

IMF Reform: In Search of Good Governance and Macro Stability

*Notes for remarks by
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A Social Contract

The basic “social contract” between government and its citizens in a democratic society is a delegation of authority upward for government to ensure the safety and security of its citizens, and to provide an enabling environment for individuals and communities to pursue freely their full potential.

Allow me to focus in my remarks today on the second purpose of government – to provide an enabling environment admittedly sounds a bit “laissez faire”. But the freedom and autonomy of the individual is reflected in the Canadian Charter of Rights. And each person is promised opportunity and choice.

However, societies recognize that without more affirmative action by government, we cannot respect that right. *Equality* of opportunity

¹Mr. Fried delivered his remarks in his personal capacity, and the views expressed should not be taken as reflecting the position of the International Monetary Fund.

demands of us that we give government the means to level the playing field – for example, sectorally, by way of efforts to ensure health care coverage and through education policies.

So our governments have been mandated by our respective voters, through the laws of Parliament or legislature, and the executive actions of our executive branch, to create and maintain the conditions to permit individuals and communities to flourish.

So far, what I've described is a fairly self-contained universe – a compact between people and their government, “for limited purposes”, to borrow from Thomas Paine, in a given society, and in a world of nation-states, within a given territory.

At first glance, it may appear that government can achieve this objective through domestic policy alone – sound fiscal and monetary policy, a framework for expenditure management with accountability, and tax policy and economic regulation that spurs innovation, and promotes initiative and entrepreneurship. Accompanied by appropriate social policy, including providing the necessary infrastructure (including for human capital through health and education), a government's agenda can create opportunity and guarantee equality of opportunity.

But the world intrudes. You know full well that for Canada more than for most other countries, creating conditions for opportunity at home depends in significant measure on a similarly hospitable environment

abroad. Our dependence on trade and two-way investment means we have a significant and self-interested stake in the economic well-being of other countries, and in an international economic system that creates globally the same conditions we seek at home – an enabling environment for growth.

I'm From Government and I'm Here to Help...

So, government has a role, both domestically and internationally, to create and maintain an enabling environment for individuals and communities. But as I suggested, government's role is, and should be, limited.

Permit me to review the widely accepted framework that should guide public policy interventions in both the domestic and international sphere. There are three rationales that justify public sector action, whether at the sub-national, federal or international level.

First, governments can provide the necessary *scale or scope* to achieve an objective. Individuals and firms may simply not be large enough to undertake certain projects, whether it be sending a man to the moon, building the Hoover Dam, or, drawing on the experience of Canada, financing the construction of a transcontinental railway early in our history. Public sector institutions – government – provide a means for people to pool resources on the scale necessary to accomplish massive projects.

Second, governments are the only entities that can provide *public goods*. These are goods and services – for example, defence, or a clean environment – that it makes most sense to provide to everyone, or not at all. This is usually the case because the cost of providing the service to one person is the same as providing it to everyone.

Third, governments can help address *externalities* – instances where the actions of one person impose costs on others. Combating pollution and crime are the obvious examples here.

Just as these three rationales – achieving scope and scale, providing public goods, or combating externalities -- provide the basis for actions by governments within national borders, they are the basis for collective action at the international level, whether through informal groupings of countries, or formal international institutions.

The Resulting Agenda

Against this backdrop, the responsibility of our democratically elected governments to fulfill the mandate delegated to promote an enabling environment is reasonably clear.

Domestically, governments should provide the rules and the institutions that permit the market to function both smoothly and fairly. In addition to sound macroeconomic policy, government provides regulation of the conditions of competition, of framework sectors on which economic activity depends, such as transportation,

communications, energy, and financial markets, and provides regulators, tribunals and courts to resolve disputes. And although societal consensus may vary from country to country, most governments play a major role in such social policies as health, education, the environment and such social safety nets as unemployment and welfare benefits for the disadvantaged, and pension regimes for the retired. Ultimately, through providing infrastructure, institutions, and public goods, governments smooth the rough edges of the market and if successful, indeed allow individuals and communities to flourish.

The same is true internationally.

Governments have created international rules and institutions, too, to permit the market to function smoothly and fairly. Specialized organizations such as the Universal Postal Union, the International Telecommunications Union, the International Civil Aviation and Maritime Organizations, and the International Energy Agency and Atomic Energy Agency promote compatible regulation of framework sectors. The WTO provides an internationally-agreed set of rules to ensure a level playing field for trade in goods and services, and increasingly, investment.

