

Reason and Rules in International Economic Policy Making

Presentation for CASE

by

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Outline of Presentation

- How to persuade countries to adopt policies that are in the international interest
- Two case studies
 - Multilateral Consultation at the IMF
 - Updating the IMF's Surveillance Mandate
- Pointers for the Future
 - International Financial Regulation
 - Mutual Assessment in the G20

Basic Principles

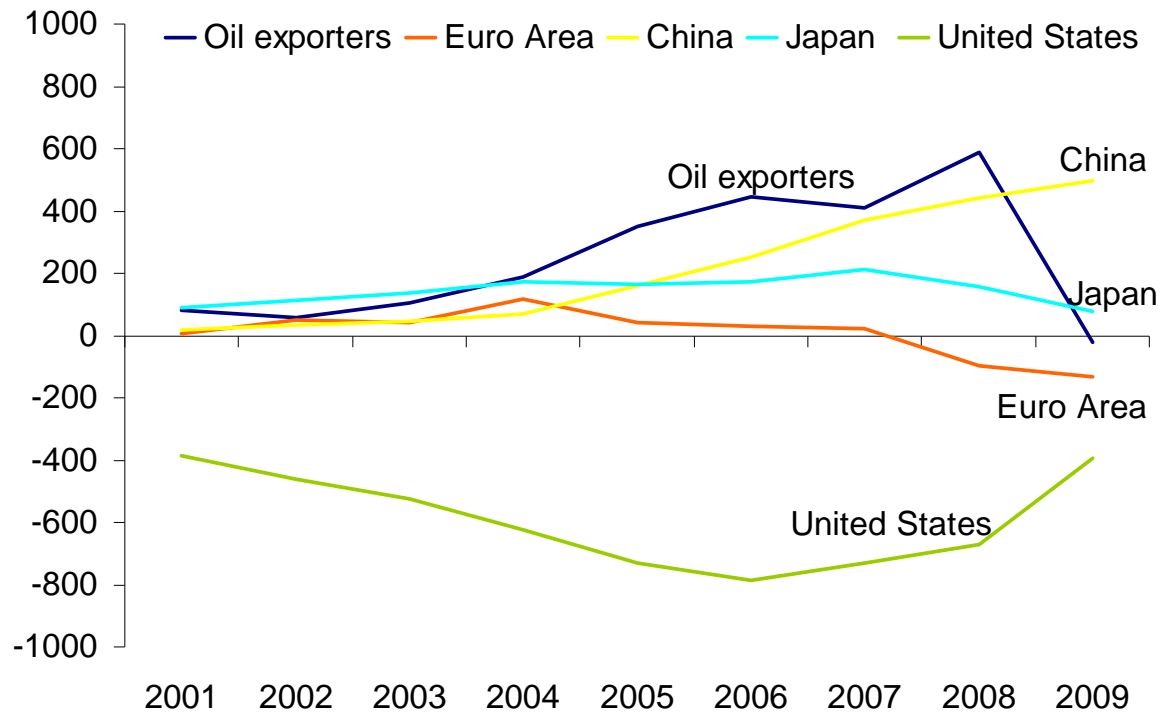
- The “Reasoned Approach”
 - Persuade countries to change policies in a coordinated way to promote the greater good
- The “Rules Approach”
 - Countries agree in advance to be collectively bound by rules which they believe will provide for better outcomes (EU, IMF, WTO)
- Do we want policy coordination at all?

Challenge of Policy Coordination in 2006

- Growing unsustainable international imbalances
- Need for higher US savings
- Need for others to sustain demand
- US concern over Chinese exchange rate
- Ritual references at international gatherings
- Led to both Multilateral Consultation and Revision of IMF Surveillance Decision

