INTERNATIONAL MONETARY FUND

TSR External Commentary—A Short Note on Surveillance and How Reforms in Surveillance Can Help the IMF to Promote Global Financial Stability[1]

Prepared by Joseph E. Stiglitz

July 22, 2011

[1] This paper represents the views of the author and does not necessarily represent IMF views or IMF policy. The views expressed herein should be attributed to the authors and not to the IMF, its Executive Board, or its management.

A short note on surveillance and how reforms in surveillance can help the IMF to promote global financial stability

Joseph E. Stiglitz[1]

Surveillance has widely been viewed as a key instrument by which the IMF ensures member states adhere to the kinds of policies which promote global economic stability and through which the global macroeconomic coordination necessary for economic stability is achieved. Indeed, as Ocampo (2011) notes, "...the first objective of this institution is to provide 'the machinery for consultation and collaboration on international monetary problems.'" But there is also widespread agreement that there are major shortfalls in the achievement of these lofty objectives. Part of the problem has been in the view that countries—particularly those not borrowing from the fund—lack incentives to comply with the advice that would achieve such stability. Since those countries include virtually all of the systemically significant countries, if surveillance has an impact on global stability (as opposed to the well-being of particular countries) it is only the result of (i) a process of consensus building in which actions which they might previously have thought to not be in their interest were in fact in their national interest; or (ii) enough small countries, each of which is systemically insignificant, are affected in a meaningful enough way so as to have systemically significant effects.

Unfortunately, having influence on the systemically significant countries is very difficult. Each believes that they understand their own interests and global interests as well as, or better than, the IMF. They have their own analytic capacities, which they combine with a deeper understanding of their own economics, politics and self-interest, including a better understanding of their own political and economic constraints and a greater sensitivity to the trade-offs that they face.

For large emerging countries (and especially all countries other than the U.S.) the problem is compounded by several factors: (a) the historical dominance of the U.S.; (b) the historical dominance of U.S. "fresh water" economics; and (c) the historical dominance of financial markets. The three combined to give a set of prescriptions that placed excessive confidence in self-regulating markets (especially financial markets) and insufficient attention to unemployment and other dimensions of economic policy which are of concern to at least large segments of the population within the country.

Even in the United States, the second and third factors have undermined the impact of IMF "advice." I served as Chair of the Council of Economic Advisers under President Clinton. I know that the IMF surveillance had zero impact on our own thinking, though occasionally we worried that it might have an impact on others, but never saw any evidence that that was the case.[2]

---

[1] University Professor, Columbia University. I am indebted to helpful discussions with Kemal Dervis and Jose Antonio Ocampo, and research assistance from Laurence Wilse-Samson.

[2] Matters may be slightly better now. In the view of some, the Clinton years were the peak of the "unipolar moment." For instance, in the European crisis, the IMF analysis is not only taken note of, but often looked upon (in some circles, including those that had formerly been very critical) far more favorably than that of the ECB.

The question is, can IMF surveillance have an impact on the systemically significant countries (for whom macro coordination is presumably important, because of the significant externalities that can arise from their actions), and if so, how? Of course, IMF can have some impact on those countries that turn to the IMF for assistance, but that is not likely to be the case for the systemically significant countries.[3]

The experience with the crisis provides both examples of why IMF influence may be limited, and how it can be exercised. There is, by now, widespread agreement that policy dictums supported by the IMF played a role in the crisis and its rapid spread: the crisis was in large measure a result of inadequate financial sector regulation and financial and capital market liberalization contributed to its rapid spread. The IMF should, of course, not be singled out: it was simply reflecting much of the conventional wisdom, emphasizing self-regulation, the role of rating agencies, reliance on capital adequacy, etc. Little or no attention was focused on issues that are now recognized to be critical: non-transparent over-the-counter derivatives, excessive bank interdependence, off-balance-sheet activities, countercyclical macroeconomic prudential regulation, the risks of too-big-to fail institutions. Early warnings from the BIS staff were probably more strident than from the IMF staff, though to be sure, these warnings were not heeded, and there is little reason to believe that had the Fund been more vocal in its warnings, that that would have altered the course of events.

I should emphasize that there were some prominent economists who had warned of the risks. The crisis was not, in that sense, unpredictable or unanticipated. It was just not part of the prevailing "conventional wisdom," with dictums suggesting that low inflation was necessary and almost sufficient for stability; that because markets are efficient, there is little reason to worry about bubbles; that even if bubbles existed, one couldn't be sure until after they broke; that monetary authorities had limited instruments; and that the interest rate was a blunt tool, with likely adverse effects were it to be used to control asset inflation as well as CPI inflation.

