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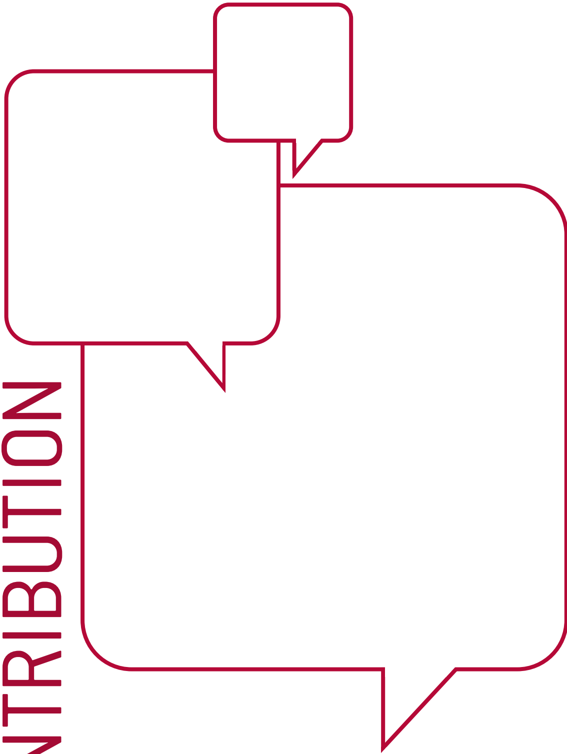

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WILL THE CRISIS TRIGGER A REVIVAL OF THE IMF?

Note based on remarks prepared for a panel organised by the Per Jacobsson Foundation in Washington, DC, on 12 October 2008

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As recently as a few weeks ago, a widely held view was that the IMF had lost its relevance in a world of increasingly free capital mobility where the financing needs of more and more developing countries were covered by capital markets. At the same time its legitimacy was at stake as a large part of the developing world openly questioned the sincerity of its advice and the structure of its governance. Even the governor of the Bank of England, Mervyn King, echoed the queries, commenting that "the Fund's remit is unclear. Its lending activities have waned, and its role in the international monetary system is obscure" (King, 2006).

Suddenly, however, calls for a "new Bretton Woods" have again put the Fund at the centre of the discussions on the reform of global financial and monetary arrangements. This note discusses the main challenges it faces and some options for reform[1]. Its main conclusion is that while the financial crisis and the revival of international cooperation put an end to existential questioning about the future of the Fund, it is unlikely to recapture the central role it once had and must rather adapt to a fragmented and changing landscape.

1. A changing landscape

What a difference a year makes! Among officials gathered in Washington for the Annual Meetings of the Fund and the Bank there was noticeable anxiety about the state of the world economy, but also palpable relief about an institution that had just completed a major downsizing and whose relevance had been openly questioned. Several reasons can be given for this change of heart:

- The need for **assistance** is rising again. The sudden rise of sovereign bond spreads and reversals of capital flows are hurting emerging countries that had previously enjoyed unrestricted access to cheap private capital. Furthermore, while there were until recently many potential substitutes for the IMF, such as regional powers and regional development banks, in the current environment of high risk aversion the Fund is the only institution able to elicit market confidence in the quality of policy in countries suffering from sudden stops. The IMF is thus likely to regain its central role in the provision of conditional assistance to countries in crisis.

[1] This note is based on remarks prepared for a panel organised by the Per Jacobsson Foundation in Washington, DC, on 12 October 2008. The transcript of the panel discussion with Andrew Crockett, Stanley Fischer, Trevor Manuel and Raghuram Rajan can be found on http://www.imf.org/external/np/tr/2008/tr081012.htm. I thank Martin Kessler for assistance in the preparation of this note and Ignazio Angeloni and Stéphane Rottier for comments on an earlier draft.

- The IMF has the best **expertise on financial and banking crises**. No other institution in the world has first-hand experience of the variety and the common characteristics of the problems encountered in financial crises. No other institution has accumulated similar expertise on the resolution of such crises[2].
- The current financial crisis has triggered an unprecedented call for **coordination at global level**, as illustrated by the remarkable degree and speed of convergence of the G7 countries (and soon afterwards of the International Monetary and Financial Committee) on the response to the crisis. Governments had started to be pulled apart by national politics, but markets have forced them to hang together and converge on a common template in spite of political and institutional differences. Having been much despised in recent years, international policy coordination is experiencing a revival.
- Last but not least, the IMF has (re)gained **intellectual credibility**. The Global Financial Stability Report (GFSR) of April 2007 accurately described the first stages of the crisis that unfolded four months later. The GFSR of April 2008 estimated the losses at a level (about a trillion dollars, which proved to be a conservative estimate) which suggested that the ad-hoc solutions contemplated by governments would not do the job. The April 2008 World Economic Outlook (WEO) was markedly more pessimistic than forecasts by national governments and was widely criticised for that. In retrospect it was right – even not pessimistic enough.

