Preparing for a Postcrisis World

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If current plans are implemented as anticipated, the postcrisis world is likely to be one characterized by enhanced multilateralism, greater policy coordination, and a more effectively regulated financial system. In the wake of the April summit of the Group of Twenty (G-20), the IMF is set to play a key role in this new global environment and is working to ensure that it has the tools and resources to fully meet the challenges this new role implies.

Assessing the IMF's role in the future international financial architecture

THE global financial crisis presents an unprecedented challenge that calls for—and has in many ways already produced—an unprecedented response. Countries have acted together in ways that have been innovative and effective. This joint action has been underscored by the new G-20 process and was embodied in the novel Leaders' Summits in November 2008 and April 2009. These meetings were both substantive and symbolic—with important commitments on the part of G-20 industrialized and emerging market countries to cooperate more closely on macroeconomic and financial sector policies.

The IMF has found itself at the center of the new international agenda. In particular, it has been recognized broadly that systemic changes are needed if we are to maintain the benefits of an open and integrated global economy, ensure that these benefits are broadly shared, and limit the risk from future crises. The two Leaders' Summits generated key commitments to enhance global macroeconomic policy collaboration, to reinforce financial sector regulation—including by broadening the perimeter of regulation and strengthening cross-border cooperation—and to refrain from protectionism in both trade and financial policies.

In this context, the global community is looking to the IMF for leadership in several key areas. But what precisely will the IMF's role be in the postcrisis international financial structure? And what changes are needed to ensure that it can succeed in its new and expanded role?

The tools for success

Since its founding, the IMF has evolved along with the world economy. In particular, major moments of international macroeconomic stress—for example, the end of the Bretton Woods exchange rate regime and the collapse of COMECON (the Council for Mutual Economic Assistance of the former Soviet Union)—have led the IMF into new territory. Despite this evolution, it had become increasingly clear that the IMF lacked some of the

Photo shows journalists at the G-20 summit in London.

policy tools needed to be fully effective, especially in crisis prevention. The IMF's tool kit was developed during a period when financial markets were dominated by banks, sovereign debt constituted most international debt flows, and securitized financing was in its infancy. But as we know, cross-border private capital flows have grown explosively in recent years, intermediated by increasingly sophisticated financial technology. Financial integration also has deepened across countries, accompanied by a complex web of spillovers between the real economy and the financial sector. These developments helped fuel an historic global expansion during 2003–07, but they also culminated in the recent financial crisis—a crisis that originated in a narrow segment of the U.S. housing market and spread dramatically to every corner of the world.

More effective crisis prevention

Most notably, the absence of a sufficiently large and attractive precautionary facility—an insurance policy of sorts for member countries—has been a major weakness in the IMF's tool kit and in the global financial architecture. Without such a facility, countries typically sought IMF financing only *after* a crisis had struck, limiting the IMF's role to providing financing in order to smooth sometimes painful adjustment. In addition to raising the ultimate cost of macroeconomic shocks to member countries, it also meant the IMF was often associated with politically thorny austerity programs. Many countries, especially in Asia, opted instead to self-insure by building large buffers of foreign reserves. Although this may have made sense for single countries, it contributed to the buildup of global imbalances over the past decade, which, in turn, played a role in the current economic crisis.

There have been several false starts over the years as the IMF attempted to implement a precautionary facility, but it took the current crisis to provide the consensus among member countries to see the effort through. In March of this year, the IMF introduced a Flexible Credit Line (FCL), which grants access to large amounts of rapid financing—with no ex post IMF policy conditions—for countries with very strong economic policies and a proven track record. This is perhaps the biggest change in how the IMF interacts with its members since the end of Bretton Woods. Mexico, Poland, and Colombia have already tapped this new facility and are treating the financing—a total of some $78 billion for the three—as precautionary. Markets have responded very positively to the announcement of these operations—with exchange rates strengthening even as two of the countries took advantage of the breathing room provided by the FCL to loosen monetary policy (see chart). In light of this positive initial experience, it is likely more countries will follow in the near future.

This new facility is not, however, appropriate for all countries. For some, a precautionary facility would contribute to greater market confidence, but policies and policy frameworks may still need strengthening. For these countries, the IMF has introduced High Access Precautionary Arrangements, or HAPAs, which again provide an insurance policy, but in return for necessary policy measures.

More focused and flexible conditionality

For these and most other IMF programs, conditionality will remain critical to ensure that necessary policy adjustments are made and that the revolving nature of IMF credit is preserved. But conditionality has become more focused and streamlined, to encourage countries to approach the IMF early on, before their problems become too severe. At times, conditionality was seen as unduly burdensome, laden with conditions that—although potentially beneficial—were not always crucial for the success of the program or that were implemented without sufficient flexibility with regard to timing or nature of the policy actions. The IMF had already made efforts to streamline conditionality in recent years, but these efforts have taken a leap forward with recent changes that eliminate structural performance criteria and replace them with a more flexible benchmark approach based on a broader progress review. Under this approach, IMF-supported programs would continue to provide the strong policy framework country authorities often value, while moving away from a rigid checklist approach to policy evaluation.