On the positive side, the Fund did play a very positive role *after* the breaking of the bubble in assessing the potential magnitude of the losses, and warning of the serious consequences (at a time when some prominent monetary authorities were giving assurances that the risks were well contained). But the call to action, while widely noted, seems to have had less of an impact in the systemically significant countries than one would have hoped (though more recent disclosures suggest that there was some behind-the-scenes activity). [4]

The good news is that there is widespread acceptance of not only the presence of important macroeconomic externalities, but of their importance. For years, there have been warnings of a disorderly unwinding of global imbalances. The reserve system, with so much seeming dependence on the currency of a single country (or a couple of countries) seems an anachronism in the multipolar world

---

[3] The Greek and Irish crises illustrate, however, that in a world of high interdependence, even seemingly systemically insignificant countries can have systemically significant effects, especially if they are interlinked with systemically important countries. (Lack of transparency in financial markets contributes to this, since that increases the uncertainty about the consequences, say, of a default on the part of a country.)

[4] Though critics like Aiyar (2010) cite statements coming from the IMF even just before the collapse of Lehman Brothers that paralleled those of Bernanke that the risks were contained.

of the 21st century, and many scholars believe that the current system contributes to global instability. In the aftermath of the financial crisis, there is a recognition of the importance of financial regulations, including those affecting cross-border flows; but there is also a recognition that unless there is a modicum of harmonization, there will be forces for arbitrage, and actions to limit the extent of such arbitrage will lead to fragmentation of the global financial markets. More generally, the absence of adequate macroeconomic coordination has led some countries to take actions to prevent what they believe are the effects of the monetary policy of other countries that have also contributed to global capital market fragmentation.

In this context, then, the question of how multilateral surveillance could be designed and implemented in a way to make it more effective, in particular in advancing multilateral coordination among systemically significant countries, takes on increased importance. Indeed, in the aftermath of the crisis, the G20 realized the need for a better early warning system, in which IMF surveillance of the systemically important countries and their policies would play a key role.

This report suggests four important reforms:

1. Broadening coverage of surveillance, seeing issues such as inflation, within a broader economic and social context.

2. Broadening the range of models underlying the analysis, recognizing that those that were implicit or explicit in earlier analyses were flawed or at least lack the support of significant fractions of the affected countries.

3. Broadening participation in surveillance.

4. Enhancing the role of the IMF as "mediator," looking for compromises which take into account the divergences in interests and perspectives, as solutions to problems of global collective action.

Out of this it is likely that fewer strong prescriptions will emerge. There will be increased sensitivity to trade-offs and to uncertainties. Lower inflation might be desirable, but there will be costs, and we need to assess both their distributive and intertemporal incidence. When, however, there is broad support for a particular set of measures, it will make the impact of such consensus all the more effective. For instance, economists of different persuasions may well agree that a country that is living beyond its means must engineer cutbacks.

One might argue that, if the current focused surveillance has limited effectiveness, then why should we expect broadening—weakening its current focus—to have a positive effect? The answer is simple: When an institution that is seen as reflecting the interests of financial markets says that there should be less financial regulation, it has no impact. It is what we expect such special interest groups to say. Much of what the IMF says today is not taken as seriously as it might (or should) be because it is seen as reflecting particular sectoral interests (the financial sector), giving short shrift to other concerns, such as those of workers. It is seen as reflecting particular national interests (the controlling groups, the G-7, and particularly the US), rather than global interests. And it is seen as reflecting particular models (which presume that markets work well, except in the isolated instances when they do not, when the remedy is a massive bail-out). To be sure, each of these special interests and perspectives reflects an important constituency in the global economy. But the knowledge, or even the belief, that IMF views are so shaped hinders their acceptance by others; it hinders the influence that they might have.

Some have argued that what is missing is an IMF enforcement mechanism: there is no way of punishing those whose actions diverge from the "public good," in the way that the WTO has an instrument (trade sanctions)that can be imposed upon those that engage in protectionist actions. If there were consequences to a failure to cooperate, then cooperation would be more easily forthcoming. Though (almost tautologically) that would be true, given the lack of confidence that particular proposals of the IMF would actually lead to Pareto-superior outcomes (rather than to outcomes that would benefit the US or the Western financial sector), there is understandably a reluctance to grant the IMF significant enforcement powers. Indeed, in the aftermath of the crisis, the reluctance should be all the greater: if the kinds of policies that it had advanced had been more widely adopted (such as deregulation and capital market liberalization), the crisis would have been all the more severe; if privatization of social insurance schemes had been taken further, the social consequences of the crisis would have been all the more severe.

Even if the governance of the IMF were fundamentally reformed, so that voting rights more accurately reflected today's economic circumstances, there is a fundamental disconnect between such governance and democratic governance within most countries, where voting is allocated on the basis of one person/one vote. Domestic interests do not necessarily coincide with economic power, and so it is not a surprise that many democratic countries would be reluctant to cede substantial authority to an international institution where power is allocated in another way. In short, the reluctance to grant enforcement power to the IMF is not likely to be resolved even with a successful conclusion of on-going debates about the restructuring of IMF governance.

In the following paragraphs, I expand briefly on each of these reforms.

