The Orderly Resolution of Financial Crises – A G20-Led Initiative

How could a Leaders' Level G20 make a difference?

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BRIEFING NOTE

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Preparing for the Next Financial Crisis

Preparing today for the next financial crisis is a bit like buying fire insurance in a flood, in that the likelihood of the problem occurring in the short run is limited. Currently, financial stability in emerging markets is supported by three conditions: strong prudential policies, current account surpluses, and low interest rates. The premise of this paper is that this constellation of stability-making circumstances is temporary and sooner or later problems will recur.[2]

- While there has been progress in terms of prudential policies, much remains to be done. Emerging markets have further to go in terms of strengthening their banking systems, building domestic financial markets, limiting the growth of public debt, improving corporate governance, and moving to greater exchange rate flexibility. So long as these institutional reforms are incomplete, emerging markets will remain more vulnerable than their developed-country counterparts to disruptions to market access and sudden capital outflows.[3]

- In terms of current accounts, the emerging markets of Asia and Latin America will notrun surpluses indefinitely. When their growth slows or commodity prices decline, they will again want to run deficits in order to smooth consumption and sustain investment – precisely as textbook models suggest they should. To the extent that they have been motivated to run balance-of-payments surpluses by the memory of recent crises, which has created a desire to build reserves, it is hard to argue that this process of reserve-building has further to run.

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[2] This is what the historical record suggests; see Bordo, Eichengreen, Klingebiel and Martinez-Peria (2001) or Reinhart, Rogoff and Savastano (2004). Countries with significant external financing needs in 2005 that are high on my personal watch list include Colombia, Ecuador, Hungary and Turkey.
[3] Where this vulnerability can be measured by output costs suffered and damage done to the financial system.

- Real interest rates in the United States are still below historical norms for this stage of the business cycle, reflecting the series of dramatic cuts undertaken by the Fed at the beginning of the present decade. Recent interest rate hikes have gone only part way toward normalization. Low interest rates in the financial centers reduce the cost of servicing variable-rate debt and make it cheaper for emerging markets to re-fund maturing obligations. A sharp rise in those rates could make the external debt situation much more difficult.[4]

The IMF is at the forefront of crisis-prevention and resolution efforts.[5] In what follows I will argue that discussions of IMF reform should focus on two issues that are more closely related than they may appear: rationalization of its lending facilities and governance.

1. Lending

The IMF possesses a proliferation of lending windows, and the sense remains that it lends too much and too indiscriminately – that because it has done so in the past it may do so again in the future. This perception, together with the expiration of the CCL, has led to discussion of how those lending operations might be streamlined and simplified.

There are three basic ways of organizing the Fund's lending functions: rules, discretion, and market discipline. A rules-based reform might limit the circumstances under which countries could be extended exceptional access, capping loans at a country's quota under most circumstances.[6] It might limit IMF lending to those countries whose debts were sustainable, whose banking systems were strong, or which had met some other demanding preconditions.[7] To gain exceptional access it might require countries to pre-qualify for assistance under some successor to the CCL.

However appealing such rules are in principle, they are not feasible in practice. Stuff happens. Country credit-worthiness can deteriorate unexpectedly, making prequalification impractical. Threats to systemic stability are impossible to fully anticipate, making a commitment to limit lending time inconsistent. At some level, the concept of debt sustainability is impossible to operationalize.

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[4] At the end of this memo I suggest what could bring about a sharp increase of this sort.

[5] I therefore limit myself in this memo to a discussion of its reform. A longer report would discuss also World Bank reform. To summarize: I oppose merging the Bank and Fund into one institution, since this would create a confusing mandate for the resulting institution. I favour closing the non-concessionary facilities of the Bank, since the countries for which they are relevant can now fund their development needs on global financial markets. I also favour shifting the focus of the Bank's concessionary facilities from loans more fully in the direction of grants. To be sure, if the Bank did not have loans on which to earn interest, its lending capacity would be constrained, other things equal. But I do not see a second-best model in which it makes sense for the Bank to extract resources, in the form of interest earnings, from some developing countries in order to be able to extend additional loans to others.

[6] As suggested by Council on Foreign Relations (1999) and Bank of Canada-Bank of England (2001). On the Fund's own review of exceptional access policy and framework for the same, see IMF (2004).

[7] As proposed by International Financial Institutions Advisory Commission (2000).

The Argentine crisis has prompted discussion of whether these problems might be solved through the application of market discipline. If the IMF, like the World Bank, funded its loans by borrowing on private financial markets and if it no longer enjoyed preferred creditor status, it would have a strong incentive to loan only when its operations had a high probability of success. Otherwise it would not be paid back, and it then would be unable to borrow to finance future operations.[8]

Unfortunately, this idea is fundamentally flawed. The role of the Fund is to lend precisely when the markets will not, because it perceives the existence of a divergence between the private and social costs and benefits of external finance. If this was not the case, there would be no role for the institution in the first place. Financial market participants, in contrast, take positions purely on the basis of private costs and benefits. To "discipline" IMF policy on the basis of their actions would thus be misplaced.

This leaves constrained discretion as the only sound basis for IMF lending policy. Here the analogy with an independent central bank is direct. Like an independent central bank, the Fund should have discretion over its tactics – for example, over how to respond to an emerging market financial crisis or a threat to systemic stability. It needs to be able to respond flexibly to unexpected challenges. But that flexibility should have limits. The Fund should be constrained by a clear mandate in the objectives it pursues, and its officials should be held accountable for their failures. There is also a relevant analogy with corporate governance: large shareholders (insiders) should be prevented from pursuing private agendas, and the board of directors should be representative of the stakeholders.