Regarding macroeconomic policy, the Articles of Agreement of the IMF reflect an agreed commitment to create the conditions that will foster stability and growth. More broadly, much as the UN works to ensure global peace and security, such forums as the IMF, the Bank

for International Settlements, and the Financial Stability Forum bring together national regulators to foster a more stable international economic and financial system.

On matters such as health and education, rich countries band together to mobilize the funds necessary to meet the development challenge, pooling funds through multilateral institutions like the World Bank and other parts of the U.N. system, or coordinating less formally through donor groups in particular developing countries. In doing so, they achieve economies of scale that they could not realize acting individually.

The International Economic Agenda

Taking these institutions and rules together, an international economic agenda becomes clear. Particularly among developed countries, there is an increasingly shared recognition that domestic policies can have spillover effects to the detriment of a well-functioning globalized economy. Canadian economist Sylvia Ostry described the rules of the WTO as designed to reduce “system friction” – to mitigate the distorting effects of domestic policies on international trade. Similarly, at the IMF, ongoing oversight of members’ macroeconomic and monetary policies is increasingly focused not only on promoting a coherent domestic framework of fiscal, monetary, and related policies, but also on assessing the risk of damaging effects on others, and on the international monetary system itself.

In effect, I would submit that countries are increasingly aware of their shared responsibility to ensure that **both** domestic and external economic policies work to ensure the smooth functioning of global goods and capital markets. The IMF thus has been given a role in preventing countries from pursuing policies that harm their neighbours or the global economy as a whole.

Though less developed economies are stakeholders in these various international institutions, they face a different set of challenges. LDCs are admittedly less focused on providing an enabling environment for global growth and more squarely focused on raising the standard of living for their inhabitants. In this context, the March 2002 International Conference on Financing for Development in Monterrey, Mexico is a landmark. The General Assembly resolution adopted at that time, referred to in the business as the Monterrey Consensus, sets out an economic agenda that is both “pro-poor” and “pro-growth” – an agenda that if pursued provides an enabling environment for growth and greater equality of opportunity between rich and poor.

The Monterrey Consensus is based on the premise that developing countries have primary responsibility for their own economic and social development. They commit to taking ownership of the development process, in particular by building the institutions necessary to sustain development and implementing the policies that underlie successful growth.

If the developing countries implement the necessary reforms and make a sufficient effort to mobilize their domestic resources, we in the rich countries are expected to respond by mobilizing additional international resources. On the official side, this means substantial increases in ODA, debt forgiveness, technical assistance and capacity building. On the private side, this means measures to facilitate direct investment, provide business services and develop innovative financing mechanisms for small enterprises.

Rich and poor countries alike also committed to enhance the coherence and consistency of the international economic architecture, a theme to which I will return shortly.

But we in the rich countries are falling short of an important Consensus commitment. At Monterrey, the developed countries committed to promoting freer international trade as an engine for development. The current impasse in multilateral trade talks is therefore not just risking a missed opportunity; it is jeopardizing the sound and constructive international understanding that Monterrey reflects.

The IMF's Agenda: Fostering Global Stability and Prosperity

As I indicated earlier, the IMF, where I am Canada's Executive Director, has a key role to play in fostering an enabling environment for stability and growth. I believe this is best achieved through the

Fund's surveillance activities, though there is an active debate regarding this view.

What do I mean by surveillance? This is a concept that has changed through time, along with changes in the Fund's mandate. By surveillance, I mean the evaluation of a country's macroeconomic policy framework. Are monetary and fiscal policies working in tandem to achieve desirable economic outcomes? Are domestic policies consistent with a country's exchange rate regime?

More generally, surveillance is a means by which the Fund works with members to help them improve their economic governance. The approach here is very much consonant with the philosophy I described at the outset. First, the Fund provides advice to help its member governments better fulfill their social contracts with their own citizens. And, second, it helps all of its membership by encouraging each member to pursue policies that support a well-functioning global economy. It does this by providing its own independent assessment of those policies that fall within its areas of expertise, and subjects both its own assessment and the policies of members themselves to a process of "peer review" by the Fund's entire membership.

Although in theory and under the Articles of Agreement the Fund should look at the international impact of each country's policies, until recently, the Fund in practice more often than not has examined a country by assuming that the world beyond its borders was unaffected by developments within its borders. However, the

economic policies of some countries have important spillovers on other countries. This is patently evident from the current policy activity surrounding global imbalances. The reduction of the US current account deficit, for instance, cannot be achieved without a concerted effort on the part of a number of other countries.