1. Broadening coverage of surveillance

Surveillance is aimed at assessing a country’s economic performance. But judgments are based on the performance of certain indicators. The questions are, which indicators are used, how are they used, and what weight is given to each? In principle, the focus should be on variables of interest in their own right, not on intermediate variables. Intermediate variables are of importance when there is a clear relationship between those variables and the ultimate variables of interest, either today or in the future; and when those intermediate variables can be more accurately or easily assessed than the variables of ultimate interest. The variables of ultimate interest are the well-being of the citizens of the country, today and in the future. GDP per capita is typically used as the metric, but as the international Commission on the Measurement of Economic Performance and Social Progress pointed out, there are serious (and correctable) deficiencies in that measure. If one were to look for a pair of numbers that best assessed where the country is today and its prospects for the future, perhaps they would include median income per capita (appropriately defined) and wealth (and the change in those variables). With a recognition that inequality may be of direct concern to shaping the nature of society as well as for economic stability, good indicators of inequality would be desirable.[5]

The Commission also noted that employment had a direct impact on well-being, beyond the income to which additional employment gives rise. High levels of unemployment also contribute to increased inequality and lowering of median income.

The IMF has focused a great deal on inflation, presumably because of its link with stability and inequality. The latter is questioned (at least in some schools of thought, at least in countries where labor markets are competitive, and so respond to increasing prices, and where social insurance is adequately indexed). Some economists have argued that a focus on *price* stability may come at the expense of greater *real instability.*

Instability itself is of concern because it may lower welfare (in the absence of adequate insurance), lower growth, or increase inequality. But whether it is real or price instability which has greater adverse effects remains a question in dispute.

In the past, surveillance also assessed a country's policies, with a clear view of there being a link between those policies and certain intermediate variables (and presumably thereby, certain variables of ultimate concern).

Prior to the crisis, certain prescriptions (like capital market liberalization) were viewed almost as objectives on their own, with some surprise when it was shown that such policies may actually increase instability and lower growth.

In short, surveillance that simply reports that a country has "high inflation" and therefore suggests that interest rates should be increased probably will (and probably should) have limited impact. What is needed is a careful laying-out of the diagnosis, the alternative responses, and the effects of each. (The link between the observed variable and the variables of interest depends, of course, on an understanding of how the economy functions, and that in turn may be highly dependent on the "model" of the economy, a subject discussed in the next section. For instance, low inflation may not be an unmitigated blessing, if it is the result of exchange rate appreciation, related to large and unsustainable capital inflows, even if in the short run, it is accompanied by high measured growth. On the other side, during crises, rising inflation may be due to depreciation; if authorities respond to the inflation with monetary tightening, the recession is worsened—so again inflation may be a wrong signal.[6])

The Fund might take a view of which of the alternative courses they prefer and why, but the fundamental point is that *there is seldom a Pareto dominant policy,* one which, taking into account all

---

[5] The IMF 2005 issues paper on multilateral surveillance in fact sets out a broad reach. While surveillance focused on exchange rates, it argues that an appraisal of exchange policies must take into account broader economic objectives: "financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment." (citing the 1977 Decision).

[6] All of this points to limitations in inflation targeting as the basis for monetary policy. See the further discussion below.

the risks, is optimal for all parties. And so long as that is the case, the choice among the alternatives must be a political one, to be made by the responsible authorities within the country.

As an example, some economists believe that how a country should respond to inflation should be highly dependent on the source of inflation—whether it is a result of excessive tightness in domestic labor markets or "imported" through global increases in oil. In this view, monetary policies centering on inflation targeting are likely to be misguided. If the country is already suffering from high unemployment, raising interest rates is likely to create more unemployment, lower wages further, and do little to influence the source of concern. If the source of inflation is imported food prices, in a country where the poor are highly dependent on imported food, then the impacts on the poor will be severe, with little benefits. (Of course, today, even most advocates of inflation targeting take a more nuanced approach, "flexible inflation targeting.")

Advice warning about the risks of regulation may be relevant in some contexts, but those concerned about inequality cannot ignore (as so many Western governments did) abusive, predatory lending practices. Discussions of deregulation often seem to ignore the legitimate reasons that regulation was adopted in the first place. Thus, the focus of discussion should not have been just on deregulation, but on how the regulatory objectives could best be achieved.

Surveillance has to focus simultaneously on the short run and the long run. The crisis also illustrated the inability to separate out structural issues from macroeconomic issues. If the analysis indicates that inequality contributes to instability, then surveillance has to take within its purview what is happening to inequality.

At the same time, surveillance has to be sensitive to issues of data availability. For short-run analyses, particularly, variables of intermediate interest may have to be relied upon in the absence of more up-to-date data on other variables. At the same time, there has to be sensitivity to differences across countries: in emerging markets, one should focus on changes in the degree of informality, because that, rather than open unemployment, may be a major mechanism of adjustment in labor markets. In the US, the broader measure of unemployment (U-6), which includes discouraged workers and those working part-time involuntarily, may be a better measure of slack in the labor market than the formal unemployment number.