One way of more effectively constraining IMF discretion is transparency. If the IMF has to take its decisions in the light of day, there will be less scope for management to encourage decisions that simply augment the size of the institution's loan portfolio or for the principal shareholders to advocate programs on the basis of geopolitical self-interest rather than economic criteria. It will be harder for the Fund to justify lending to a country whose financial situation is fundamentally unsustainable, like Argentina in 2001. The IMF has gone a long way toward greater transparency in the last decade. It now needs to go further. It is time to eliminate the members' right to suppress publication of staff reports on Article IV consultations and other documents. It is time to create a rule that the reports of the Independent Evaluation Office will be published. It is time to consider timely publication of the minutes of Executive Board.

2. Governance

Transparency is a way of constraining IMF discretion by holding the institution accountable for its actions in the court of public opinion. But the public has a notoriously limited attention span, and its interest in IMF policy is diffuse. Only large shareholders

[8] One can imagine, for instance, that under such circumstances the IMF would not have lent to Argentina again in August 2001. I return to this example below.

with concentrated stakes have sufficient incentive to invest in this process of monitoring and accountability. This means that it is ultimately the governments of the member countries, operating through the Executive Board, the International Monetary and Financial Committee, and the Board of Governors on which we must rely to monitor management's actions, hold it accountable, and constrain its discretion.

But accountability to shareholders produces results that are compatible with underlying interests only if those shareholders are adequately and equitably represented. Thus, proposals for relying more heavily on, inter alia, the Executive Board and the IMFC to hold management accountable and constrain its discretion founder on objections to the representativeness of these bodies as currently constituted. This means that a more efficient and effective IMF requires governance reform.

My own agenda for IMF governance reform would focus on the following issues.

- Address problems of representativeness by increasing the share of basic votes and using GDP at purchasing power parity in quota calculations. The first step will go some way toward restoring the principle of universality, enhancing the representation of poor countries, like those of Africa, that are frequently the subject of IMF programs. The second step would enhance the representation and quotas of rapidly growing countries like those of Asia.[9]
- Enhance the transparency of the quota review process by adopting a simple formula like that recommended by the Quota Formula Review Group but using purchasing power parities and allowing for an increase in basic votes as recommended above.
- Appoint a single executive director for the European Union. When a version of the document drafted by its constitutional convention is adopted, the EU will be a juridical entity. The majority of its members have a single currency and no more possibility of balance of payments problems among themselves than there is scope for balance of payments problems between U.S. states. Rationalizing Europe's board representation in this way will free up chairs for underrepresented countries.[10]
- Rely more on the International Monetary and Financial Committee for defining the objectives and strategies of the institution (including meetings of IMFC heads of state, which can substitute for G7/8 summits). This will be possible insofar as the composition of the IMFC becomes more representative as quotas and constituencies are adjusted.[11]

[9] At present, Belgium has twice the quota of Mexico, despite the fact that its share of world GDP (at purchasing power parity) is only a third as large. The seven largest Asian countries have smaller quotas than Austria, Belgium, Denmark Finland, Norway, Sweden and Switzerland combined, despite having seven times the share of world GDP in PPP terms. See Boorman (2004).

[10] On this see Bini-Smaghi (2002) and Mahieu, Oomes and Rottier (2003).

[11] Another option, which may be particularly appealing to the present audience, would be to instead rely on the G20 (see for example Henry 2003). But there are problems with this approach, including the ad hoc nature of that entity. For discussion see Eichengreen (2003).

- Base selection of the managing director and deputy managing directors on considerations of technical qualification rather than nationality.[12]

3. Coda

Finally, one can't help but observe that the greatest risk to financial stability at the moment emanates from the United States.[13] A sudden decline in the willingness of foreigners, foreign central banks in particular, to finance U.S. current account deficits and even limited sales of their current U.S. dollar holdings could lead to a sharp fall in the dollar and, more to the point, in the U.S. Treasury bond market. Higher Treasury yields will make life harder for emerging markets, in still heavily indebted Latin America in particular. Slower U.S. growth or even an outright recession will make it more difficult for them to maintain export-led growth.

This risk to financial stability could have been averted by earlier steps to address the U.S. current account problem.[14] But it is hard to know what should have been done at the level of the international financial institutions to encourage earlier action. The IMF has been unusually forthright in its criticism of the United States' twin deficits, but its warnings have had little resonance among American policy makers. It has encouraged China and other Asian emerging markets to let their exchange rates fluctuate more freely so that they might reduce their own current account surpluses and, in principle, contribute more demand to the world economy at a time when the adjustment of America's current account means that the United States will be contributing less. But here we see just another example of the limited effectiveness of the IMF's surveillance function – in particular when the member in question is a large high-income country like the United States – to address underlying imbalances when the going is good. In the context of China, we see the limited ability of the Fund to compel a member to modify its exchange rate regime. We see the limited ability of the Fund to facilitate the coordination of national economic policies.[15]

Solving these problems will require the IMF to become still more forthright in its advice. It will require creating the perception that it can act as an honest broker in policy-coordination exercises. The reforms of governance, accountability and representativeness described above are logical steps in that direction.

[12] The relevant reference on this is Kahler (2001).

[13] What follows is the briefest possible account of how such a crisis scenario could unfold. A more elaborate version is in Eichengreen (2004).

[14] I would have favoured a combination of pay-as-you-go spending restraints and limited tax increases to address the budget deficit and quicker normalization of Federal Reserve discount rates to limit the ability of households to live off of inflated asset values, thereby raising personal savings rates.

[15] Note that recent discussions of a "New Plaza Accord," like Porter (2004), have entailed essentially no discussion of a possible role for the IMF.

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