issue interest-bearing certificates denominated in SDRs against dollar reserves handed over by central banks at the market exchange rate, and invest these reserves in interest-bearing US Treasury bonds. The operation would not affect the total volume of international reserves but its composition. Countries can use these certificates to settle international payments or acquire reserve currencies. The substitution would result in a withdrawal of a large stock of dollar reserves from the market and put them into IMF coffers. This would not only help diversify reserve holdings, but could reduce the risk of monetary turmoil that could result from occasional unloading of dollar reserves by central banks.²¹

Several issues of importance to DEEs would need to be sorted out.²² First and foremost, there is the question of who will bear the exchange rate risk. A change in the dollar/SDRs exchange rate would create losses and gains for the IMF since, by definition, a substitution account would mean a currency mismatch between assets and liabilities. A sustained decline in the dollar against other currencies that make up the SDRs will imply

²⁰ For an account of these deliberations see, Boughton (2001: 936-43). See also Bergsten (2009)

²¹ Kenen (2005) suggests that a widespread unloading of dollar reserves into euro could be absorbed by establishing a similar substitution account at the European Central Bank.

²² These are discussed in Boughton (2001, 2007) and Bergsten (2007a, 2007b).

losses. The exposure of the Fund can be considerable if the account is open-ended, rather than restricted in size. There is no guarantee that interest differentials between the dollar and SDRs would provide cover for such losses.²³

In previous discussions of this proposal, the IMF gold was proposed to be used for cover. But this would mean pushing the losses onto all members of the Fund, rich and poor alike. If, on the other hand, the exchange rate risk were to be borne by holders of the SDRs, the operation would be meaningless – there would be no incentive for holders of dollar reserves to subscribe to the account. An alternative would be for the US to bear the risk – that is, to supply more interest-bearing dollar assets to cover exchange losses if the dollar falls against the other currencies. A more equitable solution would be to share the risk between the US and the Central Banks subscribing to the substitution account.

It is often argued that SDRs cannot become a principal reserve asset without significantly expanding its private use. An increased holding of SDRs as reserve assets would not be possible unless central banks can use them in currency interventions and diversification of their portfolios, and this calls for a deep and liquid market whereby banks and non-bank financial firms, as well governments issue and hold SDRs-based instruments. This is necessary for the substitution account to be attractive to central banks, not only for replacing reserves held in dollars but also in other currencies.²⁴

SDRs can provide a more stable store of value in so far as they help impose spending discipline on reserve-currency issuers and restrict the deficits they can run. They would allow expansion of international liquidity without requiring the US to run ever growing deficits. They would also reduce the cost of reserve holdings by DEEs. However, a shift from the dollar towards SDRs cannot address the deflationary bias in the global economy because of absence of effective arrangements for adjustment in surplus countries. Indeed the deflationary bias may be aggravated because the US can no longer act as a locomotive and run growing deficits. Consequently, any initiative to move away from the dollar as the dominant reserve currency should be accompanied by arrangements to ensure adjustment in surplus countries.

²³ The IMF could invest dollar reserves into long-term Treasury bonds which normally carry higher interest rates. But this would not necessarily cover the exchange rate losses.

²⁴ This requires a market maker, see Eichengreen (2009).

V CRISIS INTERVENTION AND LENDING

V.1 Expansion and proliferation of crisis lending instruments

The Fund is authorised by its Articles to lend from its General Resources Account (GRA) to its members facing balance-of-payments deficits and/or insufficient reserves so as to enable them to make necessary adjustments to resolve their payments difficulties. Except for reserve tranche purchases, such lending is subject to conditionality to ensure that the funds are used to resolve, rather than postpone, the payments difficulties and to protect the financial integrity of the IMF. Originally access to the Fund was restricted to current account financing. The Fund was prohibited to lend to meet sustained outflow of capital and empowered to compel a member to exercise capital controls as a condition for access to its resources.

