

The IMF and the Global Crisis: Role and Reform

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We face a global economic and financial meltdown that may yet rival the Great Depression. If national economic and financial policies are sufficiently focused and mutually supportive, we can avoid the trade and financial protectionism and competitive exchange-rate devaluations that exacerbated economic distress eight decades ago. The International Monetary Fund (IMF), the World Bank, and what is now the World Trade Organization were established at the end of World War II to mitigate, if not prevent, recurrence of such destructive policies. The question is whether the IMF in particular is up to its assigned task. My answer is that I hope so, but the Fund needs our help.

In my remarks, I will make three major points.

First, the IMF is the principal institution of global economic governance positioned to help deal with the current economic and financial crisis. Unfortunately, the Fund's legitimacy and relevance has been undermined in recent years. Moreover, even in the best of circumstances, the Fund can only be as successful as its principal members want it to be.

Second, in the near term, the Fund should: (a) lend to countries that have been adversely affected by the crisis, (b) help to establish an agreed approach to global economic and financial recovery, and (c) monitor the implementation of national economic and financial policies, in particular exchange-rate policies, to minimize the negative, spillover effects of one country's policies on other countries.

Third, in the longer term, the Fund should step up its surveillance of national financial systems and the global system and help to develop a better framework for macroprudential supervision. (There is not even a generally accepted definition of macroprudential supervision. I define it as a concern for the influence of financial system developments on the global economy and, equally important, vice versa.)

Finally, I will sketch some proposals for consideration by the new US administration as it takes over discussions on economic recovery and financial reform with the group of twenty countries in London on April 2.¹

Before turning to the role of the IMF in the current crisis, let's remember some historical context. The Fund was established at an international conference in 1944 at Bretton Woods, New Hampshire. The conference was preceded by several years of largely bilateral discussions and conferences involving principally the United States and the United Kingdom. The objective was to prevent the type of competitive exchange-rate adjustments that had characterized the interwar period. The agreed mechanism was a system in which exchange rates were fixed and international permission was required before they could be adjusted. It was recognized that if a country was going to defend its exchange rate from devaluation pressures associated, for example, with a trade deficit, it would be useful to provide international financial assistance, through the IMF, to cushion the process of external adjustment. Domestic macroeconomic policies were to be used primarily to achieve that result. An important subsidiary objective of the IMF was to facilitate the removal of the exchange controls in order to promote the expansion of world trade.

The Bretton Woods system served us well though not entirely as intended. It facilitated the postwar recovery without a large number of economic and financial crises. There were a few, but they tended to be associated with individual countries rather than the system as a whole.

However, the US dollar was the linchpin of the system, and it became overvalued. Moreover, international capital mobility increased, exerting increased pressures on fixed exchange rates. The result in 1971 was the collapse of the Bretton Woods system and the eventual emergence of substantially greater flexibility in exchange rates among the major currencies, and ultimately among most currencies.

However, the IMF did not go out of business once its principal *raison d'être* of supporting fixed exchange rates largely disappeared. Countries continued to experience external financial crises. Moreover, they tended to be more generalized; crises were associated with the oil shocks of the 1970s, with recession and the global debt crisis in the early 1980s, and with Mexico and Asia in the 1990s. IMF financial assistance and policy advice helped to

¹ The G-20 countries are the seven major industrial countries, Australia, and 11 other large, systemically important countries, such as China, India, Brazil, and Russia.

cushion those shocks. The IMF also was called upon to play a major role in helping the so-called transition countries of Eastern Europe and the former Soviet Union to adopt market-oriented economic systems.

Despite substantial continued, overall success over the past three decades, three problems emerged: First, a country's adoption of economic adjustment programs in connection with IMF financial assistance is politically controversial. Second, the private sector came to play the dominant role as the source of international capital flows, and global surveillance and supervisory systems failed to keep pace with many of the resulting implications for the countries attracting the inflows. Third, the governance of the IMF continued to be dominated by the major industrial countries, in particular the United States and the European countries, which undermined the legitimacy of the institution in a changing world.

