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Crisis Prevention and Crisis Management: the Role of the IMF

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1. It is a pleasure to be here this afternoon, to have the opportunity to speak before such a distinguished and knowledgeable audience, on so timely a topic. The crisis that began in Thailand in mid-1997 has spread beyond Asia to Russia and is now affecting countries all over the globe. As the world's finance ministers and central bank governors gather in Washington this week-end for the annual meetings of the IMF and the World Bank, the global economic crisis dominates the agenda. The current and future roles of the IMF, which has been at the center of action and controversy for over a year, will inevitably come in for close examination. Crisis prevention and crisis management are at the heart of the goals and purposes of the IMF. In this paper, I discuss the evolving role of the IMF against the background of its charter, the Articles of Agreement. Then I deal with crisis prevention and management in the context of recent world developments.

The Purposes and Role of the IMF

2. The goal of the representatives of the 44 countries who met in Bretton Woods, New Hampshire in 1944 was to rebuild the international economic system, whose collapse had contributed to the Great Depression and the outbreak of war. To this end they proposed setting up the International Monetary Fund, the World Bank, and what much later became the World Trade Organization.

3. The primary purposes of the Fund are set out in Article I of the charter, which has remained essentially unchanged over the past fifty years. They include:

- "To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems";
- To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income ...";
- "To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation";
- To assist in the establishment of a multilateral system of payments in respect of current

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transactions ... and in the elimination of foreign exchange restrictions which hamper the growth of world trade"; and

- "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

4. The world economy has prospered mightily and changed dramatically since 1944, but the approach laid out at Bretton Woods has stood the test of time. The IMF too has changed, but its original purposes remain valid on the verge of the twenty first century.

International economic cooperation

5. The Fund, with its 182 member countries, is the premier forum for international economic cooperation and consultation. Issues relating to the organization and functioning of the international system are generally discussed and where decisions are needed, decided on in the Fund -- by the Executive Board,[2] and by the Finance Ministers and Central Bank governors who constitute the Board of Governors of the Fund. Often the initiative may come from elsewhere, for example the G-7, or a member government, but it is the Fund that "provides the machinery for consultation and collaboration on international monetary problems" that is used to examine and make these suggestions operational. The Fund's highly professional staff, including 1000 economists, 450 of them with Ph.Ds, prepares the analysis that forms the basis for the discussion.

6. Almost every major international economic problem of recent years has been discussed and usually acted on (often together with other institutions, especially our Bretton Woods non-identical twin, the World Bank) by the IMF: the Mexican and Asian crises; technical and financial assistance to the economies in transition, including Russia; the debt problems of the poorest countries (in close cooperation with the World Bank); the attempt to improve international banking standards; economic assistance to Bosnia-Herzegovina; the ongoing effort, initiated following the Mexican crisis, to improve the quality and public provision of data, which has led to the Fund's Special and General Data Dissemination Standards; the unfortunately long-running problems of the Japanese economy this decade; the activities of hedge funds and their role in the Asian crisis; and the list goes on and will go on.[3]

7. Much of what the Fund does consists of *surveillance*, reporting by the staff to the Executive Board and thus to member governments on developments and problems in the

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[2] The Executive Board has 24 members, called Executive Directors, appointed by and representing the 182 member countries. Eight Executive Directors, those for the largest countries, represent only their own countries; the 16 other chairs are organized into constituencies, each representing several countries. Each country's vote is proportional to its share in the Fund, with the United States currently holding about 18 percent of the shares. A majority of 85 percent is required for most major decisions.

[3] Information about Fund activities and publications is available on the Fund's website (www.imf.org).

international economy and in individual economies. The staff's surveillance of the international economy is published, after discussion by the Board, in the semi-annual *World Economic Report* and in the annual *International Capital Markets* report. In addition, the staff reports regularly to the Board on world economic and market developments. Drawing on its continuous surveillance of the world economy, the Fund staff provides briefings on the international economy for meetings of the G-7 and other G's and organizations, including APEC.

8. Approximately once a year, the Fund staff prepares an *Article IV report* for each country, an in-depth analysis of the country's economic policies and performance. In its discussion of the paper, the Board conveys its views -- encouraging or critical -- to the policymakers of the country. Through this process, policymakers seek to encourage their colleagues in other countries to improve policies. In addition, the staff reports regularly to the Board on countries facing particular economic difficulties or whose programs with the Fund may be off track.