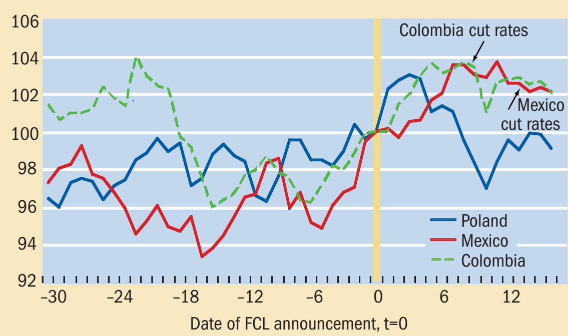
More resources required

These reforms will have little impact if the IMF lacks sufficient resources: in a world of high-volume private capital flows that can swiftly change course, financing packages must be large enough to make a difference. The IMF has thus far had enough resources to do the job. It has already increased its aggregate lending sharply during the crisis and has enlarged the size of its programs in accordance with the size of the global shocks hitting these countries. For example, three emerging market countries—Hungary, Romania, and Ukraine—are each set to receive IMF financing in excess of $15 billion. Access limits, including for low-income countries, have been doubled to assure those countries that their needs can be met. The IMF also intends to provide $6 billion in concessional resources to

Breathing room

The currencies of countries that made use of the Flexible Credit Line mostly did better against regional peers.

(currency performance against regional peers; FCL announcement = 100)



Source: IMF staff calculations.

Note: The blue line is an unweighted average of the Czech krona, Hungarian forint, and Romanian leu per Polish zloty; the red line is an unweighted average of Brazilian real, Chilean peso, and Colombian peso per Mexican peso; the green line is an unweighted average of the Brazilian real, Chilean peso, and Mexican peso per Colombian peso.

low-income countries over the next two to three years: these countries, in particular in sub-Saharan Africa, have experienced several years of very strong growth, and it is crucial that we not allow the crisis to undermine this progress.

World leaders have pledged to ensure that IMF resources remain adequate, even if the crisis ends up deeper or longer than anticipated. The G-20 leaders have agreed to triple the IMF's lending capacity to an unprecedented $750 billion and to at least double its capacity for concessional lending to low-income countries.

The G-20 has also mandated that the IMF agree on a new general allocation of Special Drawing Rights (SDRs), which would provide $250 billion in global liquidity. While this is quite small relative to overall global liquidity, it can have a sizable impact on international reserves for emerging market and low-income countries, potentially providing some additional breathing room for countercyclical macroeconomic policies.

Better and expanded surveillance

Although reform of IMF lending facilities is critical, success in contributing to crisis prevention will ultimately rest on strong surveillance. The IMF was already in the process of making important changes to its surveillance before the crisis struck, by increasing its emphasis on financial risks and their links with macroeconomic outcomes and by emphasizing cross-border spillovers. However, the crisis has clearly pointed to the need for further efforts in this area. The IMF was among the first to warn about risks to the financial sector and was ahead of the curve in its forecasts and calls for global fiscal stimulus and the cleansing of bank balance sheets. However, the IMF did not fully anticipate the depth of the crisis and underestimated the strength of domestic and international linkages. Moreover, the warnings were not loud enough, and were often ignored by policymakers. The IMF is learning from this experience and taking a number of steps to increase the effectiveness and scope of its bilateral and multilateral surveillance:

- A key initiative, in response to a request from both the International Monetary and Financial Committee and the G-20, is the ***development of an Early Warning Exercise***, in collaboration with the Financial Stability Board (FSB). This initiative, envisaged as a twice-yearly exercise, is an effort to take a more systematic view of tail risks and global interlinkages, which, ultimately, should lead to earlier and better policy responses to those risks. The first full presentation to members of this exercise will take place at the IMF–World Bank Annual Meetings in Istanbul this October.
- ***The IMF is strengthening its Financial Sector Assessment Programs***, focusing more closely on cross-border and systemic issues and integrating more closely with bilateral surveillance.
- G-20 leaders have also asked the IMF to assess regularly the actions required and taken by countries in dealing with the crisis. In this context, ***the IMF has begun publishing a G-20 Fiscal Monitor***, which tracks the implementation of fiscal stimulus by countries and will monitor, together with the FSB and other international bodies, implementation of commitments made by G-20 leaders on financial oversight.
- The IMF has also been tasked with monitoring ***implementation of regulatory and supervisory reforms*** agreed under the FSB and other standard-setting bodies.

It is important to emphasize that effective surveillance is a two-way street, with countries being open to the IMF's views and policy recommendations. In this regard, the crisis may be having a salutary effect: the G-20 countries, for instance, have made a commitment to candor and evenhandedness under IMF surveillance.

Reformed governance

For the IMF to be fully effective in its new role, it must be perceived as representing all countries in a fair manner. With that in mind, governance reform is being accelerated to ensure a decision-making structure that reflects current global realities. Completion of a second round of quota reform is scheduled for January 2011 at the latest, and emerging and low-income countries will be given a greater say in this reform. This is an important development, but the significance of quotas should not be overstated: dynamic emerging market countries already are serious global players, and their voice in the policy debate is increasingly heeded. Quota increases will, to this extent, simply reflect a reality that is already here.

What next?

Global efforts have been focused largely on the crisis at hand, but the reforms in progress are aimed equally at the postcrisis world. It is surely too much to ask that any set of institutional changes eliminate business cycles or periods of financial sector stress. Moreover, economic and financial sector policies inevitably will remain primarily the business of national governments. Nevertheless, it is not unreasonable to hope that the ongoing changes to the global financial architecture—including to the IMF—can reduce the frequency and depth of future crises. If that can be accomplished, we will have gone a good distance toward ensuring that the benefits of our increasingly open and integrated global economy can be preserved and extended.

What additional changes might be expected? For one, although there have been major changes in global governance in recent months, the situation remains very much in flux. The enhanced role of the G-20 represents a major expansion of the international decision-making process, but it has at least two potential weaknesses. First, a vast majority of the world's countries are excluded from the G-20: 165 members of the IMF are not represented directly in the process. And, second, the G-20 lacks a voting structure that allows difficult decisions to be reached except with overwhelming consensus. These shortcomings need to be addressed, and a new architecture might allow greater scope for joint decision making on a wider set of international economic and financial issues, with the IMF in its newly expanded role as a central player. ■

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