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Abstract

The authors examine the institutional and governance framework of modern central banks to determine whether there are lessons that can be applied to the International Monetary Fund's (IMF's) institutional framework. Such a comparison is appealing for two reasons. First, both central banks and the IMF carry out tasks that can be described as "delegated responsibilities." Second, while monetary policy has yielded mixed results in many countries for decades, it has recently enjoyed considerable success in reducing inflation. Substantial changes to the institutional frameworks of central banks have, at least partly, contributed to this success. This raises a simple question: can the lessons learned from modern central banking help to strengthen the governance of the IMF? The authors argue they can. Governance reform would enhance the IMF's decision-making process and make the Fund more transparent and accountable, thus improving the effectiveness of its main instruments – surveillance and lending. The reforms proposed by the authors in this paper should not be viewed as immediately achievable goals; rather, they constitute a set of guiding principles for long-term governance reform.

JEL classification: F3
Bank classification: International topics

Résumé

Nous examinons le cadre institutionnel et de gouvernance des banques centrales modernes en cherchant à déterminer si celui-ci peut fournir des leçons applicables au cadre institutionnel du Fonds monétaire international (FMI). La comparaison présente de l'intérêt pour deux raisons. D'une part, tant les banques centrales que le FMI assument des responsabilités qu'on peut qualifier de « déléguées ». De l'autre, la politique monétaire a remporté depuis peu beaucoup de succès dans la réduction de l'inflation, après avoir donné lieu durant des décennies à des résultats mitigés dans de nombreux pays. Cette réussite découle – du moins en partie – des changements substantiels qui ont été apportés au cadre institutionnel des banques centrales. D'où cette question simple : les leçons inspirées de l'expérience des banques centrales peuvent-elles contribuer à renforcer la gouvernance du FMI? Nous soutenons que oui. La réforme de la gouvernance permettrait d'améliorer le processus décisionnel de l'organisme et amènerait le Fonds à faire preuve d'une plus grande transparence et à mieux rendre compte de ses actes. Résultat, l'efficacité des principaux instruments de l'institution – soit la surveillance et les prêts – s'en trouverait accrue. Les réformes que nous proposons ne représentent pas des objectifs immédiatement réalisables; il convient plutôt d'y voir un ensemble de principes directeurs susceptibles de baliser une réforme de longue haleine de la gouvernance.

Classification JEL : F3
Classification de la Banque : Questions internationales

1 Introduction

The International Monetary Fund's (IMF's) strategic review provides the opportunity to examine its role, functions, and governance. Following the IMF's annual meetings in Singapore in 2006, there was widespread consensus that members' quotas must be updated to reflect the growing importance of emerging-market countries in the global economy. While the reform process places considerable emphasis on the question of quota allocation, we advocate a broader view of governance reform. In particular, given the issues raised by the Independent Evaluation Office (IEO) (2006), we argue that the IMF reform process should also examine the Fund's corporate governance structure and how decisions are made.

In our view, good corporate governance is an important feature of the reform process. The recent approval of the "2007 Decision on Bilateral Surveillance" (IMF 2007) (which replaces the "1977 Decision on Surveillance over Exchange Rate Policies" [IMF 1997]) ensures that the IMF has the appropriate tools for conducting surveillance. However, the usefulness – and, hopefully, success – of surveillance under the new decision depends upon whether the Fund has a corporate governance structure that allows it to use its surveillance tools effectively.

We examine the institutional and governance framework of modern central banks to determine whether there are lessons that can be applied to the IMF's institutional framework. Such a comparison is appealing for two reasons. First, both central banks and the IMF carry out tasks that can be described as "delegated responsibilities." Second, while monetary policy has yielded mixed results in many countries for decades, it has recently enjoyed considerable success in reducing inflation. Substantial changes to the institutional frameworks of central banks have, at least partly, contributed to this success.

Key elements of these changes are that many central banks have been given a clear objective and they are no longer subject to political pressure in their daily operations. Also, central banks have become more transparent and more accountable. Taken together, these institutional changes have helped central banks to reduce inflation to levels that are unprecedented in recent times.

