# A new role for the IMF?

*There is no denying: the world is going through a severe financial crisis that is characterised by some as the worst since the Second World War[1]. The severity of this crisis causes an all-too-familiar call for increased regulation. In the G7 and even in the US, the self-proclaimed advocate of free-market principles, the introduction of stronger forms of regulation for financial institutions is put high on the agenda. The International Monetary Fund (IMF), which is in the process of redefining its own role and position, also put forward proposals to alleviate the crisis. In a sense, the current situation provides an ideal platform for the Fund to reaffirm its importance for global financial stability. Notwithstanding the effort, it remains the question what the IMF's contribution would actually be, and what future position the Fund will hold. This special report aims to shed some light on these questions, while also going into the position of the financial sector in this debate.*

## Shifting mandates

The IMF was conceived by 44 countries at the Bretton Woods conference held in 1944. It was designed to preserve the worldwide monetary system from crises such as the one that struck in the 1930's. At that time, many saw this crisis as one of the prime causes of the Second World War. The countries that were involved promised to prevent this from happening again by coordinating their economic policy actions. The crisis of the 1930's was concentrated in the industrialised world of those days, the United States and Europe. Its effects were intensified as a consequence of a series of devaluations, with which the countries individually aimed to increase their competitive position. Coordination of the stability of mutual exchange rates and the underlying economic policy, therefore, became one of the prime mandates of the IMF. In addition, industrialised countries had to draw on financial assistance from the IMF, like for instance the United Kingdom and Italy (1977) and the United States (1978).

Later on, the focus of the Fund shifted to the group of less-developed countries. In the 1980's, many of these countries faced an unsustainable debt load. Given that Western banks and investors put massive amounts into debt obligations of these countries, the stability of the worldwide financial system was at stake again.

**Box 1: IMF financial reorientation**

The financial future of the IMF is a subject of heavy deliberations. The economic success of developing countries significantly reduced their residual financing requirements and their need for financial assistance from the Fund. This success has a dark side in that it eroded the financial base of the Fund. On 7 April 2008, it decided to embark on a financial reform plan that is almost as drastic as the medicines it prescribes for developing countries. In short: 15% reduction in staff, reduction of other expenses, sale of 12.5% of its gold reserves (403.3 tonnes, conservative estimate of the proceeds: USD 11 bn.) and a less conservative asset management strategy. The last two proposals in particular feed a fierce discussion in the financial world. Given the sheer size of the intended sale, the IMF should be seen as a potential price maker on the gold market. And by acting too aggressively, the IMF could put her assets at risk and introduce market imbalances. It is difficult to predict whether and how these plans will become reality, as the Fund's 185 members have to approve this new strategy, making some sort of compromise more likely.

In more recent decades, the Fund became more focused on development issues in the

[1] Alan Greenspan in Financial Times, 16 March 2008

broader sense. As the US and the other rich countries still accounted for the largest contribution to the world economy, they maintained a dominant position in the Fund. As the emerging economies of the present days have increased their share in the world economy and since the need for financial assistance has been reduced to a significant extent, the institution has embarked on a renewed process of reform.
Moreover, the IMF decided it should be better able to signal possible crises in financial markets[2]. However, despite many warnings (also from the IMF itself), the crisis enfolded earlier than expected and it came from an angle that was previously seen as non-suspect. It is interesting to see that, at the IMF's conception, the US had the idea of using the IMF as an instrument to stabilise the world economy while, these days, that same country is one of the most important sources of world-wide financial instability.

## Crisis provides new platform for the IMF

The IMF operates on the basis of three primary tasks that can be summarised as follows:

- Financial assistance: Providing (emergency) loans to countries that face a crisis on the balance of payments.
- Technical assistance: Providing knowledge and expertise for the determination of economic policy. The implementation of IMF policy programs is often a precondition for financial support. The Fund also provides training and education for local policy makers;
- Surveillance: The analysis and monitoring of economic policy, with special attention to the macroeconomic backdrop. This includes the so-called Article IV consultations and the Financial Sector Assessment Program (FSAP).

Along the years, the IMF expanded its mandate far beyond these three main tasks, loosing its focus and, more importantly, its moral authority. Now that the global economy came under fire, the heads are turning also to the Fund to find a solution. This provides an ideal stage for the IMF to reaffirm its position as a pivotal institution in bringing together information and analysis on a global scale, and in trying to console the diverging interests of its member states.
In order to be able to effectively contribute to the alleviation of the current financial crisis, the three main tasks of the IMF must therefore be reconfirmed as the central mandate of the institution.

## Crisis also challenges financial sector

Obviously, a flawed economic policy and the structural weaknesses of the US are not the sole causes of the sub-prime crisis.
Fundamental changes in the financial sector, particularly the progress in terms of product innovation in the different types of Asset Backed Securities and Credit Default Swaps, played their part as well. Action in the US and in the financial sector are, obviously, equally important in a successful strategy to overcome this crisis. But how to achieve this?
For one thing, there is a call for intensified regulation of the financial sector. This approach was voiced widely during the G7 meeting in Washington in the second weekend of April. From the perspective of policy makers, this is a sensible approach. Banks, however, tend to think differently. The past decade has seen a marked increase in regulation already. The implementation of frameworks such as Basel-II, IFRS, intensified compliance and the introduction of 'smart sanctions' against governments and individuals, all caused a substantial work load. In addition, there are two major undesired effects that follow from these measures.