2. Lingering questions

It would, however, be misleading to consider that questions and doubts about the role of the Fund were only the result of an exceptional period and that, as the 'Great Moderation' is now over, it will naturally regain the attributes of its past glory. In the medium term, four factors that are likely to persist raise questions about the Fund's future mission.

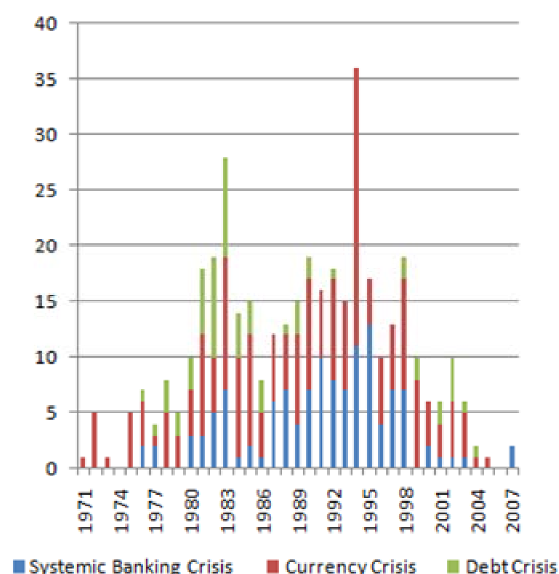
- There will be a continuing need for an institution in charge of **conditional financial assistance.** But even though there will be many more countries under Fund programmes in 2009 than in 2007 – including, for the first time in a decade, an advanced country – some of the factors behind the observed drop in the number of financial crises in the 2000-2007 period (Figure 1) are likely to be persistent.

  To start with, the quality of domestic policy institutions in the emerging and developing world has been strengthening continuously, as indicated for example by the status of central banks, and the quality of policies has been improving too. As an illustration, in 2007 only 5% of the countries in the world had inflation above 15% as against 18% of countries in 1997 and 28% in 1987. For sure, this is no guarantee against policy mistakes, but this certainly diminishes their probability.

[2] This is best illustrated by the comprehensive data assembled by Laeven and Valencia (2008).

Second, many countries in the world are better self-insured than they were. Over the last ten years, the median reserve ratio has grown from 10% of GDP to 20% of GDP – essentially because reserve ratios have been rising in the developing and emerging world.

Figure 1: Annual number of financial crises, 1970-2007



Source: Laeven and Valencia (2008)

Even though these improvements have often given rise to complacency – as illustrated by vulnerability to inflationary shocks and the fact that a number of countries have recently been taking risks with current account deficits of unprecedented magnitude, in the medium term it is far from certain that there will be a return to the frequency of crises observed in the 1980s and the 1990s. The need for conditional financial assistance will remain, but it is probably still on a declining trend.

This does not mean that the role of the Fund in this respect is unimportant, nor that the revamp of its facilities is unnecessary. But conditional financial assistance function is too specific, and in the medium term the countries in need of it are likely to be too few, for this role alone to justify putting the IMF at the centre of the world international financial and monetary architecture.

- **Surveillance** is handicapped by the rise of giants and by doubts about the adequacy and legitimacy of Fund advice.

  Bilateral surveillance retains a role for small and medium-sized countries but the litmus test is whether the Fund is able to speak truth to large players such as the US, the EU or China – and be influential. On this criterion, the IMF has not performed well in recent times. Even though its analysis was accurate, nobody can remember what

exactly the Fund told the US government about credit risks and policy responses, and this is going to diminish its ability to exercise surveillance in the years to come[3]. This did not escape the Chinese authority, as indicated by Deputy Governor Yi Gang's statement at the International Monetary and Financial Committee[4].

The same can be said of exchange-rate surveillance. In 2007, at US insistence, the IMF revised its principles for exchange-rate surveillance, which dated back to 1977. The purpose of the revision was to give it the possibility to slate countries whose exchange policies contributed to 'external instability'. But the only significant result of the revision of the decision on exchange rates has been to weaken the authority of the Fund itself: after having been too shy to resist US pressure, it has been too shy to criticise China.

Finally, multilateral consultations, though an innovative initiative, have not delivered much more than the rehearsal of previously stated positions. To assemble China, the euro area, Japan, Saudi Arabia and the US at the same table was an achievement, but the exercise lacked ownership, and in the end the result was disappointing.