Clearly, the IMF is not a central bank. But the successes of modern central banks have shown that significant economic gains can be realized by creating a sound institutional framework. This raises a simple question: can the lessons learned from modern central banking help to strengthen the governance of the IMF? In this paper, we argue that they can. Governance reform would enhance the IMF's decision-making process and make the Fund more transparent and accountable, thus improving the effectiveness of its main instruments – surveillance and lending. The reforms proposed in this paper should not be viewed as immediately achievable goals; rather, they constitute a set of guiding principles for long-term governance reform.

2 Delegated Responsibility

Today, monetary policy is a delegated responsibility in most countries; i.e., a principal (the government) has given an agent (the central bank) the mandate to perform a specific task (the conduct of monetary policy). The insight that tying one's hands can be beneficial underlies the idea that monetary policy should be a delegated responsibility. As Kydland and Prescott (1977) and Barro and Gordon (1983) show, monetary policy faces a time-inconsistency problem: the optimal policy ex ante may not be optimal ex post, and this creates an inflationary bias. The bias vanishes if policymakers are able to credibly commit themselves to monetary stability (Cukierman 1998). Theoretically, there are two ways to achieve this:

- rule-based monetary policy ("monetary policy by computer"), or
- discretionary monetary policy with a defined objective and an institutional framework that shields the central bank from political pressure.[1]

Since it is impossible to foresee all contingencies, most countries have pursued the second option and delegated monetary policy by creating an institutional framework to avoid political interference in the daily operations of the central bank. Thus, while the government sets the central bank's target, the central bank has full discretion in the use of its policy instrument to achieve its objective (Debelle and Fischer 1995). Importantly, this form of "constrained discretion" has led to substantial economic gains – empirical studies show that limiting political interference leads to a decline in inflation (Berger, de Haan, and Eijffinger 2001). Overall, improvements in the institutional framework result in inflation expectations being more firmly anchored at lower levels. Consequently, in the face of shocks to the economy, monetary policy is more effective, and a "modern" central bank – i.e., one embedded in an appropriate institutional setting – needs to make only small adjustments to its policy instrument.

Similar issues apply to the IMF. First, in 1944, the international community delegated to the IMF responsibility for promoting international monetary stability and co-operation. Second, in its operations, the IMF is confronted with multiple time-inconsistency issues. Consider lending: ex ante, the IMF may want to limit lending for fear of creating moral hazard on the investors' side,

1. Having a "conservative central banker" (Rogoff 1985) is one of many possible institutional arrangements to shield the central bank from political pressure.

but, ex post, there are substantial incentives to deviate from this strategy when a country experiences a crisis. For example, political pressure from its members may force the IMF to perform a bailout. The knowledge that the IMF might provide an aid package if a country slips into a crisis could induce investors to take overly risky positions, since sovereign bond prices would not properly reflect default risk.

In this sense, the inability of the IMF to "tie its own hands" may create a suboptimal outcome with respect to crisis lending. Instead of creating strong ex ante incentives to avoid crises, the political pressure in the IMF's lending decisions may induce moral hazard and thus help to create an environment where crises are more likely to occur. In a similar way, the conduct of IMF surveillance may be affected by time-inconsistency issues. Surveillance can be defined as "all aspects of the Fund's analysis of, scrutiny over, and advice concerning, member countries' economic situations, policies, and prospects" (Crow, Arriazu, and Thygesen 1999).[2] Members may commit themselves to frank and candid surveillance assessments to identify inappropriate policy frameworks and to prevent imbalances from building up. However, when corrective action is warranted, policy-makers may be unwilling to publicly acknowledge the inappropriateness of their policies, as identified by the IMF, and may be reluctant to undertake the necessarily difficult policy decisions that are required. As a result, political considerations may compromise the objectivity of the surveillance process (Cottarelli 2005), or, at the very least, the surveillance process may fail to properly engage members (IMF IEO 2007). And even where detailed procedures are set out (such as the "Special Consultations" included in the "1977 Decision on Exchange Rate Surveillance"), experience shows that they may not be invoked, because of an unwillingness to confront members regarding their policy decisions. Thus, time inconsistency can affect the effectiveness of surveillance. These considerations suggest that governance reforms, similar to those undertaken by modern central banking over the past two decades, might be useful for the IMF.