The IMF has evolved with the globalization of our economies, but not as fast as some would prefer. A fresh reform effort was begun four years ago, but there was little sense of urgency given the benign global economic and financial conditions that generally persisted until the middle of last year. Many observers argued that the IMF no longer had a major role to play as a lender or in helping to guide the global economy and financial system. IMF credit outstanding peaked (on an end-of-year basis) at almost \$100 billion at the end of 2005, but had declined to about \$10 billion by the end of September 2008. One consequence was that the package of IMF reforms that was agreed in the spring of 2008, after years of contentious discussions, was modest at best.²

It is ironic that a year ago it was fashionable to argue that the IMF was irrelevant as a lender and marginalized in its surveillance of the global economy and financial system. Benign economic and financial conditions were projected to continue indefinitely. Moreover, the prevailing view was that the systemically important countries either had guaranteed access to international financial markets or had effectively self-insured against future external financial crises by amassing huge stocks of foreign exchange reserves.

² The package includes: (1) an incomplete reform of the formula that is used to determine financial contributions to the IMF and voting shares in the Fund; (2) small increases in the financial contributions of the United States and about 50 other members totaling less than a 10 percent increase overall; (3) an increase in the number of basic votes for each member country regardless of its economic size; (4) expanded investment powers for the Fund; and (5) sale of about 12.5 percent of the IMF's gold. US congressional approval is required for any of these elements to go into effect.

Starting in mid-September last year, criticism shifted to: “Where has the Fund been? The IMF is not discharging its duty to protect the international financial system. We must remake the international financial architecture with the IMF at the center.”

Some of us who have been pushing for more substantial IMF reform, in particular in the area of governance and legitimacy, take the view enunciated by Rahm Emanuel: “You don’t ever want a crisis to go to waste; it’s an opportunity to do important things that you would otherwise avoid.” I will return to this theme when I outline my proposals, but first let’s consider the crisis itself and the potential role of the IMF in cushioning its impacts. How the IMF handles the current global financial crisis will affect its future and support for it by the United States and other members.

The global economy and financial system are in the midst of a massive deleveraging process. The increased globalization of the world economy and, more important, of the world financial system in recent decades means that countries can run, but not hide, from this crisis or future crises. Every country has been affected, and those with the weakest policies and the most precarious financial circumstances have been affected first. The incidence and virulence of future crises may be reduced by decisions taken in the wake of this crisis, but crises will not be prevented. What is important now is to cushion the impacts of the global recession and to restore stability to financial markets.

The world has turned to the IMF for answers and help. Under managing director Dominique Strauss-Kahn, the IMF has moved aggressively. In the fourth quarter of 2008, the IMF committed about \$45 billion to six of its member countries to support their adjustment programs. A program for Belarus was approved on January 12, and programs for several more countries are in the pipeline.

On another front, on October 27, the IMF executive board approved a new short-term lending facility (SLF). Countries with sound economic and financial policies and underlying fundamentals plus sustainable external and internal debt positions (on the basis of their most recent Article IV consultations) can borrow immediately as much as five times their IMF quotas for three months with two possible rollovers. (Normally a member can only draw the amount of its IMF quota over the course of one year.) The executive board notionally set aside an initial \$100 billion for this facility. This is out of its estimated total forward lending capacity of about \$200 billion as of the end of September—\$250 billion including financing available under established IMF borrowing arrangements. Does the IMF have the financial

resources to continue such lending? I am concerned even though in mid-November the government of Japan offered to lend the IMF an additional \$100 billion.

Also on October 27 last year, the Federal Open Market Committee (FOMC) of the Federal Reserve System approved reciprocal swap, or short-term lending, arrangements with each of four emerging-market countries—Brazil, Korea, Mexico, and Singapore—of \$30 billion each. It remains to be seen whether any country draws on the SLF and how that facility interacts with the Federal Reserve swap arrangements with these four and the other ten central banks.

As of the end of 2008, the Federal Reserve had extended more than \$600 billion in dollar credit to the fourteen. (In early January, a small portion of that amount has been repaid.) Thus, the Federal Reserve lent to other countries almost twice the amount that the IMF can lend out of its normal resources augmented by the potential Japanese commitment. (I will return to this topic shortly.)

The management and staff of the IMF have also been proactive in making the case for a concerted effort to address the global recession. In fact, the managing director was ahead of the curve. About a year ago, he recommended economic stimulus programs by those countries that had the fiscal room to maneuver; now he supports fiscal stimulus equal to two percent of global GDP—about \$1.3 trillion. Not all countries will be able to participate because some have limited capacity to issue additional government debt in foreign or domestic markets. However, it is important to have broad participation. Without it, some countries in effect become free riders. They benefit from the fiscal stimulus of other countries without having to increase their own government debt obligations. This is where the surveillance role of the IMF is important. It can act as a neutral observer and help to ensure that each country is doing its fair share to promote global economic recovery.