With increased payments instability and recurrent capital account crises in emerging economies resulting from their rapid integration into global financial markets, the distinction between current and capital account financing has been lost and the Fund has increasingly become a lender to countries experiencing rapid and sustained outflows of capital and difficulties in debt servicing to private creditors. This role of crisis lending effectively started with the outbreak of the debt crisis in the 1980s when many developing countries borrowed heavily from multilateral sources to finance debt servicing to private creditors (Sachs 1998). The more the IMF has failed in crisis prevention, the more it has become involved in crisis management and lending. Indeed after almost every major financial crisis the IMF has sought a new role and this has almost always been construed in terms of expansion of its lending to countries facing difficulties in external debt servicing and maintaining an open capital account. Efforts to expand crisis lending have not been matched by meaningful reforms to improve the quality and effectiveness of IMF surveillance and to introduce enforceable obligations in order to reduce the likelihood of crises with global repercussions.

In the wake of the Mexican crisis the Managing Director of the IMF suggested to the Copenhagen Social Summit in March 1995 that an effective response to financial crises such as the Mexican one depended on “convincing our members to maintain, at the IMF level, the appropriate level of resources to be able to stem similar crises if they were to occur”, adding that this should lead to a decision in favour of “further work on the role the SDR could play in putting in place a last resort financial safety net for the world” (*IMF Survey*, 20 March 1995).

A new lending device, the Supplemental Reserve Facility (SRF), was created in response to the deepening of the East Asian crisis in December 1997 in order to provide financing above normal access limits to countries experiencing “exceptional short-term BOP (capital account) need resulting from a sudden and disruptive loss of market

confidence.”²⁵ This was followed in Spring 1999 by the Contingency Credit Line (CCL) designed to provide a precautionary line of defence in the form of short-term financing which would be available to meet future balance-of-payments problems arising from contagion. Simultaneously the Chief Economist of the IMF (Fischer 1999) suggested turning the Fund into an international lender of last resort, ready to provide liquidity to countries with sound policies so as to protect them against contagion and financial panic. The Exceptional Access Policy (EAP) adopted in 2002-03 allowed lending above limits to countries experiencing exceptional balance of payments pressure on the capital account.

The CCL was discontinued in November 2003 because countries had avoided recourse to it owing to fears that it would give the wrong signal and impair their access to financial markets. Again an alternative facility proposed in 2006, the Reserve Augmentation Line, based on prequalification and automatic access, was never activated because of concern over the prequalification process and adequacy of Fund’s resources. However, the current crisis has given the Fund reasons and opportunity for expanding its lending instruments and capacity. With the deepening and global spread of the crisis it introduced in October 2008 the Short-term Liquidity Facility (SLF) for countries with “short-lived and self-correcting BOP needs arising from external market developments despite strong fundamentals”, with access based on ex-ante qualification with a cap of 500 per cent of the quota. This was subsequently replaced in March 2009 by the Flexible Credit Line (FCL) “for countries with strong fundamentals, policies and track records of policy implementation” to be assessed by the IMF according to several pre-determined criteria. Unlike the SLF it can be used on a precautionary basis without any hard cap. The High-Access Precautionary Stand-By Arrangements (HAPAs) introduced for members who could not meet the FCL’s high qualification requirements have recently been replaced by a new Precautionary Credit Line (PCL), stipulating less demanding criteria for access.

All these initiatives have been supported by a decision of the G20 to triple the resources of the IMF to \$750 billion through expansion of borrowing from its major members, and to raise them further to \$1 trillion under a reformed quota system. The IMF is currently working with the government of Korea on a proposal for a global financial safety net including swap lines fashioned after those made available by the Federal Reserve to several emerging economies in the recent turmoil as well as multicountry lending under the FCL, to be discussed in the G20 summit in Seoul in November 2010.