3 Key Elements of Modern Central Banking

Although legal provisions for central banks differ across countries, modern central banks share a number of common characteristics. We define the key elements of the institutional framework of modern central banking as follows. Modern central banks have a delegated responsibility and a clear mandate. As such, they

2. One can distinguish between bilateral and multilateral surveillance: bilateral surveillance refers to the surveillance of individual countries; multilateral surveillance refers to the surveillance of economic linkages between countries and international economic and financial market developments.

- have clear objectives and policy instruments, and

- are transparent and accountable.

These elements are equally important, since only the *combination* of them has enabled elected governments to delegate responsibility for monetary policy. In many countries, this has resulted in a formal mandate for the central bank, often enshrined in national legislation. In what follows, we analyze these elements in more detail, before proposing how they could be applied to the IMF.

3.1 Clear objectives and instruments

The task delegated to central banks is to conduct monetary policy. To make the objective of monetary policy operational, central banks are given a clear goal, typically a target for the inflation rate or an explicit mandate for "price stability" or "monetary stability." Today, the overriding goal of most central banks is to safeguard the value of the domestic currency. In a survey of 94 central banks, Fry et al. (2000) find that 90 of the banks have monetary stability as a legal objective, with 95 per cent having a definition of price stability, an inflation target, or a monitoring range. By explicitly restricting the central bank's responsibility to price stability, there is little confusion over its objective.

To achieve their goals, central banks require effective policy instruments. For example, to achieve its inflation target, the Bank of Canada uses the overnight rate to influence market interest rates.

3.2 Transparency

Transparency can take many forms, but they all share one common characteristic: the central bank's actions are identifiable and can be evaluated. As Blinder (2004) points out, "Whereas central bankers once believed in secrecy and even mystery, greater openness is now considered a virtue."

In many countries, transparency is achieved through reporting requirements that disclose how the central bank made its decisions; i.e., the information (macroeconomic variables) and analysis that were used to make the decision. When decisions are made by a committee, many central banks also disclose information on voting patterns, or on the consensus of committee members regarding the analysis (Maier 2007). Making the central bank and its decision-making process transparent yields two advantages. First, the conduct of monetary policy is more effective when central banks are better understood and their actions are perceived to be predictable, resulting in lower or better-anchored inflation expectations (Chortareas, Stasavage, and Sterne 2001). Second, transparency makes the institution accountable, because its performance can be judged against a clearly stated objective.

3.3 Accountability

Accountability is a means to ensure that the central bank conducts good monetary policy (Cukierman 1998). Accountability is the counterpart to delegated responsibility and the limitation of political interference in the central bank's daily operations. To avoid deviation from optimal policies, central banks should not be made independent unless there is accountability. And without independence, central banks cannot be held accountable, because they are not unilaterally able to undertake the required actions to achieve their goals.

A common form of accountability involves an obligation for a central bank's senior officials to testify before national legislatures on a regular basis. An important function of these appearances is to discuss the performance of the central bank relative to its objectives.

Accountability complements and reinforces the benefits gained from limiting political interference. For example, Nolan and Schaling (1996) argue that accountability reduces agents' uncertainty about the central bank's future actions. Consequently, making a central bank accountable improves the anchoring of inflation expectations. Walsh (2003) finds that accountability can reduce political pressure and support a stricter targeting regime.

4 Applying the Lessons to the IMF

Modern central banking is successful partly because of its clear objectives and policy instruments, transparency, and accountability. The question is simple: can these lessons be applied to the case of the IMF?