Summing up, what will remain of surveillance in the last decade is most probably that, against the background of a credit boom of rare magnitude, massive capital flows from poor to rich countries, the build-up of colossal reserves, and enduring controversies over exchange rates, the Fund has not been able effectively to exercise its mission to 'oversee the international monetary system in order to ensure its effective operation'.

- The **oversight of capital markets regulation** is a major task for the years ahead. It will certainly be given priority on the agenda for global financial reform. However, in the main advanced countries this role has been taken over by the Financial Stability Forum (FSF) after its creation in 1999.

This is a surprising development because the FSF is nothing but an ectoplasm. It has no legal status, no structure, no power and no staff, yet it has become the core institution where the agenda for financial regulators in the advanced countries is set and its recommendations have been followed through. In recent times it has been

[3] Its task was complicated by the fact that the US was among the few countries to refuse to accept a Financial Sector Assessment Programmes (FSAP) by the Fund.

[4] "The lack of effective surveillance of the reserve currency issuing countries and their weak financial policy discipline has resulted in [..] difficulties for other countries in preserving macroeconomic stability and boosting growth while posing serious risks for global economic and financial stability [..] The Fund must draw lessons from the crisis and take corrective measures to enhance its surveillance over the developed countries – especially the reserve currency issuing countries [..]" (Yi Gang, 2008).

able to define, promote and monitor a coordinated response to a series of regulatory challenges raised by the financial crisis[5].

This is a major challenge for the Fund, and not only on account of the potential turf battle. The FSF is in many respects the exact opposite of the Fund. Its effectiveness results from the political mandate given by the G7 but also from its informality and versatility. National authorities – governments, central banks and regulators – are willing to cooperate within it because their participation in it does not involve any formal transfer of power. So an informal club can succeed where an institution with nominally formidable powers has not – at least as long as the number and diversity of participating countries remains limited.

- **Politics** are increasingly difficult. Ever since the Asian crisis, the Fund has been struggling to regain political legitimacy. Put simply, its job was easy when, backed by the only superpower and a powerful group of like-minded countries, it was giving advice to medium or small-sized countries whose economic policies were of debatable quality. Those days are gone. Beyond the accusation that its advice may be questionable and the suspicion that it does not apply the same yardstick to all countries, the deeper problem is that the Fund is now torn between the G7 and the developing countries. To regain the legitimacy lost in the developing world it needs to distance itself from the G7, but it cannot afford to lose the support of the advanced countries which still form the majority of its shareholders.

The upshot is therefore that the need for closer market oversight and strengthened international cooperation does not automatically translate into a broader mandate for the Fund.

3. A pragmatic agenda

Against this background, how can the Fund reinvent itself and what should it now do?

- It must first **adapt to a changing institutional landscape**. The view is sometimes expressed that the 'new Bretton Woods' agenda implies that the IMF should again become the leading global economic and financial institution. However the centrality of the IMF is gone. Michel Camdessus' dream of transforming the International Monetary and Financial Committee (IMFC) into the governing structure for the world economy is beyond reach[6]. There is certainly a role for a reformed IMFC in the governance of the Fund, but it is unlikely to substitute any of the existing or would-be 'G's'. Robert Zoellick spoke in a recent speech of a new '*Facebook* for multilateral

[5] Angeloni (2008) provides a discussion of the record of the FSF in comparison to the lack of significant achievements at European level.

[6] The roots of this view can be found in Art. 12, Section 1 of the IMF's Articles of Agreement, which states that the Fund shall have a Council if so decided by an 85% majority of its members.

economic diplomacy', and this telling image indicates how much the world has changed since the days of Bretton Woods. The existing G's and other ad-hoc groupings are likely to remain and new ones are about to be created such as the G14 or the 'Steering Group' advocated by Zoellick himself. Instead of dreaming of a return to the good old days, the objective for the IMF should be, as it were, to make friends on *Facebook*, ie to provide expertise and support to the G's. It is the institution that can bring analytical and policy consistency to what otherwise risks being a loose system of governance. This was alluded to by Dominique Strauss-Kahn (2008) in his speech at the Bruegel/Peterson conference on Friday 10 October, and there are rumours of Italian ideas to enlarge the G7 and use the IMF as a supporting institution.

- It must support the G's, and rely on them, to foster **multilateral surveillance.** The lessons from recent years is that the Fund has been unable to exercise its surveillance mission effectively. The question is what reforms would make it better able to exercise it in the future. There are two different issues here.