First, there is a 'black box effect'. Many banks face a risk of putting a blind trust in their rating- and risk models. In that sense, the

[2] Kremers and Schilperoort in ESB, July 2007

present crisis is the first real-life stress test. Many models will have to be redeveloped on the basis of new experiences and refreshed concepts. The mark-to-market method that is central to the IFRS has a similar effect. In this approach, everything is based on current market valuation. When the market fails, essential information for these calculations is missing, causing mutual distrust to spread out among banks. The transparency that was supposed to flow from the IFRS program eventually turned out to have a contradictory effect.

Second, taking a macro-scale perspective, the mark-to-market valuation of assets and liabilities, as well as the methodologies that are the foundation of many Basel-II models, cause a procyclical effect. From the perspective of credit and control, the ratio behind these approaches is one of unflawed logic. On a macro-level, however, a macro shock causes a self-amplifying effect that in turn affects the granting of credit by banks. The aftermath of the sub-prime crisis is a real-life illustration of this. Both effects have serious implications and require further evaluation.

## What the IMF could do

With an eye on transparency and through strong and detailed surveillance, the IMF could provide a valuable contribution to macro-economic and financial stabilisation. Given the roots of sub-prime, the Fund should first and foremost focus on the US and the coordination of economic policy between the G7, as well as the most important emerging economies.

Clearly, the American economy, its rapid increase of government debt and an excessive accumulation of private debt, are causes of concern. Part of the costs of these problems is passed on to other countries by allowing the US dollar to remain relatively weak. As the US holds a dominant position in the IMF, the Fund is rendered powerless in trying to correct this. Moreover, as the crisis has already unfolded, there is little use in taking preventative action. Furthermore, the weak dollar lured several European politicians into proclaiming that the euro should be weakened too in order to safeguard the competitiveness of European industries. The European Central Bank, wisely, chose too ignore this appeal.

From the above, it becomes clear that effective resolution of the (fall-out of the) sub-prime crisis requires a strong effort in terms of policy coordination, which in effect brings us back to the original objectives of the IMF.

*Focus on emerging economies*

So far, it remains rather unclear to what extent other parts of the world will be affected. The channels through which the US sub-prime troubles may spread to emerging economies can be described nonetheless.

The first effect is felt through the financial channel. Still, emerging economies are seen by many as a 'safe haven' in these difficult circumstances. Nonetheless, they also experience higher prices for risk taking and a diminished pool of liquidity, especially within the interbank relations and even with banks in non-industrial countries.

The second effect will be much more stealthy. If the American consumer adjusts its economic behaviour, and there is every reason to believe that this is actually happening, US imports will be reduced. Obviously, emerging economies' export engines will sputter as a result. The macroeconomic effect of this on the emerging economies is difficult to quantify. The current high commodities prices compensate for the volume effect of lower exports to the US. Taking into account that the prices are at high levels partly due to speculation, a possible correction in commodity markets will bring about harmful effects. In addition, the domestic demand base is still strong in these countries.

It is difficult to adequately gauge the sensitivity of domestic demand to export reductions, mainly because trade between emerging economies has also increased markedly.

The IMF can make a difference nonetheless, especially with respect to emerging economies. Through effective technical assistance in economic policy and in contingency plans, the fund may be able to assist in keeping these countries from entering into the danger zone. This role can be augmented by scrutinous surveillance on the economic developments in these countries. Augmented transparency helps financial agents to adjust their behaviour in a timely fashion, without falling into the knife of overexaggerated expectations on emerging economies.
Moreover, most emerging economies boast sufficient fiscal room to compensate for a temporarily faltering in external and/or domestic demand. Exactly because emerging economies are currently seen as safe havens, these countries and the financial sector share a mutual interest in the IMF taking up these roles effectively.

## What the IMF should not do

As described earlier in this Special Report, policy makers voice there desire to strengthen regulation of the financial sector, for instance by curtailing the unrestricted extension of credit. No doubt, the financial industry should acknowledge that the rules were stretched in some cases; this was in fact one of the reasons behind the sub-prime crisis.
But the IMF should not add to the pressure for more regulation. As was mentioned earlier, the Basel-II and IFRS frameworks required extensive efforts from the financial industry, most likely making new and additional regulation less effective. And even though the process may be difficult and painful, we should to a large extent put our faith in the industry's self adjusting capabilities. As to this last matter, the sector should also take its public responsibility to the full, as the bailing-out of some large actors has been done with tax money.

The process of 'creative destruction' keeps on demanding sacrifices, but it will also contribute to a better standard in risk management. On the one hand, the most risky or opaque instruments will become obsolete, as they lost their value to the markets. On the other hand, this real-life experience will generate invaluable amounts of knowledge, with which the structure of risk-mitigating financial structures may be ameliorated. In order to achieve this, transparency and a level playing field on a global scale are prime requirements. This is an area in which the IMF may be able to prove it is still valuable to the financial system.

## Circular history

*L'histoire se répète, to a certain extent at least. The world of macroeconomics keeps on displaying cyclical movements, taking banks and other financial institutions with it. In this context, the International Monetary Fund received a role and a mandate to work on stabilisation. Originally, the IMF had been established to coordinate the economic and financial policy of the richer countries in the world, in order to prevent new world-wide economic (and political) crises from happening. Over the past decades, the Fund increasingly focussed on the poorer developing countries and broadened its objectives.*
*Obviously, the more important emerging economies, (Brazil, Russia, India and China) must be involved in the coordination plans that are slowly being conceived. Now that the richer countries are suffering from their deepest financial crisis since the Second World War and pose a serious threat to global financial stability, the IMF would truly be able to add value by refocusing on its original objectives.*

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