This realization is leading to a change in the way surveillance is performed at the Fund. Twice a year, in the World Economic Outlook, the Fund now routinely examines the impacts of the policies of certain systemically important countries on everybody else. Both the Executive Board and officials in capitals are currently debating how Fund staff can better and more explicitly integrate these spillover considerations when they engage in one-on-one talks through so-called Article IV consultations. The aim of course, is to sensitize the Fund member to the impact its economic policy is having on the rest of the world, in the hope that this will lead to better economic decision-making. And the Fund has launched a process of “multilateral surveillance” – bringing authorities of key countries together at the same table to foster a greater appreciation of the benefits of concertation, in the first instance to address global imbalances.

The Fund is not limiting its internal review to surveillance. An important lesson of the Asian Crisis is that crisis prevention is just as, and perhaps even more, important than crisis resolution. It’s certainly cheaper. That is why the IMF has been working not only to improve its surveillance, but also to extend its assessments and advice to

areas that it has not in the past looked at as deeply, but which experience has shown are sources of potential vulnerability in both advanced economies and emerging markets.

To provide a concrete example, an important lesson from the Asian Crisis was the recognition that better regulation and supervision of the financial sector would have helped steer capital to more productive purposes, rather than more speculative activity. In the wake of an external shock, there would have been a significantly lower likelihood of money fleeing the countries affected.

This has led the IMF to broaden its expertise in the area so as to advise countries on financial sector regulation and supervision. Importantly, the IMF worked with a number of international bodies to develop a set of standards and codes whose aim was to provide policymakers with best practices, and to provide financial markets reliable information on which to transact. The development of these standards was accompanied by efforts to increase capacity in financial sector regulatory authorities, particularly in emerging markets, to ensure that domestic authorities had the technical expertise to promote sound regulation and supervision.

The Fund and the Bank examine and report on members' observance of 12 relevant standards and codes of practice in data transparency (statistical, fiscal and monetary), financial sector regulation (banking, securities, insurance, payments) and market integrity (corporate governance, accounting, auditing, bankruptcy) every few years. Most

recently, the IMF has devoted significant efforts to building capacity to help domestic financial institutions identify and reduce the incidence of money laundering and to combat the financing of terrorism.

This focus has an even more significant benefit. Deeper, more diverse and more efficient capital markets are the best means of allocating capital to its most productive use, and thus is a key driver of growth.

The Fund's efforts at crisis prevention also go beyond its surveillance activities in another important respect. For example, the Fund has been working to develop a lending new instrument that would help emerging markets to avoid financial crises. While the details remain to be worked out, the instrument would essentially serve as a pre-approved line of credit on which countries could draw when they needed to augment their international reserves. Countries with sound economic and financial policies would have access to this facility, and they would draw on it when an unanticipated financial trauma occurs. This could both provide the country with additional financial resources and bolster the confidence of markets.

While such an instrument seems relatively straightforward, its design is complicated by three principal factors. The first is *borrower moral hazard*. Having qualified for an instrument that, in principle, reduces the likelihood of crisis, countries may have an incentive to engage in unsound policymaking. The second is *lender moral hazard*. It is argued that when borrowers having access to what could be

considered a bailout from a public sector institution, private lenders will be less diligent in assessing risks. Thirdly, there is the *entry and exit problem*. Will a country be penalized by markets if it seeks access to such a contingent instrument? And can the IMF credibly commit to cancelling a line of credit if the borrowing country's policies deteriorate, even if a cancellation might itself trigger a financial crisis?

We don't know. Despite these important challenges that will need to be overcome in designing an effective facility, the Fund's Board of Governors expect significant progress to be achieved in this area by the Spring Meetings.

Finally, despite our best efforts at crisis prevention, crises will inevitably happen from time to time. The Fund also remains committed to helping countries that have been unable to prevent financial crises. The Fund has provided, and will continue to provide, significant financial resources to countries in the throes of a financial crisis.

But What of Good Economic Governance More Generally?

For low-income countries, collecting data and compiling indicators of the quality of more basic economic governance has been quite the growth industry over the last several years. There are, at last count, 66 sources of data that purport to measure various aspects of governance, 33 of which are reliable enough to be useful, in the UNDP's opinion, 14 of which cover enough countries and enough

aspects of governance to be used for regular monitoring and assessment, in the Fund and the Bank's opinion.

These key indicators include aggregate measures of the relative quality of

- property rights,
- rule-based decision making,
- public expenditure and financial accountability,
- investor perceptions of the control of corruption,
- business transaction costs and red tape, and
- macro, structural and social policy outcomes.