There is sometimes a concern not just about emphases (too much on inflation, too little on employment and inequality), but about gross omissions. The anticompetitive practices of the financial sector in its running of the payments mechanism, the risks of floating rate mortgages or of abusive lending practices, or of derivatives and excessive financial sector interdependence, the possible adverse consequences of flash trading, the dangers of securitization, etc., are all important critiques that were perhaps given short shrift in surveillance. The crisis showed that there can be first-order impacts not just on well-being and the distribution of income, but directly on economic stability. Most of these critiques were voiced well before the crisis. But even more so, because insufficient attention was given to these, surveillance has been seen as "unbalanced," undermining its credibility.

Part of this lack of balance reflects (and is reflected in) prevailing models that shaped views about how a deregulated economy would work.

2. Broadening the range of models underlying the analysis

There is now widespread recognition that the models that economists relied upon and which provided guidance to policymakers before the crisis were badly flawed.[7] At the very least, the models did not predict the crisis, the most important economic event in three quarters of a century—and prediction is the critical test of any theory. This is not the occasion to review the many deficiencies and doubts about the standard models (from the lack of attention to the details of banking and the shadow banking system, to the market imperfections arising out of information asymmetries, including those associated with agency and corporate governance, to the problems that arise from excessive interdependence.) While IMF models before crisis feted the benefits of economic integration, after the crisis they focused on the risks of contagion—risks that increase with financial market integration. A coherent approach would have balanced the benefits of integration with the costs and focuses on architectures that minimized the latter while maximizing the former. Before the crisis, a growing body of work had focused on precisely such issues, but unfortunately this work was not incorporated into much of the IMF's analysis, particularly in relationship to surveillance. (Some research reports did highlight some of the problems.)

Views about how the economic system works are a hotly contested topic within many countries and within academia. It should be obvious that labor markets do not instantaneously clear; yet many of the mainstream models assumed that they do. When pressure was put to incorporate unemployment, the advocates of these models typically introduced search models, which can explain frictional unemployment, but has little to say about the high levels of cyclical unemployment currently being observed. There is likely to be a lively debate in the next few years about the extent to which the current unemployment is structural, but even if unemployment is largely structural, there are models that argue that Keynesian policies combined with active labor market policies can be part of an effective response. The problem is that the models that were often at the center of IMF analyses (and hence surveillance) assumed that markets worked well, and thus the focus was on government interference with markets. If, however, one believes that markets often don't work well, surveillance should focus on market failures and how government is failing to correct them.

This is especially important in multilateral surveillance, where there needs to be more concern over how government failures on the part of systemically significant countries like the US to adequately regulate their own markets might have spillovers on others.[8] But it should be emphasized that the exchange rate is only one way by which cross-border effects are realized and which give rise to external

[7] See Stiglitz (forthcoming-a) and Caballero (2011). I should add, however, that not everyone shares this view. Bernanke (2010), in particular, has argued that the models were fine; there was just a failure in economic management, in the details of the implementation of policies emanating from the models. The broad consensus, though, at the IMF conference and at the INET Bretton Woods conference this spring on rethinking macro-models was that there were serious deficiencies in the conventional formulation.

[8] In the aftermath of the crisis, the IMF has recognized the importance of cross-country spillovers. See IMF (2010).

imbalances, and that exchange rates themselves exercise their effects in part (some would argue mainly) through capital flows—and it is especially short-term capital flows which give rise to instability. Country A may have a surplus because other countries have imposed trade restrictions, e.g. on their exports to that country. Exchange rates are relative prices, and actions by all parties affect both exchange rates, and the external imbalances associated with any given level of exchange rates. Restrictions on inflows of capital (e.g. investments by Sovereign Wealth Funds) can lead to a lower exchange rate, even if that is not the motive of the restriction.[9]

Policy advice is always done in the context of uncertainty—uncertainty about the data, and about where the economy is going—but there is also uncertainty about the structure of the economy and how best to model it. To pretend that modern scientific economics has resolved these uncertainties, or even reduced them to an extent that there is broad agreement around major policy tenets, is simply wrong. This kind of hubris contributed to the crisis. (It is not, for instance, even a settled matter whether optimal interventions should take the form of price or quantity interventions, in a world in which there are an incomplete set of risk markets—contrary to the presumptions in neoclassical analyses, which assume perfect markets.)[10]

Hence, for IMF surveillance to be more effective, there needs to be more explorations of the consequences of different ways of modeling the economy. If, for instance (as some recent IMF papers suggest) inequality contributes to instability, then making labor markets more flexible may not only lead to more inequality, but more instability. If, as many economists believe today, there is a deficiency of aggregate demand in many countries, more labor market flexibility may lead to higher, not lower, unemployment. If, as Irving Fisher argued, deep recessions and depressions are related to a debt-deflation cycle, then so are more wage and price flexibility risks pushing the economy further into recession.[11]

---

[9] But as we have noted elsewhere, ascertaining motives is difficult. Rodrik argues, for instance, provides empirical support that real exchange rate suppression can improve growth, and Stiglitz (forthcoming-b) explains why this may be particularly so in the presence of other restrictions on industrial policy. Thus, "unfair" trade agreements (or at least trade agreements that restrict countries' freedom in pursuing growth-enhancing industrial policies) have implications for the appropriate exchange rate policy. Conventional stances on trade policy, which ignore impacts on dynamic comparative advantage, and therefore the long-term growth potential of emerging and developing countries, will (and should) be treated with some skepticism.