The IMF shares the following characteristics of a modern central bank: it is an institution with a delegated responsibility, it faces issues of time inconsistency, and it could benefit from an institutional framework that delineates clear roles and responsibilities (Macklem 2006). In this section, we examine the Fund's institutional characteristics and analyze the extent to which they conform to those of modern central banks. We then propose reforms that could help to improve the governance of the Fund.

4.1 Clear objectives and instruments

The IMF's objectives are set out in the Articles of Agreement (IMF 1944): to "promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems" (Article I). This objective was formulated in the era of the Bretton Woods system of fixed exchange rates. After the collapse of the Bretton Woods system, in an effort to modernize its exchange rate surveillance, the IMF introduced the "1977 Decision on Surveillance over Exchange Rate Policies." Similarly, in light of the rapid globalization of the world's economy, the IMF again reformed its surveillance framework, in the "2007 Decision on Bilateral Surveillance."

The "2007 Decision" is a good example of how the IMF recognized the need to keep its surveillance instruments up to date. The previous surveillance framework, as embodied in the "1977 Decision," emphasized exchange rate stability as its objective, a reflection of the preferences of policy-makers in the aftermath of the breakdown of the Bretton Woods system. Since 1977, however, the world has changed dramatically: today's economic landscape is characterized by capital account liberalization, a reduction in barriers to trade, and more flexible exchange rates. It is no longer sufficient to focus primarily on exchange rate stability. Rather, IMF surveillance must consider a broad range of economic policies (Lomax 2006). Moreover, the abolition of capital controls in many countries has yielded many benefits, but also, the possibility that crises can be propagated more easily through spillovers and contagion. This highly integrated world reinforces the need for Fund policies to focus on the prevention, not the resolution, of economic crises.

Under the new surveillance decision, the IMF has a clear objective for surveillance, now defined as "external stability." Assuming that the Fund has the expertise to give good policy advice, we argue that the effectiveness of the new surveillance decision depends on whether the Fund's institutional framework can support it. So far, the Fund's tools have not always been used in the most effective way: for instance, some Article IV reports – among the most powerful tools of surveillance – remain unpublished (IMF 2005),[3] and staff lack the proper incentives from senior management and the Executive Board to produce high-quality surveillance (IMF IEO 2007).[4] Likewise, the respective roles of the Fund and its members in the surveillance process are unclear: as the IMF IEO (2007) notes, there is uncertainty about the various roles the Fund has to play (confidential advisor, ruthless truth-teller, broker for international policy coordination, etc.), which makes it difficult for staff to decide on the appropriate policy advice. This limits the Fund's ability to shape exchange rate decisions; there have even been cases where member countries were reluctant to share sensitive

3. One in five reviews for emerging markets were withheld from publication in 2005, with much higher rates for countries in Asia, the Middle East, and the western hemisphere, where most systemically important emerging markets are found (IMF 2006). Publication lags for emerging markets are considerable, with the average report being published nine months after completion of the initial staff document. And of those made public, nearly a fifth are published with significant deletions.

4. For instance, from a career perspective, Fund staff have incentives to oversee a large lending operation, rather than to produce a tedious surveillance report.

data, because of uncertainty over what the information would be used for and how public the data would be made. Consequently, instead of being accountable for gaining traction in their discussion with member countries, staff aimed at maintaining a smooth relationship with authorities.

Many observers have raised concerns regarding lending, which has yielded mixed results in promoting economic prosperity and growth (de Resende 2007), since it does not always provide the proper ex ante incentives, and, in the aftermath of a crisis, often results in delayed adjustment. Consequently, as in the case of surveillance, the objectives and modalities of lending could be improved.

Proposal for IMF reform

To address these issues, the current IMF framework could be modified in the following manner. First, under the "2007 Decision on Bilateral Surveillance," the IMF has been given the *responsibility* to improve the functioning of the international monetary system, but has insufficient *incentives* to conduct high-quality surveillance. Second, the IMF needs to consider how its main instruments – surveillance and lending – can be augmented and/or redesigned to help it achieve this goal. For instance, the IMF could consider rebalancing its instruments so that there is more focus on crisis prevention (surveillance) and less on crisis resolution (lending).