V.2 Pros and cons of crisis lending

According to the Fund, its lending plays a key role in both crisis resolution and prevention. In a country facing a serious shortage of international liquidity and capital account crisis because of rapid capital outflows and interruption of its access to

²⁵ For a summary of various Fund GRA facilities, see IMF (2009a and 2010e).

international financial markets, the availability of Fund's resources would mitigate the burden of adjustment both by giving the country more time to adjust and by helping restore confidence (IMF 2009a: 12). However, such lending is often accompanied by pro-cyclical conditionality, leading to significant losses of jobs and income. Despite claims to the contrary, this still appears to be the case in current IMF programs in several European countries. In many of these cases such as Greece, the funding provided by the IMF is serving to bail out creditor banks in more affluent European countries such as Germany, Switzerland and France, while fiscal tightening, austerity measures and other pro-cyclical policies accompanying IMF lending are increasing the risks to their economic recovery (Weisbrot and Montecino 2010).

The IMF is now shifting emphasis from lending for "crisis resolution" towards lending for "crisis prevention" by offering precautionary credit lines under the FCL and PCL to qualified countries to protect them against speculative runs due to adverse spillovers from a crisis in a systemically important country. Although this role is described as crisis prevention, such lending is found necessary because of the failure of the IMF to forewarn and prevent systemic crises – such as the one triggered by the subprime debacle – in the first place. The *ex ante* conditionality provided by the pre-qualification criteria is expected to encourage countries to pursue sound policies, thereby reducing the likelihood of such a run. The automaticity of access to adequate IMF financing is also expected to mitigate the need for self-insurance through large stock of reserves and hence reduce the associated costs and imbalances. Indeed, the recent proposal to bolster international financial safety nets appears to contain a provision to cap countries' foreign exchange reserves in return for their access to IMF-anchored currency swaps (Narendranath and Venu 2010).

Such an expansion of crisis lending also creates a number of difficulties. First of all, it leads to a further fragmentation of IMF membership by creating different categories in terms of their eligibility of access to GRA. Although differentiation is practiced in the access of countries to different facilities introduced over time to address specific problems, such as the Compensatory Financing Facility established to offset export shortfalls and the Extended Fund Facility for structural payments imbalances, and the Fund is given discretion in determining the size of access, the ongoing reform of lending instruments and practices would imply that the IMF could become an institution primarily for a small number of more prosperous emerging economies.

Second, in differentiating among different classes of members in terms of their eligibility to access to precautionary lending, the Fund would effectively be acting as a credit rating agency. However, the past record of the IMF in anticipating crises, issuing early warnings and distinguishing between solvency and liquidity problems is not very encouraging, and definitely not better than private rating agencies. This would have implications for its financial integrity since, unlike these agencies, the IMF would be putting its money where its mouth is. The claim that it enjoys a preferred creditor status (IMF 2009a) has no legal basis. It is true that in Paris Club debt restructuring exercises official bilateral creditors have been willing to exempt the Fund from the restructuring process. However, this status has not always been accepted by private creditors. Thus,

the “IMF could be party in any insolvency court or insolvency proceeding by arbitration. No right to preference of any kind exists” (Raffer 2009: 7). On the other hand, the suggestion that the IMF could protect its financial integrity at least in part by lending against collateral (IMF 2010a: 9 and 2010b: 19-20) has little practical value.

Third, since risks assumed by the IMF would not be identical even among the countries within the same category, it would need to differentiate charges to price them properly. However, this is not permitted under Article V, which requires that the rate of charge arising from the Fund’s holdings of members’ currencies must be “uniform for all members” (IMF 2010b: 18).

Fourth, in order to reduce risks and protect its financial integrity, the IMF would need to constantly monitor the fulfilment of conditions for access to ensure that the pressures on the capital account of a qualifying country have resulted from a sudden loss of confidence amongst investors triggered largely by external factors rather than macroeconomic and financial mismanagement. In these respects difficulties are likely to emerge in relations between the Fund and the member concerned since such an assessment would involve considerable discretion on the part of the IMF. It would also open the door to political influence by its major shareholders, particularly when the level of access is not fixed. On the other hand, Maastricht-like pre-qualification criteria could create more problems than they resolve.