[10] To the extent that exchange rates matter, it is *real exchange rates,* not nominal exchange rates. The *real* consequences of temporary misalignments of nominal exchange rates depends, of course, on adjustments of wages and prices, which may differ across countries and over time, and have to be modeled. There may, of course, be disputes about how to measure real exchange rates. It is worth noting that the *Economist* (November 10, 2010) suggested that even then, since 2005 the yuan had appreciated 45% against the dollar—half as a result of an increase in unit labor costs.

[11] It is important, however, to note differences in the types of labor market flexibility. For example, flexibility in hiring and firing combined with strong support for job search and strong unemployment benefits as well as training programs a la Scandinavia don't have the negative macro and distribution effects of flexibility without such programs. This illustrates that what is required is more subtlety in the analysis. (Some theoretical models based on information imperfections—variants of the Shapiro-Stiglitz no-shirking model—even show that increasing labor market flexibility in the narrower sense of reducing penalties for firing workers results in higher unemployment.)

Empirical economists are prone to cite econometric studies to buttress their positions, and such studies and empirical regularities are useful, but need to be used with great care. An analysis, for instance, of fiscal multipliers when the economy is near full employment is of little relevance to the current situation where unemployment is high. An analysis of the multipliers associated with tax reductions "normally" may be of little relevance to a situation where individuals are facing high risks of unemployment and are burdened with a legacy of debt.

Those inside a country may be far more sensitive to the institutional nuances and the appropriateness of standard models to their current situations than outsiders. It is not just stubbornness and pigheadedness that leads those in the country to resist the advice of outsiders. They may feel that outsiders may have other objectives (as discussed in the previous section), or they may feel that outsiders' models do not adequately reflect what is going on in their country.

To return to an earlier example: An undervalued exchange rate may *typically* lead to inflation in the context of a country which is growing very rapidly; but that may not be the case in a country which has effective administrative control of large parts of its banking system, and can use administrative measures to affect other sources of aggregate demand. Such administrative controls may lead to distortions, but these may pale in comparison to the distortions evidenced in the markets' allocation of capital in some Western countries. Models that do not adequately reflect such important differences across countries will not be taken seriously.[12]

3. Broadening participation in surveillance.[13] This paper has been largely concerned about how to make IMF surveillance more credible, by broadening the range of models and coverage. But the IMF is, in many quarters, viewed as reflecting disproportionately the interests and perspectives of financial markets. Workers are more concerned about unemployment, and rhetoric about inflation having its worse effects on workers has never been fully persuasive. Most would rather have a little more inflation if it led to higher levels of employment. It is high unemployment that typically leads to weakening of real wages. Nor have workers and their representatives ever been fully convinced by natural rate arguments that say that there is no trade-off. Some form of participation on the part of workers, small businesses, civil society, etc. could garner more support for surveillance. This is especially important in

[12] Part of the difficulty that has been encountered in exchange rate surveillance arises from markedly different views of the links between the exchange rate and other economic variables. Lavigne and Schembri, for instance, note that "all core policies (monetary, fiscal, exchange rate, and financial sector) could have a direct effect on external stability, without necessarily being reflected in large real exchange rate movements." Moreover, exchange rate intervention is criticized (inconsistent with Article IV, section 1 (iii)) if its goal is "to increase exports." Ascertaining motives, however, is difficult. An increase in exports can be viewed as an incidental effect of monetary policies designed to remedy a shortfall of demand; but monetary policy could also be designed to stimulate aggregate demand *through an increase in exports as a result of an induced change in exchange rate.*

[13] See also Lombardi and Woods (2008) who argue that "For the IMF to undertake more effective surveillance would require a reinvigoration of the collaborative machinery of the organization .... By adopting processes that foster greater engagement among member countries, the IMF could not only better undertake surveillance but could better fulfill its role as a mechanism for multilateral cooperation." Greater engagement entails engagement of more than the finance ministry or financial markets.

the systemically significant countries, where IMF influence is exercised not through conditionality, but through persuasion.

4. Enhancing the role of the IMF as "mediator,"

As difficult as the issues are that I have discussed so far for bilateral surveillance, matters are even more problematic when it comes to multilateral surveillance, for arriving at frameworks for global economic cooperation. Alternative policy frameworks may have different impacts on different countries as well as different groups within a country—again, there is seldom a Pareto-dominant strategy, especially in the short run (within the time horizon of most of the political actors). And while, in principle, countries can engage in explicit or implicit compensation to offset losses incurred as a result of the choice of a particular policy, this is especially hard to do in the international context.