This is a very important development because political leaders, international financial institutions and donor agencies can now discuss "what is to be done" -- informed in part by valid, reliable and comprehensive measures of governance.

Increasingly, stakeholders ranging from donor governments to NGOs to potential investors look forward to regular updates on country and regional performance against these indicators. Going forward, they

will likely serve more often as a basis for planning and decision-making by donors and recipients alike.

Of course, good governance has costs, too. For a government to meet the criteria in the boxes on the flowchart of the governance system, they must have the *capacity* to register titles and issue licenses efficiently, hear cases fairly and promptly, clear goods through customs with delay or side-payments, consult effectively on budgetary priorities, and account transparently on budget execution.

This helps to set the priorities for technical advice and training, to which the Fund has a significant commitment. The Fund provided about 430 person-years of technical assistance in the fiscal year ended April 30, 2006, about three-quarters funded from the IMF's income and the balance from donors. It also put nearly 5,000 trainees, 80 percent from low-income countries, through IMF courses at headquarters and in the field.

Lately the issue of corruption has garnered a fair amount of attention. But acts of corruption are often an outcome of poor governance, not synonymous with it. Of course we all expect IFIs to safeguard their resources against diversion, but IFIs and donors can best help by supporting their member countries' capacity to manage and be accountable for the use of public resources.

The International Architecture: Toward Greater Coherence and Effective Institutional Governance

Permit me to now turn to **how** the international community delivers on this agenda for good economic governance.

Our current international system dates, with a few important exceptions, from the period following World War II. The structure of international institutions put in place at that time showed a clear and coherent vision that reflected the realities and priorities of that era.

The World Bank was created to mobilize capital to finance reconstruction and development in Europe.

The planned International Trade Organization – which later came into being as the GATT and was then institutionalized as the WTO – would create a framework for the expansion of trade through progressive reductions in tariffs and non-tariff barriers.

The IMF would create the international monetary stability needed to allow countries to take advantage of the opportunities offered by a more open international trading system.

The aim of these arrangements was of course as much political as economic: it was to create the prosperity that would help guard against the threat of extremism and consolidate trading linkages among countries to make it unthinkable that they would ever go to war again.

So it was natural that these international financial and economic institutions were situated within an overall architecture aimed to deliver peace and security – the U.N. system.

Yet this neat division of labour has tended to blur over time. While the World Bank has remained the premier institution for general economic development, a number of other institutions, including the IMF, the United Nations Development and World Food Programs, UNCTAD, the WHO, and IAO, to name just a few, now undertake activities with a development orientation.

One could thus be forgiven for holding impression that the international community's objective of promoting development in the world's poorest countries is being implemented in a way fraught with overlap and duplication.

Optimists, on the other hand, could conclude that the expansion in the number of institutions, and the potential for problems of coordination, simply reflects the cross-cutting nature of the international community's engagement in development. On this view, it is not surprising that once sharply-differentiated institutional mandates have begun to blur.

A similar weakening of the inter-institutional division of labour is also evident with respect to a much newer area of focus: the work that I described to support better financial market regulation and supervision, which began in earnest after the merging markets crises

of the late 1990s. Despite the relatively recent arrival of financial sector strengthening as a priority on the international scene, there is already a proliferation of institutions active in this area, starting with the IMF, the World Bank, the Financial Stability Forum, and the Bank for International Settlements. And governments have added various groupings of national finance ministers and central bank governors, such as the G-7 and G-20, whose participants are devoting ever greater attention to financial sector issues.

Taken together, these examples illustrate in my view a more general need for the international community to take a careful look at the constellation of international governance arrangements, and to develop a clear strategy to clarify mandates, disentangle areas of overlap, and avoid duplication of activity.

While it could be argued that the glass is half empty in terms of the coherence of mandates among international institutions, there is another area where I think the glass is more than half full. I am referring to the emergence of informal caucuses where countries can discuss and coordinate action in a flexible way, adding additional members if needed to appropriately deal with a particular policy question. A successful example of this is the creation in 1999 of the G-20 forum of Finance Ministers and central bank Governors. It was established in the aftermath of the emerging markets financial crisis to bring together a broad set of emerging markets and developing countries, whose policy actions increasingly matter to the global economy, or who are critical partners for achieving key objectives

such as development. The G20 has solidified a sense of shared ownership of, and commitment to, the strengthening of standards and codes. And in the wake of 9/11, it was the G20, not the G7, that first set out a new framework for improved oversight of the risk of terrorist financing.

In a similar vein, the Paris Club – that informal group of government-to-government creditors – has been making more systematic efforts to open a dialogue with non-members, such as China, who are beginning to play a more active role in international lending.