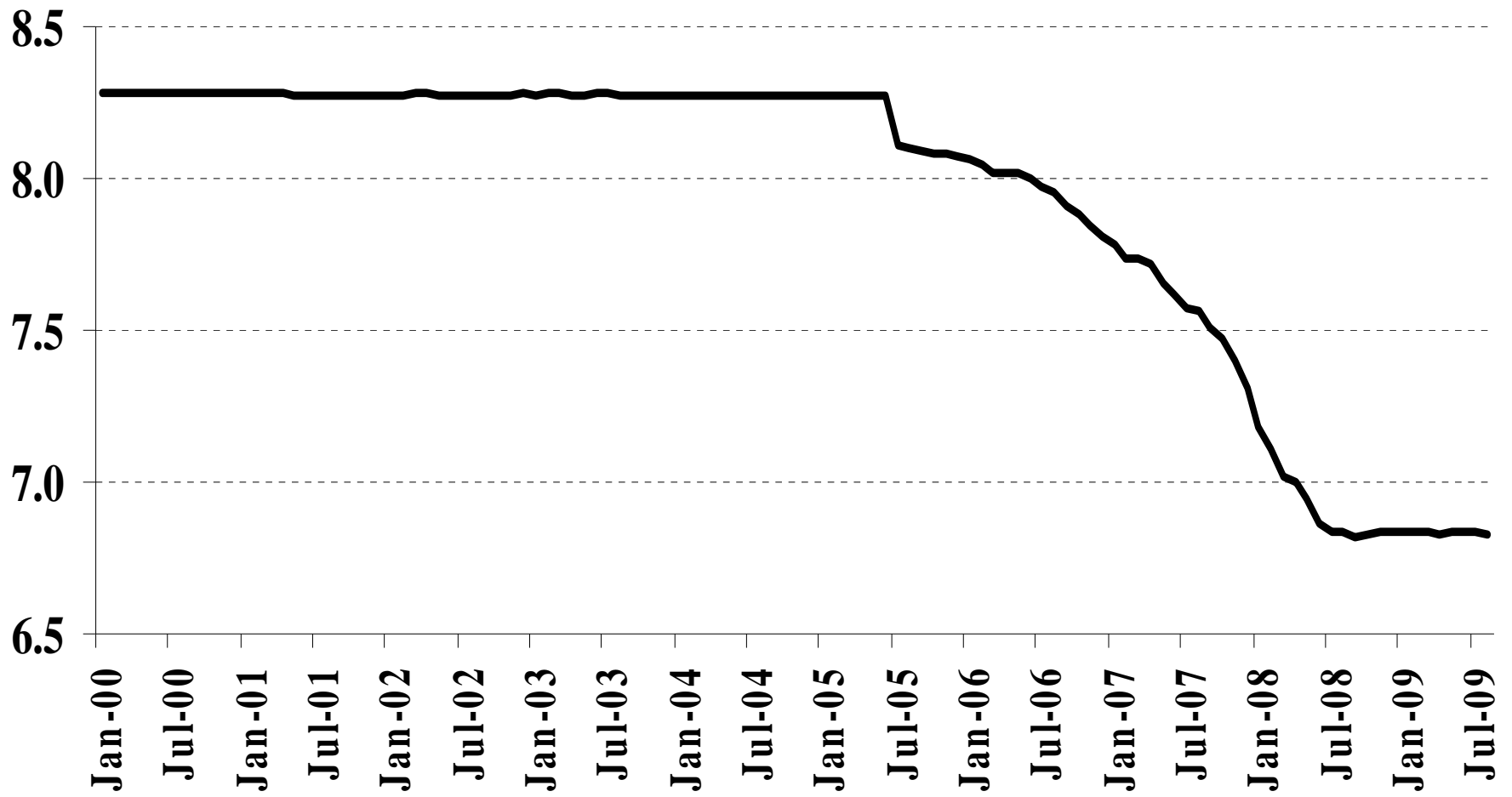
Global Imbalances

Current account balance (billions of US dollars)



Source: WEO.

Renminbi per US dollar 2000-09



Idea of Multilateral Consultation

- Small forum of key policy-makers
- Fund staff to present
 - Global picture
 - Country actions
 - Proposals
- Debate, followed by agreement on actions
- Publication
- Follow up by Fund and participants

Problems in conducting Multilateral Consultation and Results

- Problems
 - Participation
 - Publicity
 - Focus on domestic audiences
- Results
 - Publication of documents and presentation to IMFC
 - Underwhelming
 - Dry run for something bigger?