Indeed, while there is, as I said before, widespread recognition of the importance of externalities, the systemically significant countries are likely to pay little attention to those externalities when engaging in policies that they think of as centered primarily on domestic concerns. A lowering of the interest rate will be justified as stimulating the economy, responding to concerns, say, of domestic deflation; but such a policy will likely also have an effect on exchange rates, with global repercussions on trade patterns. Normally, these exchange rate effects might be thought of an "incidental" effect—collateral damage. But how should we think of the situation where domestic credit channels are blocked, interest elasticities of investment are low, and a—or even *the*—major channel through which the policy stimulates the economy is the competitive devaluation?

Agricultural subsidies in some advanced industrial countries are directed at helping farmers in their country, but when the subsidies are large, and the country is systemically significant, these drive down agricultural prices. Since farmers in many countries are among the poorest citizens, this contributes to inequality. For an emerging market to respond by subsidizing its own farmers would take away money badly needed for growth or education or health. A natural response is to impose countervailing duties, but globally unfair trade agreements may proscribe such a response. Is it wrong for a country in setting its own exchange rate to take into account the impact on its poorest citizens of the rich country's subsidies to its rich and political powerful farmers? Both actions have generated externalities, and a discussion that does not begin by at least acknowledging this is not likely to go far. (The difficulty of ascertaining whose action is imposing an externality is one of the central themes in the law and economics literature growing out of the work of Coase.)

Not surprisingly, reaching agreements on policy responses (e.g. on how to deal with global imbalances or reform the global reserve system) has proven difficult. Countries differ in their diagnoses, the sets of concerns that they bring to the table, in the models they use. Obviously, what is required is a global general equilibrium model, in which the effects of each systemically significant country on the global equilibrium can be assessed. But given the lack of consensus on the adequacy of models currently used to describe what happens within a single country, getting consensus behind any such global model will prove difficult.

Fortunately, in addressing many of the central issues, what is required is not econometric precision (even if one could obtain that), but broad understandings. Here, I think, the IMF could have an important role as a mediator, in developing consensus around certain policies that could enhance global growth and stability.[14] But if the IMF is to do this, it has to be seen to have successfully moved along all of the first three reforms that I have described.[15]

Consider, for instance, the highly contentious debate about China's exchange rate. The US has sometimes taken the position that China should let its exchange rate be market determined. But this approach pays ideological homage to the wonders of unfettered markets, something that even many Americans are doubtful about after the crisis. China is probably reflecting the view of most economists today in arguing for a managed exchange rate. Of course, even if China had a totally market-determined exchange rate, but simultaneously lowered interest rates, and took other regulatory measures, the effect of which would be to lower the exchange rate, the U.S. would not be happy, even if China had legitimate domestic reasons for taking these actions. This suggests that the real concern is not a more flexible exchange rate system, but a lower exchange rate. Sometimes, the US seems to argue that China should do this because it is in its own best interest. In doing this, there is a certain condescension that the US would know better than China what is in China's own best interests. Other countries are likely to view themselves as knowing better what is in their own best interests than the US (or the IMF), and they may be skeptical about whether those who make such claims have another agenda (namely, pursuing their own interests).

This is where the IMF could have a distinct advantage, if it could distance itself from its largest shareholders (which may, in fact, be difficult). But if the IMF is to be credible, it cannot be seen as reflecting primarily the views and interests of Western financial institutions either—or employing models which rest on assumptions which are suspect.

To return to the example, mediated solutions look for policies in which everyone could (in principle) gain. A growth strategy—in which the US took policies which enhanced its growth, or the world collectively did so, and as global growth increased, China committed itself to increase its exchange rate--might be an example. The growth would alleviate worries that appreciation would leave large numbers of individuals unemployed.

Similarly, the IMF could play a constructive role in reforming the global reserve system, by explaining forcefully how reserve build-ups diminish from global aggregate demand, with particularly adverse

---

[14] In this context, there is considerable discussion of alternative "venues." As the UN Commission on the Reform of the International Monetary and Financial System (2009) emphasized, the G20 lacks representativeness and political legitimacy. Indeed, some (such as Ocampo) have suggested that it is peculiar that a representative global institution should be serving an ad hoc mechanism.

[15] That is, if multilateral surveillance is to be effective, there has to be broader scope, better models, and more participation. As our analysis has emphasized, one can't focus narrowly on one or two variables (like nominal exchange rates or trade deficits). These variables have to be seen within a broader context that includes, for instance, the unemployment rate, inequality, the wage determination process, and the policy challenges facing the country and the instruments available.

effects on reserve countries. While there is yet to emerge a consensus about what a new reserve system might look like, there is widespread (though far from universal) agreement that reform is needed.

In this report, I have focused more on reforms to surveillance that are likely to increase its impact on systemically significant countries—where macroeconomic coordination is likely to have its largest benefits. I want to add a few words about bilateral surveillance of non-systemically significant countries.

While the policies pursued by any individual country may have little impact, in the aggregate, these countries can have systemically important impacts, especially if they follow highly correlated policies. Thus, if all countries liberalize in a similar way, following a particular "model," then, if there is a flaw in that model, there will be systemic consequences. That is what happened in the US in the crisis. There is virtue in diversity. In fact, of course, there is a natural diversity across countries, both in their circumstances and in perspectives. Attempts to impose excessive harmonization may thus be counterproductive, at least from the perspective of systemic stability.