Another area where the architecture of the international system is evolving is the increasing debate on what are the right arrangements for member countries to oversee the delegation of authority upward to their international institutions. Often lost in the detail of these debates is the underlying reason why these arrangements are important: to be effective, institutions need the support of their shareholders. Both the structure of voting, and the governance systems through which votes are cast and influence is heard, need to create a sense of shared ownership among the members of an institution and “buy-in” to its aims.

Clearly, one of the most important aspects of this is the system of voting by members. And whatever the particular mandate of the institution, the objective of their voting arrangements is the same: to make sure that the institution remains responsive to the needs of the

countries who are its members, and in a very real sense are its “owners”.

The means by which they achieve this end will depend on the aims of the body. At international financial institutions such as my own IMF, a country’s influence is based on its relative economic and financial size, rather than a one-country, one-vote model. The focus of reform here is to make sure that the weights used in these systems of weighted influence are the right ones, and keep pace with developments in the global economy.

The IMF is going through just such a reform at present, prompted by the rapid pace of change we have witnessed in the global economy over the last several decades – a process with which the Fund’s governance arrangements have simply not kept pace.

At the Annual Meeting in September, IMF Governors launched the first phase of a two-year program to review and reform these arrangements. The first phase, which has been completed, gives an *ad hoc* increase in voting power and the associated financial subscriptions to the IMF, to four rapidly growing emerging market countries – Mexico, Turkey, China, and Korea, whose voting power had previously been most lagging their economic clout.

Phase II of this process is now underway. It will include a more fundamental realignment of voting and financial arrangements for a broader group of members. The challenges here will be significant, in

part because some countries perceive this undertaking as a “zero sum game”. I see it differently, as a positive sum game for the international community – a way for everyone to win by making the IMF more legitimate, thus more able to persuade country authorities to implement its policy recommendations, and thus more able to achieve its mandate of supporting global prosperity.

In contrast, at institutions with more political mandates, such as the U.N., voting arrangements will tend to place more emphasis on the equality of sovereign states. But of course even here, the realities of asymmetric power need to be accommodated: witness the veto system in the U.N. Security Council and the continuing debate over changes to the number and composition of permanent membership.

Another dimension to governance at international organizations is the question of policy leadership. In the private sector, corporate governance principles allocate responsibility between management, a board of directors and shareholders. Here a wide variety of models present themselves, based on different choices in the trade-off between representativeness versus effectiveness. But throughout the international system, analogous divisions of responsibility are being re-examined.

At one extreme is the Security Council model, where certain powers are reserved by a subset of powerful countries. More inclusive is the model adopted by the IMF, in which decision-making power is wielded by an Executive Board composed of direct representatives

from a small number of members, but where the full membership is represented through a mechanism whereby a given seat at the Board can represent a constituency potentially containing many countries. Most egalitarian, of all, but also perhaps the most unwieldy, are the WTO Council and the UN General Assembly, at which all members are represented.

The WTO effectively has a shareholders' meeting in continuous session, a Director-General as CEO, but no board of directors. The UN has a board of directors – the Security Council, a shareholders' meeting – the General Assembly, both in ongoing session, and a CEO in the person of the Secretary General. The IMF has an Executive Board in continuous session, a Managing Director as CEO and Chairman of the Board, an oversight board (the International Monetary and Finance Committee) with suasive power only, and governments as shareholders meeting only annually largely for ratification purposes.

Conclusion

To sum up, we are witnessing a rapidly growing consensus on what constitutes good economic governance – the domestic and international policies required to insure prosperity and stability – and the important role for international institutions in supporting continued improvements in their members' policies. Our challenge is to ensure that the international institutions fulfill that mandate effectively.

And to do that, two issues must be addressed. First, we need to consolidate our agreement on the key elements of good economic governance, and agree on the proper means to support implementation of the measures necessary at the domestic level.

In turn, and secondly, there is some rebuilding to do in the international architecture, to ensure that the institutions we create to support global prosperity and security operate as effectively as possible.

In particular, the governance arrangements in each of our international institutions have to be effective ones, balancing efficiency with the need to support among their memberships a sense of widely-shared ownership in decisions and outcomes.

Finally, we need to strive for the highest degree of coherence in the division of labour between and among institutions, so they can achieve the full range of objectives we have set for them in the most efficient way possible.

Just as governments need to be responsive and effective to fulfill their part of the “social contract” within a national society, the objective for international institutions with economic mandates is to support and maintain an international environment that promotes the attainment of prosperity, security, and social justice in their members.