Two immediate steps can be considered: a "surveillance performance agreement" (SPA), and the imposition of strict access limits on program lending. The SPA would address the lack of incentives: it would give the IMF operational responsibility for the conduct of surveillance over members' economic policy frameworks. A key element of the SPA would be the obligation for the Fund to conduct surveillance in a transparent and candid manner, so that it could be held accountable for the conduct of surveillance.[5] With respect to lending, the Fund could impose strict access limits on program lending and utilize modern, market-based risk-management techniques to assess risks to its balance sheet.

4.2 Transparency

The disclosure of information relevant for the decision-making process helps make a central bank more predictable and helps anchor market expectations. Similarly, by being transparent about its lending decisions and surveillance, the Fund could help reduce distortions in markets. Notwithstanding improvements in recent years, IMF decision making, program lending, and surveillance could benefit from increased transparency.

5. A detailed framework is given in Lavigne, Maier, and Santor (2007).

First, the decision-making process at the Fund lacks transparency *(internal transparency)*. Most decisions are made at the Executive Board level, and since the Managing Director works closely with the Executive Board, their respective roles and responsibilities can become blurred. Consequently, it can be difficult to assign responsibility for any particular decision to the appropriate level of decision maker.[6]

Second, the IMF does not always communicate its policies clearly to the public *(external transparency)*. For example, the exceptional access lending framework does not set out clear lending limits, and therefore markets may not know the true size or duration of IMF program lending. External transparency can also be improved regarding surveillance. For instance, IMF Article IV reports sometimes remain unpublished, or are published with significant delays.[7]

Because of this lack of transparency, IMF lending is unpredictable. This can increase uncertainty in financial markets and may distort the behaviour of market participants. In the case of surveillance, more candour and greater transparency would improve its effectiveness, since it would result in the disclosure of important information to the public.

Proposal for IMF reform

The Fund's decision-making process could be strengthened along two lines: internal and external transparency.

- Internal transparency requires a clear delineation of responsibilities within the IMF and timely disclosure of the reasons for Executive Board decisions.

- To improve external transparency, clear and transparent rules for credit access are needed. If the rules for access are not respected, there must be a clear process to explain the motives underlying this decision.

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6. Lack of transparency is also evident in the appointment process for Managing Director. Since variations in this procedure for Managing Director could potentially lead to different candidates being chosen, it is an important element in determining the overall stance of Fund policy. However, in this paper, we focus primarily on governance with regard to the Fund's daily decision-making; a more in-depth, critical review of the appointment process is given in Van Houtven (2002).

7. Non-disclosure of information is typically justified by the IMF's role as "trusted advisor." The effectiveness of this role is debatable. Also, because the input of a "trusted advisor" is not transparent, there is no possibility for third parties to scrutinize (i) the IMF's advice and (ii) member countries' compliance with policy recommendations.

- Regarding surveillance, the IMF could further encourage the timely publication of Article IV reports, and multilateral surveillance reports.

Put simply, since the IMF's actions may influence financial markets, Fund analysis and decision making – including the arguments underlying the decision – should be as transparent as possible to minimize distortions.

4.3 Accountability

Clarification of objectives and greater transparency about actions and factors underlying decisions are prerequisites to holding an institution accountable. Currently, IMF accountability could be improved (Santor 2006). There is no agreed-upon benchmark against which to judge its performance. But even if such a benchmark existed, accountability would be impaired because the respective roles of the Executive Board and the Managing Director are not clearly delineated. This is further compounded by the fact that the Board sits in continuous session under the chairmanship of the Managing Director, thus further blurring their respective responsibilities. In addition, the IMF operates under "consensus decision making." The consensus model of decision making may hinder the ability of member countries, and their constituencies, from attributing the consequences of IMF decisions to the appropriate decision maker.