Moreover, imposing particular policy perspectives as a condition for granting assistance may succeed in getting more effective implementation of the results of bilateral surveillance, but at a high cost.[16] The policies are likely not to be sustainable: when the aid is no longer needed, or when the opposition wins the next election, the country may well change economic direction. But there is a broader cost: IMF prescriptions are viewed as something to be taken, if one has to, if there are no alternatives. But the systemically significant countries do not have to listen to IMF prescriptions. To the extent possible (recognizing that donors will not willingly give aid if they think the money will not have positive effects), persuasion, not conditionality, is what is needed. This persuasion would be easier if the reforms suggested above were effectively implemented.

Finally, I want to reiterate two points that are implicit, or explicit, in the above discussion: If the United States, with its large influence in the governance of the institution, is unwilling to subject itself to surveillance on key issues, it is hard to see why other countries, whether systemically significant or not, should be willing to do so.[17]

Secondly, past mistakes of the IMF impair its ability to conduct effective surveillance today.[18] [19] It will take efforts to overcome perceived and real errors in both economics and politics. For instance, while

---

[16] There is another problem posed by the link between IMF lending programs and its other roles. Country programs are predicated on certain assumptions about output, inflation, and other economic variables. Too often, those numbers are a result of a process of negotiation, rather than a more dispassionate economic forecast.

[17] For instance, in the aftermath of the East Asian crisis, the Financial Sector Assessment Program was established. The US opted not to participate. The global consequences of the failures in its financial system are now well recognized. See Bird and Rowlands (2010). Lavigne and Schembri (2009) note the concerns of, e.g. India, Argentina, and Brazil, as well as others, in the implementation of the 2007 "Decision on Bilateral Surveillance Over Members' Policies" (IMF 2007b).

[18] This has been emphasized, for instance, in Aiyar (2010), and Woods (2010). For many developing countries and emerging markets, there is considerable focus on what they view as misguided policy conditionalities, which

cross-border capital flows are widely recognized to be a major source of global instability, even the recent reforms of the IMF in its position were greeted with skepticism by emerging markets: they simply did not want the IMF to intrude in their economic management.

IMF surveillance can play an important role in contributing to global stability. But it is unlikely, in the foreseeable future, to have effective enforcement mechanisms.[20] Governance reforms, and a proven track record better than its past performance, are necessary if any mandatory enforcement mechanism is to be adopted. In the meanwhile, if surveillance is to have an impact, it must be through the credibility of its advice.[21] Only through reforms such as those suggested in this paper is this likely to be achieved.

---

exacerbated the depths of economic downturns, and in some cases, even had an adverse effect on lenders, in whose interests these policies seemed to be designed. But in the more recent crisis, IMF judgments about the financial stability of some countries were clearly badly off the mark. Notable was the IMF report on Iceland, which stated reassuringly: "The banking sector appears well placed to withstand significant credit and market shocks" (IMF, 2007, as cited in Aiyar, 2010). Even as this was being written, Icelandic banks were engaged in a frantic effort to keep what was, in effect, a Ponzi scheme going. Subramanian (2009) cites the failure to recognize the risks of the large capital flows to Eastern Europe. As he put it: "These flows to Eastern Europe was so large that it did not require hindsight to see the problems that they would lead to. Warnings about the unsustainability of these flows should have been loud and insistent. And they were not." Though the IMF had warned about the risks of global imbalances (though it had not been able to do anything about them), it should be clear that the current crisis was *not* caused by global imbalances, but by bad lending practices, excessive risk taking by financial institutions, and excessive financial interdependence.

[19] The IMF's willingness to own up to some of these mistakes—for instance, its performance in the run-up to the financial and economic crisis—including a recognition of the failures in multilateral surveillance is an important step in the right direction. See Banerji (2010) and Independent Evaluation Office of the IMF (2011).

[20] A number of scholars (see, e.g. Truman 2010) have emphasized the need for better enforcement mechanisms, but have provided little basis for a belief that countries would willingly submit to enforcement actions, given the concerns previously raised. Similarly, the Palais-Royal Initiative (2011) called for the establishment of "norms" for IMF members' policies, the breach of which would trigger not only a consultative process, but have consequences. (It focused on "positive incentives" to remain in compliance.) But this crisis exposed the problem with this approach: had efforts by the IMF to further the "norms" of deregulation been more successful, the global financial crisis would have been all the worse. Some (such as Subramanian) have suggested that the WTO dispute resolution mechanism (with trade sanctions as the enforcement mechanism) be used; after all, exchange rate “manipulation” can be as or more effective in changing trade patterns than the protectionist measures that the WTO traditionally focuses on. But the above discussion should have highlighted the difficulties with ascertaining what it means to manipulate the exchange rate. Again, without broader consensus on these issues, extending the WTO enforcement mechanism to exchange rates risks undermining the WTO mechanism.