9. Article IV reports are not published: most member governments say they would not be willing to discuss their economic problems frankly with the Fund if the reports were to be published. However last year the Board agreed to allow countries that want to do so, to publish the Chairman's summing-up of the Board discussion. So far 40 PINs (Press Information Notices) containing the summing-up and other information on the economy, about half the number of Article IVs discussed during the period, have been published, and are available on the Fund's website. In addition, at the end of its Article IV mission to each country, the Fund staff mission presents to the government a concluding statement, summarizing its views. The concluding statement generally foreshadows the conclusions of the Article IV report. Countries may if they wish publish these concluding statements, and an increasing number are doing so. Thus, gradually, the Fund's membership is moving to make public the conclusions of the Article IV consultation, a trend that is welcomed by Fund management.

10. In recent years, especially since the 1994/95 Mexican crisis, the IMF has strengthened and broadened its surveillance, paying particular attention to, among other factors, the quality and timeliness of the data it receives from member countries, the strength of their domestic financial systems, and the sustainability of private capital inflows. By providing warnings of impending problems, Fund surveillance should help prevent crises. When it does so, when a crisis is averted, surveillance has succeeded and is unlikely to be noticed -- and there are many cases in which Fund warnings were given and action taken that averted a crisis. But surveillance may fail, either because warnings are given and not heeded, or because the problem was not anticipated.

11. In the Asian crisis, the Fund warned Thailand of an impending crisis but action was not taken. Fund staff also warned about financial sector weaknesses in several of the countries subsequently badly hit in the crisis. But we failed to foresee the virulence of the contagion effects produced by the widening crisis.

12. In drawing the lessons of this crisis, the Fund will have to seek both to make warnings more effective and to improve the quality of Fund economic forecasts, particularly of crises. On forecasts of potential crises, there should be no illusion that forecasting of this type will ever be

perfect. Some impending crises will be missed. For this reason, and because in any case not all warnings are heeded, we shall have to continue to improve our capacity to deal with crises even as we strive to improve surveillance to prevent crises.

Architecture of the international financial system

13. After every crisis, the international community reflects on what needs to be done to reduce the probability of future crises, and to ensure that crises that do occur can be handled more effectively. After the Mexican crisis the emphasis was on better provision of information to the market. Now the focus is on the architecture of the international system, specifically *crisis prevention* through the arrangements for monitoring and regulating flows of international capital, and *crisis response* to improve the system's response when a crisis occurs.

14. There is no shortage of suggestions for fixing the international financial system. I will concentrate on a few key points: the need to strengthen national banking and financial systems; mechanisms to reduce contagion; capital controls; the need to deal with the moral hazard problem; exchange rate systems; and reform of the IMF.

15. Banking system weaknesses have either caused or sharply worsened all the recent crises. Most of these weaknesses were identified in advance by the IMF, but efforts to get countries to take action before crisis struck were not successful. The development of international banking standards, the Basle *Core Principles,* is an important advance. At present we have no way of ensuring that national banking systems meet best international standards. An effort is now starting to strengthen surveillance of banking systems. But we lack enforcement mechanisms. These could for instance take the form of differential provisioning requirements against loans to different countries, depending on the standards met by their banking system (and also on standards in other areas, such as corporate accounting and information provision).

16. Second, the virulence of the recent contagion raises troubling questions. Admittedly, contagion is rarely baseless: the markets generally treat countries in better shape better than those in worse shape. Nonetheless, the fact that technical factors have contributed to the recent contagion implies that it has been excessive, and that a way has to be found to moderate such excesses. The task will fall in the first instance to financial sector regulators in the industrialized countries, who will need to ensure greater transparency of the positions being taken by international investors, and to consider whether leverage has in some cases been excessive.

17. Better information should also help increase the efficiency of international capital flows. Through the *Special Data Dissemination Standard*, the IMF is encouraging countries to move toward greater transparency. It will be necessary to strengthen the standard, for instance by providing more timely data on foreign reserves and complete data on forward transactions by central banks. We also need better and more timely data on short term debt, an area in which the Bank for International Settlements is working hard.

18. Third, Malaysia's decision to impose controls on capital outflows, and support by some academics, raise the question of whether these controls will once again become widespread. The IMF's position has been that capital account liberalization should be undertaken in an orderly way: countries that have controls on outflows should lift them gradually as the balance of payments strengthens; liberalization of inflows should start at the long end and move gradually to the short end as the banking and financial systems, and macroeconomic balances, are strengthened. The IMF has not opposed Chilean-style, market-based measures to regulate capital inflows at the short end, but we recognize that they need to be considered on a case-by-case basis, and that Chile has recently eased its controls.