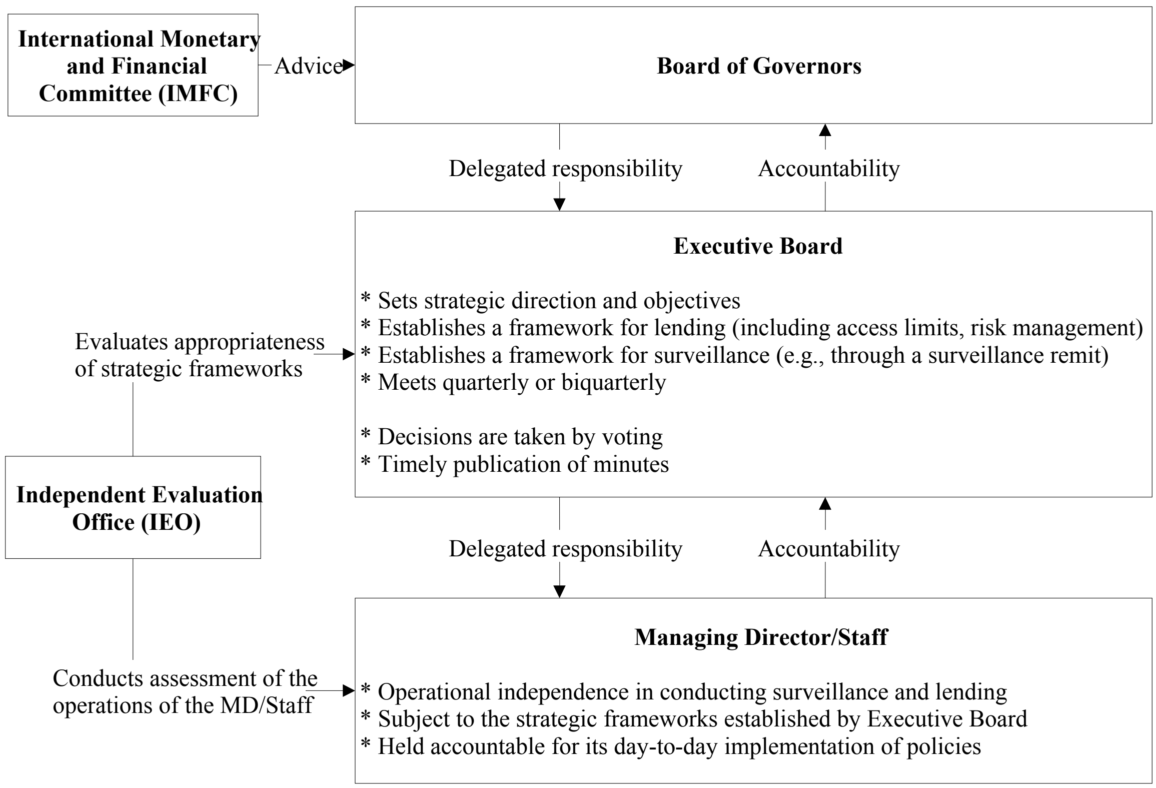
To enhance the accountability of the Fund, we need to look at two distinct elements: "internal accountability" (i.e., the IMF's decision-making structure), and "external accountability" (ways to hold the IMF accountable for its policies regarding surveillance and lending).

Proposal for IMF reform: internal accountability

To hold the IMF accountable, a clear delineation of the roles and responsibilities of the Executive Board, Managing Director, and staff is required. Figure 1 provides an example how the current governance structure could be modified.

The Executive Board remains the Fund's central decision-making body. As such, it is responsible for the *strategic objectives* of the Fund, and for setting out the instruments the IMF can use to achieve its goals. The Managing Director and the Staff would be responsible for meeting the objectives, given a set of instruments and an effective accountability framework. Lastly, strengthening the protection for the staff against political influence could help to increase candour in published IMF documents (Cottarelli 2005).

Figure 1
Example of How the Current IMF Governance Structure Could be Modified



Such reform would mean that the Executive Board could focus more on the Fund's strategic issues, and less on its day-to-day business. This is in line with Managing Director de Rato's (2005) medium-term actions aimed at "permitting the Board to focus on larger and more strategic issues." This also implies that the Executive Board could meet less frequently than the current "continuous session," allowing for a clearer delineation of the roles and responsibilities of the Executive Board and the Managing Director. Other measures to increase accountability include the use of more open voting, particularly for strategic issues, and timely publication of the minutes of Executive Board meetings.