Fifth, precautionary credit lines can also aggravate the pro-cyclical behaviour of financial markets. Countries that meet the prequalification criteria could experience surges in capital inflows which could lead to currency appreciations and current account imbalances and thus undermine the conditions that allowed eligibility to such lending in the first place. By contrast, others could come under more intense pressures from a systemic crisis simply because they are not eligible to precautionary credit lines.

Finally, crisis lending by the IMF often leads to an unequal burden-sharing between creditors and debtors. When funds are used to pay off debt to private creditors, sovereign commercial debt gets replaced by debt to the IMF which is often more difficult to renegotiate. Moreover, private debt gets dumped on the public sector – sovereign debt invariably rises after financial crises resulting from excessive build up of debt by the private sector. All these create moral hazard and prevent operation of market discipline, because they allow investors and creditors to escape without bearing the full consequences of the risks they have undertaken.

In discussing the pros and cons of crisis lending, the IMF (2009a: 15) recognizes that official financing could end up financing larger private outflows and this could lead to creditor moral hazard. However, its attention is predominantly focussed on the debtor moral hazard. In the assessment of “risks with crisis prevention instruments” no mention is made of creditor moral hazard, but concern is expressed that *“members may be tempted to use excessively large precautionary arrangements to overinsure against risks thus leading to moral hazard.”* However, this is also underplayed on grounds that earning the privilege of rapid and upfront access to Fund resources would provide

adequate incentives for sound policies and the EAP would provide a safeguard by enabling the Fund to carefully scrutinize access request and compliance with eligibility criteria (IMF 2009a: 33). More generally, the recent lending reforms are said to embed a number of safeguards to contain creditor moral hazard, notably by tailoring instruments to countries' fundamentals and policy track records (IMF 2010d: 14).

V.3 Involving the private sector in crisis resolution

Many of these problems associated with IMF lending at times of large and persistent capital outflows were recognized during the recurrent crises in emerging economies in the 1990s and early 2000s, and a wide agreement emerged for involving the private sector in crisis resolution – that is, continued or increased exposure of international creditors to a debtor country facing serious difficulties in meeting its external financial obligations as well as arrangements that alter the terms and conditions of such exposure, including maturity rollovers and debt write offs. A proposal pioneered by UNCTAD was to draw on certain principles of national bankruptcy laws, notably those of the US insolvency code, for preventing liquidity problems from erupting into full-blown financial and economic crises and bringing an orderly resolution to sovereign debt when default is inevitable.²⁶

Briefly, the application of these principles to international debt would involve, first, temporary standstills on payment of both sovereign and private external debt. The standstill decision needs to be sanctioned by an international authority to provide automatic stay on creditor litigation. This should be accompanied by exchange controls in order to stop the money fleeing the country in other ways. Standstills and restrictions need to be introduced to stop large and persistent outflows irrespective of whether payments difficulties reflect liquidity gaps or solvency problems that could eventually lead to default – something that is not always easy to identify *ex ante*.

Second, there could still be a need for the provision of external financing to the country imposing debt standstill and exchange restrictions. This could be secured by means of the so-called debtor-in-possession financing which automatically grants seniority status to new debt contracted after the imposition of the standstill. The task should primarily be assumed by the IMF by lending into arrears to private creditors. This would give *de jure* preferred creditor status to the IMF for its crisis lending. While it has to be recognized that money is fungible and in practice it is not always possible to identify the need catered for by a particular loan, it is important to ensure that IMF

²⁶ UNCTAD was the first international organisation calling for orderly workout procedures during the debt crisis in the 1980s, drawing on chapter 11 of the US bankruptcy code, noting that the absence of a clear and impartial framework for resolving international debt problems trapped many developing countries in situations where they suffered the stigma of being judged *de facto* bankrupt without the protection and relief which come from *de jure* insolvency (UNCTAD TDR 1986: annex to chapter IV). The proposal was revisited after the East Asian crisis (UNCTAD TDR 1998). For the application of Chapter 9 of the US insolvency law dealing with debt of public agencies, see Raffer (1990). For the debate around mandatory debt-workout mechanisms, see Akyüz (2002 and 2005) and Keiser (2010).

lending to counter volatility in private capital flows should aim primarily at maintaining imports and the level of economic activity rather than guaranteeing debt repayment to private creditors and maintaining capital account convertibility. This implies that there should be strict limits to IMF lending during capital account crises.