19. Long experience shows that whatever short-term benefits controls on outflows may produce are likely to be outweighed by their long-term disadvantages, as they encourage domestic evasion and capital flight, and discourage foreign investors. Following Malaysia's imposition of controls, other Asian countries firmly rejected them, as have Latin American countries. We should though recognize that the appeal of cutting the country off from the international system, will increase unless international financial turbulence declines.

20. Fourth, we need to address the moral hazard issue. It is hard to see evidence of moral hazard on the side of policymakers. All the evidence is that countries do their best to avoid going to the Fund. Nor have individual policymakers whose countries end in trouble generally survived politically. The thornier issues arise on the side of investors. Economists tend to point to investors taking excessively risky positions in the presence of an IMF safety net; others are more concerned that some investors who should have paid a penalty may be bailed out by Fund lending. These concerns should be mitigated by the facts that most investors in the Asian crisis countries, and investors in Russia who bet on the so-called moral hazard play, have taken very heavy losses.

21. Nonetheless, we still need to find ways of balancing valid concerns over moral hazard with the costs for the system of exacerbating instability by failing to assist countries in need. This issue is closely tied to the question of how to bail in the private sector, in ways that minimize contagion. The IMF will be examining this issue in the months ahead, drawing on a forthcoming report by a G-22 working group. One promising possibility is the type of contingent financing that has been arranged by Argentina and Mexico.

22. Fifth, we will need once again to appraise the choice of exchange rate systems for emerging market countries. (Although many would put a target zone scheme among the major currencies high on the reform agenda, that is not likely in the next few years.) The recent crises have all taken place in countries that had fixed or semi-fixed exchange rates. Yet several countries, including Argentina, have benefitted from having a fixed rate; and currency crises are quite possible in countries with flexible rates. The argument has been made that there are ultimately only two stable exchange rate systems: a freely floating rate; or the adoption of another country's currency. With the expected success of EMU, we may see more currency blocs developing -- and a key to their success will be banking system regulation. In the meantime, we are in an uncomfortable in-between world in which floating rates are sometimes excessively volatile and fixed rates sometimes too vulnerable to attack.

23. And sixth, reforms are needed at the IMF. Many of the architectural changes will affect the role of the Fund. There is also general support in the industrialized countries for more transparency in Fund operations. The management of the Fund supports greater transparency, and there has been a great deal of progress in that direction in recent years, as a visit to the Fund's website (www.imf.org) will show. More can be done, but only with the support of the membership, some of whom fear they are far more vulnerable to Fund criticisms than are the industrialized countries.

24. It is sometimes argued that the Fund is not accountable. That is not true. The Fund is fully accountable to its membership, through the 24-member Executive Board which represents the 182 member countries. No Fund loan or decision of any importance takes place without the approval of the Board. Overall Fund policies are set by the 24-member Interim Committee, made up of finance ministers and central bank governors, which meets twice a year. Most of the complaints about accountability turn out to relate more to transparency -- if more details of Fund operations were published, there would be more room for their appraisal by academics and others. That would be to the good.

Immediate Steps

25. While work on the international financial architecture gets under way to deal better with the next crisis, we need to focus on containing the present crisis. There are four main steps. First, as the balance of risks in the international economy has shifted, so should and has the likely stance of monetary policy in the United States and Europe, on whose continuing growth the world economy now depends. The cut in the Federal funds rate earlier this week is welcome news indeed. It is also good news that European central bankers have indicated that other European rates will converge to the low levels of France and Germany rather than meet in the middle.

26. Second, while Japan has played a constructive role in providing financial assistance in Asia, its recession is a continuing problem not only for Japan but also for other countries. Rapid action on the banking sector, and further fiscal stimulus would go a long way to help Japan and the rest of Asia recover from the crisis.

27. Third, the key to stopping the further spread of the crisis is Latin America, and within Latin America it is Brazil. Latin American countries have made real progress in structural reforms in this decade. They have generally reacted courageously and appropriately to recent financial pressures by tightening monetary and fiscal policies. President Cardoso in his speech last week sent a clear signal that he will take fiscal action after the election. Countries willing to help themselves, willing to play by the rules, deserve the support of the international community if they need it. The IMF will do what it can, within the limits of available funding.

28. Fourth, the world economy is at a critical point. If this crisis is not arrested in Latin America, we will face even larger problems. For the IMF to do its part, it will need the support of its member governments--in particular, the quota increase is vital.