The IMF's surveillance function is even more important when it comes to exchange-rate policies. In a global recession, many countries are tempted to allow or to encourage their exchange rates to depreciate. The problem is that all countries cannot depreciate their currencies at the same time vis-à-vis the currencies of all other countries. Moreover, countries that are successful in doing so in effect export their unemployment. This type of “beggar-thy-neighbor” exchange-rate policy, along with protectionist trade actions that were in part triggered by exchange-rate policies, exacerbated the Great Depression and shredded international monetary cooperation. Normally, one constraint on such competitive

depreciation is the risk of igniting domestic inflation. That constraint is largely missing at present. Most countries in the world either are experiencing low inflation or fear outright deflation.

The exchange-rate policies of IMF members remain central to the Fund's mission. In the wake of the abandonment of fixed exchange rates in the 1970s, the IMF Articles of Agreement, its charter, were rewritten. Members accepted the obligation to "avoid manipulating exchange rates or the international monetary system to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The IMF's enforcement of this obligation has been weak. Some of the blame lies with the timidity of the IMF's management and staff, but the major portion lies with the general membership of the Fund. There has been a lack of shared consensus about what this obligation means and how it should be policed.

Thus, in particular during this difficult period for the global economy, the IMF management and staff have a responsibility to call countries on the carpet if their exchange-rate policies are inappropriate. Members of the Fund, in turn, need to support such efforts to curb exchange-rate movements that are disruptive to trading relations and detrimental to the global economy.

Turning to the longer term, what should be the IMF's role in international financial supervision and regulation? I am concerned that an excessive focus on tougher global financial regulation is counterproductive at this time, discouraging rather than encouraging new extensions of credit. Notwithstanding my concern, a process of reform of international financial supervision and regulation is needed and is underway.

Until recently, that process was coordinated by the Financial Stability Forum (FSF).³ In September 2007, the G-7 ministers called upon the FSF to prepare a comprehensive set of recommendations for addressing the weaknesses that produced the crisis that was then breaking and for strengthening the financial system going forward. After several interim reports, a final report with 67 recommendations under five headings was submitted to the G-7

³ The G-7 finance ministers and central bank governors established the FSF in 1999 to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. The FSF is essentially a coordinating body. Its members include representatives of the G-7 countries, a number of other financial centers, the World Bank, the OECD, the Bank for International Settlements (BIS), the international standard-setting bodies such as the Basel Committee on Banking Supervision and Regulation, and two BIS committees. The Fund also is a member of the FSF, but it does not have a dominant role. The FSF, as formally constituted, reports to the G-7 finance ministers and central bank governors.

in April 2008 with associated timelines for action. In his report to the G-7 and International Monetary and Financial Committee of the IMF in October 2008, FSF chairman Mario Draghi added four more topics.

As the severity of the global economic and financial crisis intensified, the attention of governments also intensified. One result was the meeting of the G-20 countries at the summit, or leaders', level on November 15. It will be followed by another meeting in London on April 2. This escalation, for better or for worse, has injected national political and geopolitical dimensions into the process, including such issues as membership on the FSF and the relationship between the IMF and the FSF.

On the latter issue, the status quo is as follows: Surveillance of the global financial system is the responsibility of the IMF. Elaboration of international financial-sector supervisory and regulatory policies and standards, and coordination across the various standard-setting bodies is the principal task of the FSF. Implementation of policies in the financial sector is the responsibility of national authorities, who are accountable to national legislatures and governments. The IMF assesses authorities' implementation of such policies as well as the stability of the national financial systems.

This description of the status quo is drawn almost word for word from a letter sent to members of the G-20 by IMF managing director Dominique Strauss-Kahn and FSF chairman Mario Draghi. It is not likely to change substantially. In particular, in the foreseeable future, no country is likely to agree to turn over decisions about the supervision and regulation of its financial institutions or national financial system to an international body. However, coordination and harmonization of national policies should and will deepen. This is where the IMF's surveillance role again is important.