[21] I have focused on how surveillance can have more impact on the behavior of national authorities and on reaching multilateral agreements. IMF surveillance could have an impact on markets as well, and through markets, on the behavior of national authorities. (If there is an impact on markets, it is not as a provider of information but as a signal to the markets about the relations of the country with the IMF). Lombardi and Woods (2008), in a review of the literature, argue that there is little evidence of market impact. Their analysis seems correct. Some of the reforms suggested above may enhance market impact as well.

References

Aiyar, S. S. A. , 2010,, “Crisis Prevention Through Global Surveillance: A Task Beyond the IMF," *Cato Journal,* Fall, pp. 491-504.

“Banerji, Angana, 2010, “IMF Performance in the Run-up to the Financial and Economic Crisis: Multilateral Surveillance,” Independent Evaluation Office, December 9.

Bernanke, Ben, 2010, “On the Implications of the Financial Crisis for Economics,” address delivered September 24, 2010 at Princeton University, available at http://www.federalreserve.gov/newsevents/speech/bernanke20100924a.htm, (accessed July 28, 2011).

Bird, Graham and Dane Rowlands, 2010, "The IMF and the Challenges it Faces," *World Economics,* 11(4): 145-146.

Caballero, Ricardo J., 2010, “Macroeconomics after the Crisis: Time to Deal with the Pretense of Knowledge Syndrome,” *Journal of Economic Perspectives*, 24(4): 85–102.

The Economist, 2010, “The yuan-dollar exchange rate: Nominally cheap or really dear?” *The Economist,* November 4, 2010, available at http://www.economist.com/node/17420096, accessed June 28, 2011.

IMF, 1977, “Surveillance over Exchange Rate Policies,” Decision No. 5392-(77/63), 29 April.

——, 2005, "The IMF's Multilateral Surveillance: Issues Paper for an Evaluation by the Independent Evaluation Office," September 23.

——, 2007a "Iceland: Staff Report forthe 2007 Article IV Consultation," prepared by the Staff Representatives for the 2007 Consultation with Iceland (26 July).

——, 2007b, “IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members’ Policies,” Public Information Notice No. 07/69, available at http://www.imf.org/external/np/sec/pn/2007/pn0769.htm, accessed July 28, 2011.

——, 2008a, “Surveillance Priorities for the International Monetary Fund, 2008–2011,” available at http://www.imf.org/external/np/pdr/surv/2008/index.htm, accessed July 28, 2011.

——, 2008b. “Triennial Surveillance Review, Background Information and Statistical Appendix.” 2 September, available at http://www.imf.org/external/np/pp/eng/2008/090208D.pdf, accessed July 28, 2011.

——, 2010, "Modernizing the Surveillance Mandate and Modalities," prepared by the Strategy, Policy, and Review Department and the Legal Department, March 26.

Independent Evaluation Office of the International Monetary Fund, 2011, IMF Performance in the Run-up to the Financial and Economic Crisis, IMF Surveillance in 2004-07.

Lavigne, R. and Lawrence Schembri, 2009, "Strengthening IMF Surveillance: An Assessment of Recent Reforms," Bank of Canada Discussion paper.

Lombardi, Domenico, and Ngaire Woods, 2008, "The politics of influence: An Analysis of IMF Surveillance," *Review of International Political Economy,* December: 711-739.

José Antonio Ocampo, 2009, “Reforming the International Monetary System.” 14th Annual UNU-WIDER Lecture, delivered at the United Nations Headquarters on December 9th.

Palais-Royal Initiative, 2011, "Reform of the International Monetary System: A Cooperative Approach for the Twenty First Century," February 8. (A group convened by Michel Camdessus, Alexandre Lamfalussy, and Tommaso Padoa-Schioppa.)

Rodrik, Dani, 2008, “The Real Exchange Rate and Economic Growth,” *Brookings Papers on Economic Activity* 2: 365–412.

Stiglitz, J. E., forthcoming-a, “Rethinking Macroeconomics: What Failed and How to Repair It,” *Journal of the European Economic Association*.

———, forthcoming-b, “Learning, Growth, and Development: A Lecture in Honor of Sir Partha Dasgupta,” publication of the World Bank’s Annual Bank Conference on Development Economics 2010: Development Challenges in a Post-Crisis World.

Subramanian, A., 2009, "The IMF Crisis Balance Sheet," Washington: Peterson Institute of International Economics, September 24, available at www.iie.com/realtime/?p=942, accessed on July 28, 2011.

Truman, Edwin, 2010, "Strengthening IMF Surveillance: A Comprehensive Proposal," Peterson Institute for International Economics, Policy Brief 10-29, December.

United Nations, 2009, *Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System* (also known as The Stiglitz Commission), New York: United Nations,September. (Published as *The Stiglitz Report* New York: The New Press, 2010.)

Woods, Ngaire, 2010, “Global Governance after the Financial Crisis: A New Multilateralism or the Last Gasp of the Great Powers?” *Journal of Global Policy*, 1(1): 51-63.