  One is who should be in charge of the policing of exchange rates, if and when needed. This is probably an issue of the past, and a rather narrow one to start with, but one that has mobilised much time and diplomatic effort in recent years. The reason why the Fund has been unable to come up with a clear statement goes beyond the obvious political fact that as an institution, it cannot afford to side with the US and antagonise China. If the Fund is formally to determine whether an exchange rate is manipulated – ie to exercise quasi-judicial powers and thereby open the way to the filing of complaints at the World Trade Organisation – it needs quasi-judicial procedures. The model here should be the WTO, whose decisions on trade conflicts are taken by independent panels. Without such powers, the role of the Fund should instead be to provide analyses and recommendations to the relevant G in order for it to hold evidence-based discussions.

  The other issue is how best to provide overall diagnoses and assessments of the situation and policies of the major players – including on exchange-rate related matters but more fundamentally on the broader set of policy choices. This is certainly an issue of major relevance for the short term. With the need for urgent action the degree of coordination and convergence has increased dramatically within Europe and among G7 countries. It is unlikely to stop there. A few months ago we were all worrying about the commodity price boom and the implications of fast-growing food and energy demand in emerging countries. Markets are now pricing a global recession, the response to which is bound to require global policy action and involve emerging as well as advanced countries. The IMF can play a key role in supporting coordination within the Gs through analysis and proposals. To borrow Mervyn King's

image, it should here play the role of the cricket umpire and tell the truth to the players in order to give a sound basis to the discussion among them.

- It needs to improve its procedures for **country surveillance**. It is often argued that there is no need for Fund surveillance of national policies anymore. This is disputable. Even advanced countries can benefit from external advice and IMF reports can trigger policy discussions within them. It could conceivably even go further. For example, an important issue for the years to come is how governments can credibly anchor their fiscal policies in the medium term. They will need considerable flexibility in the short term to respond to the recession but this will entail the risk of markets questioning their sustainability. Domestic rules and institutions are often weak. One could imagine that countries would draw benefit from voluntarily submitting themselves to IMF oversight in order to lend credibility to their commitment until they get back to a normal position.

  The main issue is rather the Fund's ability to speak up, ie to emphasise the key conclusions of its analysis and bring them to the attention of national policymakers. This relates to governance. As observed in the Independent Evaluation Office report (IEO, 2008), the Board has both supervisory and executive roles, and there tends to be confusion between the two roles. Specifically, why should the Board decide on analysis? This is not best practice and, furthermore, the IEO report points out that on average only 4 out of 24 Executive Directors attend Board meetings where Article IV reports are discussed. Rather, there should be a distinction between expertise and recommendations, which would imply having staff analysis released under the responsibility of management, as for the WEO and the GFSR.

- **Macro-financial surveillance** is new territory. With the Financial Sector Assessment Programmes (FSAPs) and the GFSR, the Fund has gained leadership in a field whose importance is underlined by all observers (see for example Brown, 2008). It does can draw on a wealth of experience with the GFSR and the WEO to transform itself into the key institution in charge of linking macroeconomic analysis and financial surveillance. It does face a potential competitor in this field, the Bank for International Settlements (BIS), but the BIS is a central banks' club and the role to be played here goes beyond the remit of central banks. However it faces three problems.

  The first is the magnitude of the intellectual and policy challenge. The consistency between financial stability and macroeconomic assessments remains limited. It has been observed, not least by the IEO, that there was much too little use of the results of FSAPs in the Article IV consultations. Also, the consistency between the GFSR and the WEO is an issue. These are methodologically difficult but solvable problems, which primarily require investing resources to address them.

The second problem is that the Fund has a comparative advantage in linking macroeconomic and financial developments but not in the analysis of market developments: it is certainly an institution with a perspective on financial markets but one that primarily speaks to governments. Unlike the central banks it does not have an established channel of communication with the markets. It can hire people with market expertise but does not do business with market participants.

The third problem is implementation, which in most cases implies action by national regulators and/or international regulatory bodies. The Fund has limited regulatory powers and it is unlikely to accrue many. It should rather act through the existing regulators and their groupings. As far as advanced countries are concerned, this means the FSF and the Fund should therefore find ways to develop cooperation with it – potentially through serving as the FSF's secretariat.

Provided these problems are addressed, the Fund could gain a significant role as the key institution that links analysis of macroeconomic and financial developments and draws implications for macrofinancial supervision, relying on others such as the FSF for implementation.

In conclusion, the IMF faces the difficult task of redefining its role in a world economy that is undergoing profound political and economic change. It has done so several times in the pas – when the fixed exchange rate system broke down, when the Latin American debt crisis erupted, or when communist countries started their transition, to mention only three prominent examples. For this even more challenging transformation, it can rely on strong assets – its wide membership, its governance, the quality of its expertise, its intellectual credibility, the continued need for financial assistance. But it needs to display a combination of modesty and boldness that, in the past, has not always been a defining characteristic of the institution.

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