Strengthening IMF surveillance is probably the most complex issue growing out of the global financial crisis. In my view, the crisis had its origins in failures of macroeconomic policies, in microprudential policies, and in what are called macroprudential policies—prudential policies that have macroeconomic implications and vice versa. The challenge for policymakers at both the national and international levels is that there is no agreed conceptual framework to guide international cooperation on these three, related dimensions of policy. Because the IMF is a global institution and has substantial analytical capacities, it must play a major role in helping to reach consensus on these substantive issues and in implementing the resulting procedural agreements to reduce the incidence and virulence of future crises.

In light of the global economic and financial crisis, what should the Obama administration advocate on the role of the IMF in the crisis and on IMF reform? On the one hand, the administration has on its plate a modest package of reforms that was agreed almost a year ago. These reforms cannot go into effect without US congressional approval. On the other hand, the G-20 summit process has moved many of these issues back to center stage in conjunction with the issues of global financial supervision and regulation. The G-20 countries are scheduled to meet again in 10 weeks.

My principal recommendation is to be bold and to explore proactively with the other G-20 countries reopening the earlier package. In particular, the administration should advocate including in an expanded package: (1) a further change in the formula used to guide the allocation of quotas and voting power in the Fund in the direction of giving less weight to the traditional industrial countries to enhance the IMF's legitimacy; (2) a doubling of IMF quotas, with the allocation of increases based on the revised formula, and a parallel doubling of the amounts that the IMF can borrow from members under the general arrangements to borrow (GAB) and the new arrangements to borrow (NAB) to provide resources to the Fund to use in the current crisis; (3) a consequent further adjustment of voting shares in the Fund of at least five percentage points away from the traditional industrial countries to implement the enhancement of the IMF's legitimacy; and (4) an allocation of SDR 50 billion (about \$75 billion) to provide confidence and financial resources to the Fund's members.

I also recommend that the Obama administration seek authorization for the Federal Reserve to swap unlimited amounts of US dollars for SDR issued by the Fund for up to two years and an amendment of the IMF Articles of Agreement to allow the Fund to swap SDR for the national currencies of the United States and of other countries issuing currencies that are heavily used in international finance. These national currencies would be used to finance a short-term liquidity facility in the IMF, rather than relying on individual central banks, to assist member countries in supporting the international financial operations of financial institutions chartered within their jurisdictions.

The Fund traditionally advances credit to governments, and governments use foreign exchange borrowed from the IMF primarily to replenish their reserves. Secondly, governments use the foreign exchange to meet their own foreign currency obligations, including debt obligations, and, to a limited degree, to support their currencies in the foreign exchange market. In the financial crisis of 2008–09, governments and their central banks, in

industrial as well as developing countries, have used foreign exchange—reserve holdings as well as new borrowings—to help their domestic financial institutions to repay international creditors, in particular their interbank borrowings. In the future, with the ongoing globalization of finance, these needs are likely to increase. In general they should be met not through bilateral or regional arrangements among central banks but multilaterally through the IMF.

Finally, with respect to international supervision and regulation, I have already outlined the role the IMF should play in the development and implementation of macroprudential supervision. In addition, because the G-7 lacks legitimacy, the link between the G-7 and the FSF should be severed. Henceforth, the FSF should report to the G-20 finance ministers and central bank governors. This could be arranged at the same time that membership in the FSF is expanded, as has been agreed in principle. At the same time, the recent informal practice of having the FSF report to the IMF's International Monetary and Financial Committee (IMFC) should be formalized.

We are in the midst of what almost certainly is the worst global economic recession and financial crisis since World War II. As the principal institution of global economic governance, the IMF must be supported and encouraged to play a major role in restoring economic growth and financial stability with a minimum of distress and collateral damage to individual economies. It must have the resources to increase its lending, it must advise its members on appropriate economic and financial policies, and it must monitor those policies to help prevent destructive spillover effects.

For the longer term, the IMF is not positioned to be a supranational financial regulator. However, its surveillance role should be enhanced in part with respect to the neglected intersection between national macroeconomic developments and policies and the supervision of individual financial institutions and national financial systems.

Despite the myriad domestic economic and financial issues facing the Obama administration, it must demonstrate its commitment to multilateralism and multilateral institutions at this critical juncture. Between now and the G-20 summit meeting on April 2, it should forcefully advocate changes along the lines that I have outlined today not only to address the crisis but also to help restore the IMF as the central institution of global economic governance.