The third stage would be debt restructuring. In liquidity crises, standstills may need to be accompanied by extension of maturities of existing obligations and in most cases this can be negotiated between the debtor and creditors. The introduction of automatic rollover and collective action clauses (CACs) in debt contracts would facilitate voluntary settlements. However, in the case of insolvency when debt can no longer be paid according to original terms and conditions and default is inevitable, there would be need for impartial arbitration.

It is true that standstills and exchange restrictions could create difficulties for international lenders and investors which are often located in AEs, particularly when the amounts involved are large. Such systemic problems should be dealt with by national lenders-of-last-resort by providing support directly to their banks and other creditors in distress, rather than by IMF lending to debtor countries to keep them current on their debt payments. Many of the incentives proposed by the IMF (2009a: 17) to secure voluntary involvement of private creditors in crisis resolution, including forbearance by creditor country regulators for capital inadequacy and injection of capital into troubled lenders could be used to mitigate the impact of standstills and exchange controls on creditors in AEs.

During the earlier bouts of instability and crises in emerging economies the IMF (1999 and 2000b) recognized the need for “involving the private sector in forestalling and resolving financial crises”, but insisted on voluntary mechanisms. However, as these proved ineffective and some AEs started to oppose bailouts, the IMF Board agreed that “in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally”, and that since “there could be a risk that this action would trigger capital outflows ... a member would need to consider whether it might be necessary to resort to the introduction of more comprehensive exchange or capital controls” (IMF 2000a). The Board was also willing to give support by “signalling the Fund’s acceptance of a standstill imposed by a member ... through a decision ... to lend into arrears to private creditors.” The Fund secretariat went even further and proposed a formal sovereign debt restructuring mechanism (SDRM) to “allow a country to come to the Fund and request a temporary standstill on the repayment of its debts, during which time it would negotiate a rescheduling with its creditors, given the Fund’s consent to that line of attack” and to impose exchange controls (Krueger 2001: 7).

However, the SDRM proposal did not fundamentally address the problems associated with IMF bailouts. It was designed for countries facing insolvency while those experiencing liquidity problems were to continue to rely on IMF lending. The provision for statutory protection to debtors in the form of a stay on litigation was subsequently dropped. Even the diluted version of the proposal could not elicit adequate

political support and had to be withdrawn, and the attention has shifted to contractual and voluntary mechanisms, notably CACs in sovereign bond contracts.²⁷

While expanding its lending instruments and capacity, the Fund is once again opposing mandatory mechanisms to involve the private sector in crisis resolution and advocating, instead, voluntary mechanisms. Given the limited scope for voluntary involvement of private creditors in crisis resolution and the rapidly growing scale of bailout operations, this could not only overstretch the Fund's resources, but also endanger its financial integrity. This should be a matter of concern for a number of emerging economies which are now becoming creditors to the IMF.

Voluntary and mandatory mechanisms are not mutually exclusive. There can be little doubt that countries would use mandatory mechanisms with considerable discretion and only as a last resort, preferring, instead, voluntary agreements with private creditors. And the Fund should lend to ensure that temporary liquidity gaps do not develop into full-blown crises. However, it should not finance large and persistent outflows of capital and should insist on private sector involvement in one way or another for continuing to provide support during a capital account crisis.