Surveillance under IMF Article IV

- Origin in breakdown of original Bretton Woods system of 1944
- Negotiations of a new set of rules - 1971-4
- Obligations and guiding principles for managing pegged and floating currencies
- Result a U.S.-French compromise (Second Amendment of the IMF Articles)
- Implementation details negotiated in IMF Board leading to 1977 Surveillance Decision

Main Features of Article IV

- Obligation to collaborate for stable system
- Domestic policies should aim at orderly economic growth and price stability
- Promote stability by fostering orderly conditions
- Avoid manipulating exchange rates for unfair competitive advantage
- Follow exchange rate policies compatible with the above
- Free choice of exchange arrangements

- Fund shall oversee compliance with obligations
- Fund shall exercise firm surveillance over members' exchange rate policies

Principles for Fund Surveillance

- Three principles for the guidance of members
 - A. Avoid manipulation for BoP purposes
 - B. Intervene to counter disorderly conditions
 - C. Take account of others' interests when intervening
- List of developments that might indicate the need for the Fund to hold discussions with member

Implementing the Decision

- Article IV surveillance central to the Fund's work
- But
 - Few staff read the decision subsequently
 - Biennial reviews always concluded the decision was fine (six words added in mid-1980s)
 - Almost all exchange rate policies were found appropriate
 - No country found violating the principles in 30 years
- Questions about surveillance following Asian crisis and in light of global imbalances

Revising the 1977 Decision

- British concerns that surveillance needed to be more candid and independent
- US call for refocus on the Fund's exchange rate mandate
 - Chinese “fundamental misalignment” in their sights
- Agreement that countries should be held accountable for policies that made international monetary system less stable

Some Issues in Revising the Decision

- Legacy of distrust of Fund's evenhandedness from the Asian crisis
- Fear of traditional asymmetry in obligations of surplus and deficit countries
- Perceived as aimed at China
- Unwillingness – particularly of developing countries to accept any new obligations
 - Especially any connected with domestic, rather than exchange rate, policies

Nature of the Revision

- Clarification of the objectives and techniques of surveillance
- Addition of a new principle D
 - A member should avoid exchange rate policies that result in external instability.
- Failure to agree on new principle E
 - A member should seek to avoid monetary, fiscal, and financial sector policies that lead to external instability
- Some prominence given to “fundamental misalignment”
 - An exchange rate that keeps the current account away from its equilibrium in the steady state

Problems in Implementing the 2007 Decision

- Preliminary analysis would have allowed the Fund to find US, Japan, and China exchange rates fundamentally misaligned in mid-2007
- But
 - Change in Managing Director and disunity in Fund management team
 - Resistance of countries to “labeling” or being the first case
 - Staff afraid of worsening relations with authorities and used talents to show wide economic uncertainty on estimates
 - Tactical error on “fundamental misalignment”

Legacy and Lessons

- Legacy
 - Board and staff have not found any country violating principles or having a fundamentally misaligned exchange rate
 - Have a better surveillance decision on the books and can build on it
 - Rooted in the concept of the promotion of external stability
- Lessons
 - Clarifying national obligations is a hard-fought, legalistic process
 - Firm surveillance by the Fund is needed but hard to come by
 - A strong and independent secretariat is needed, led by a smart management seeking to widen the scope of international soft law

Tasks Ahead: Financial Supervision

- Is an International Super-regulator inconceivable or essential?
 - Logic of supervisory model
 - Need for confidence in other's regulation
 - Keeping an eye on the 100-year event
- But
 - Countries far from pooling sovereignty in this area
 - Would need a new treaty
 - Without it financial markets may become less globalized

Tasks Ahead: G20 Mutual Assessment

- Recognition in Pittsburgh Statement that policy coordination needed in G20
- Mutual Assessment of national policy frameworks
 - G20 members to agree on shared objectives
 - G20 members to assess collective implications of national policies for the level and pattern of global growth and identify risks to financial stability
 - G20 leaders to agree on actions to meet common objectives
- Mutual Assessment supported by candid and balanced IMF surveillance, looking at internal and collective consistency, and suggesting policy adjustments

Tasks Ahead: G20 Mutual Assessment

- Builds on both process for Multilateral Consultation (although with huge number of participants) and Surveillance Review
- Steps to integrate G20 efforts and governance structure with the Fund's (Board and IMFC)
- Step towards stronger global governance, but willingness of countries to adjust policies in global interest still to be tested.

Thank you!