Lastly, the accountability of the respective levels of management could be enhanced by strengthening the IMF's IEO. The IEO could also evaluate IMF performance with respect to surveillance, lending, and other Fund functions.

Proposal for IMF reform: external accountability

The external accountability of the IMF could be enhanced with regards to its two main instruments, surveillance and lending. For these two instruments, we need to distinguish between two types of accountability measures: first, accountability of the IMF's surveillance function cannot be translated into (easily quantifiable) numeric values. This is a key difference from monetary policy, where deviation from a target can be easily measured. Therefore, IMF surveillance cannot be judged against a *result*-based criterion. Instead, performance criteria for Fund surveillance must be *process* based (Hüpkes, Quintyn, and Taylor 2006).

For instance, the assessment of bilateral surveillance can focus on whether the IMF

- conducts surveillance over the internal consistency of members' economic policy frameworks (exchange rates, monetary, fiscal, financial) and identifies inconsistencies,

- provides advice to members and communicates its surveillance findings in a timely and transparent manner, and

- identifies countries at risk of a crisis and any possible spillovers to the international monetary system.

Similarly, with respect to multilateral surveillance, accountability can be created on the basis of whether the IMF

- correctly identifies multilateral surveillance issues, and

- calls multilateral consultations, as needed, consults the appropriate set of countries, and provides the right inputs.

Thus, external accountability focuses on whether the IMF correctly identifies potential crises (or ignores important indicators), and whether surveillance has been conducted in an objective, even-handed, and candid manner. An additional aspect of external accountability relates to communication: does the IMF provide adequate information to the public by communicating the findings of surveillance and by publishing Article IV reports, etc., in a timely manner?

Second, to evaluate the Fund's lending instrument, process-related, but also result-based criteria can be used. Process-related accountability can be established by focusing on issues such as whether the IMF

- adheres to the lending guidelines with respect to access limits and acceptable levels of credit concentration and risk, and

- establishes and enforces the appropriate level of conditionality.

In addition, various result-based criteria can be used to evaluate lending. For instance, the Executive Board, on an annual basis, could examine whether program lending has resulted in better macroeconomic outcomes for program countries, or whether program lending led to catalytic effects on private capital flows.

5 Conclusion

In today's highly integrated financial world, there is a need for an effective IMF to ensure that the international monetary system is efficient and stable. The crises of the past decades, and the buildup of global imbalances, have underlined the continuing need for effective surveillance. The IMF is ideally positioned to undertake this task, and the ongoing discussion on surveillance reform is aimed at improving the Fund's capability to promote a well-functioning international financial system.

With the new "2007 Decision on Bilateral Surveillance," the Fund's surveillance activities have a strong legal basis. To fulfill its surveillance objectives, the Fund needs to be equipped with the right incentives. In this paper, we have argued that limitations in the IMF's governance structure may limit its ability to perform its surveillance and lending activities effectively. Since central banks and the IMF share a number of basic features, modern central banks are an obvious reference point for institutional reform. This paper has shown that central banks and the IMF face comparable time-inconsistency issues. While the framework for central banks cannot be directly applied to the IMF, in many cases the same principles apply. Moreover, the considerable success of central banks in reducing inflation suggests that the Fund might achieve similar success in achieving its objectives, if its institutional position is strengthened and clarified.

Central banks operate within a framework that allows for discretion, while at the same time limiting the possibility that short-run considerations lead to deviations from the long-run objective of monetary stability. Similarly, the Fund's operations require a degree of discretion. We have shown how the Fund's position can be strengthened by giving it a clear objective and by making it more transparent and accountable. As a consequence, we envision an IMF that is better able to make tough decisions. This will improve its surveillance and lending operations, and, ultimately, yield benefits for the international economic community.

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