Sovereign debt workout mechanisms are on the agenda in the EU because of growing concern for insolvency of some member states and increased public discontent with bailout operations. In July 2010 the German finance minister proposed to equip the EU with a sovereign insolvency framework for orderly restructuring of unsustainable public debt in member countries and shifting at least part of the burden to private creditors. There are also suggestions for the creation of a European Monetary Fund "capable of managing an orderly default and debt restructuring of a government within the EMU" and making "the no bail-out provision of the Maastricht Treaty credible again (Gros and Mayer 2010: 2). Whether these will produce effective arrangements needed to deal with the kind of difficulties associated with bailouts remains to be seen. However, they certainly reflect a recognition that current modalities of intervention in capital account crises call for a fundamental rethinking.

²⁷ For an account see United Nations (2005: chap. V) and Herman and Spiegel (2007).

VI CONCLUSIONS

The current turmoil in the world economy has demonstrated once again that the international arrangements lack mechanisms to prevent financial crises with global repercussions. Not only are effective rules and regulations absent to bring inherently unstable international financial market and capital flows under control, but there is no multilateral discipline over misguided monetary, financial and exchange rate policies in systemically important countries despite their disproportionately large adverse international spillovers. Both national and international policy makers are preoccupied with resolving crises by opening the faucets and spigots to support those who are at the origin of the problems, rather than introducing institutional arrangements to reduce the likelihood of their recurrence. Through such interventions, they are creating more problems than they are solving, and indeed sowing the seeds for future difficulties. For the first time in the post-war era, widespread economic difficulties are seriously threatening to disrupt whatever order the international economic system may have, by giving rise to beggar-my-neighbour policies in major economies, largely because of absence of multilateral disciplines over exchange rate policies and orderly and equitable adjustment to global trade imbalances without scarifying growth.

The international monetary and financial arrangements need a major overhaul. The primary objective should be to deliver “the global public good of financial stability.” The missing components should now be evident after persistent instability and recurrent crises in emerging and mature economies:

- There is need to establish credible and effective surveillance over national monetary and financial policies with global repercussions. This very much depends on introducing enforceable commitments and obligations regarding exchange rates of major currencies and adjustment to imbalances by both deficit and surplus countries.
- The world economy should move away from the current reserves system centred on the US dollar. This is essential not only for reducing global trade imbalances and securing greater international monetary stability, but also for the scarce resources of poorer countries to be used for investment and growth, rather than being transferred to the reserve issuer enjoying the exorbitant privilege of being able to live beyond its means without encountering serious costs.
- There should be a serious rethinking of the approach to international capital flows. The international community should firmly establish that controls over capital flows are legitimate tools of policy and they should be used not only by DEEs but also AEs to secure macroeconomic and financial stability.
- Crisis intervention and lending should not undermine market discipline and distort the balance between debtors and creditors. Private creditors and investors should

be involved in the resolution of payments crises through both voluntary and mandatory mechanisms. With mounting sovereign debt with international dimensions in several emerging and mature economies, it is no longer possible to deny or ignore the need for impartial sovereign insolvency procedures.

Although some specific proposals are discussed above to address these problems, the objective of this paper is not to provide blueprints, but to draw attention to main shortcomings in international monetary and financial arrangements. Genuine reform in these areas no doubt requires considerable reflection and debate in the international community in search of viable and effective solutions. This presupposes recognition of problems and shortcomings in the first place. However, the agendas of the G20 and the IMF still miss some of the most important issues that need urgent attention.

Developing countries have a particular stake in this endeavour given their vulnerability to adverse spillovers from AEs and limited capacity to respond. If major countries do not support the establishment of an orderly and equitable international monetary and financial system, DEEs should find ways and means of protecting themselves and looking after their interests through regional cooperation. These include arrangements regarding regional currencies and exchange rate mechanisms, intra-regional provision of international liquidity, policy surveillance and regulation of financial markets and capital flows. There can be little doubt that in many of these areas regional arrangements are generally inferior to those that could be established at the global level. But they definitely are better than a “non-system” pulled and pushed around by major economic powers.

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