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A South Centre report argues that the IMF should focus on crisis prevention not crisis lending

This is based on the South Centre report on "Why the IMF and the International Monetary System Need More than Cosmetic Reform"

In its website under the rubric "About the IMF", the Fund defines its main purpose as the provision of "the global public good of financial stability". As spelled out in its Articles of Agreement, this calls for a stable system of exchange rates, sustainable current account balances and orderly currency and balance-of-payments adjustments. The Fund undertakes economic and financial surveillance at the national and global levels and provides policy advice to its members in order to prevent instability and crises and lends to those facing external payment difficulties in order to facilitate adjustment.

IMF's Poor Record in Crisis Prevention

The record of the IMF in preventing financial instability and crises leaves much to be desired. The period since the breakdown of the Bretton Woods arrangements has seen repeated gyrations in exchange rates of major currencies, persistent and growing trade imbalances, recurrent balance-of-payments, debt and financial crises with global repercussions in both emerging and mature economies. The IMF has been unable to cope with misguided macroeconomic, exchange rate and financial policies in countries with disproportionately large influence on global monetary and financial conditions as well as autonomous destabilizing impulses generated by financial markets and international capital flows unleashed by rapid and widespread liberalization.

A reason for this poor performance in preventing financial instability and crises is that the Fund has no teeth vis-à-vis its non-borrowing members. It has little leverage not only over policies in reserve-issuing countries, but also in others enjoying surges in capital flows, including developing and emerging economies (DEEs), since these countries rarely need the Fund at such times of bliss when the seeds of instability are often sown. While the Fund is charged to exercise firm surveillance over the policies of its members having a strong influence on stability and sustainability of exchange rates and external payments, its members' obligations are superfluous and non-binding and the Fund has no power of enforcement. For non-borrowing countries, the IMF is a "voluntary institution", as remarked by the IMF representative during a UN Working Group panel on 26 May 2010 on the reform of the financial architecture.

But, more importantly, the IMF has generally been unable to identify the build-up of financial fragilities, predict instability and crises and issue early warnings in large part because of its blind faith in markets. In the sub-prime turmoil, it has missed the biggest crisis of its lifetime. It has almost constantly failed to warn developing countries against destabilizing capital flows, unsustainable exchange rates, payments and debt positions.

Since the mid-1990s several countries working under IMF programs and drawing on its resources confronted severe instability and crises and in some important cases, such as Russia and Argentina, sovereign default could not be avoided. IMF's debt sustainability analyses and recommendations have left many poor countries in disarray when they fell into debt distress after being told that their external debt had reached a sustainable position and they no longer needed debt relief from official creditors.

IMF's Increasing Role in Crisis Management and Lending

The more the IMF has failed to prevent instability and crises, the more it has become involved in crisis management and lending. Indeed, with increased frequency of financial crises with global repercussions, crisis intervention and lending has become the primary activity of the Fund so much so that at times of calm when drawing on IMF's resources ceased, as was the case during the great global bubble of 2003-08, its financial viability came to be questioned. After every major financial crisis, the IMF has sought a new role and this has almost always been construed in terms of expansion of its emergency lending instruments and capacity. The current crisis is no exception – it has given rise to new facilities for crisis lending and the tripling of IMF resources.

IMF emergency lending is said to play two main roles. On the one hand, it is claimed to provide breathing space to countries facing severe liquidity problems and payments crises, allowing them more time to adjust and helping restore confidence. On the other hand, for countries with "strong and sound policies and fundamentals", rapid access to adequate and upfront financing is expected to play a preventive role, particularly under threats of spillovers and contagion from financial instability originating elsewhere in the global system. Moreover, quasi-automatic access to adequate IMF financing is expected to diminish the need for self-insurance in international reserves and the associated costs and trade imbalances.

Problems with IMF's Lending Policies

However, the evidence shows that Fund lending rarely prevent economic downturn in countries facing payments instability and crises. By contrast, such lending is often associated with pro-cyclical policy conditionality which serves to deepen the impact of the financial crises on jobs and income. This is still the case with the IMF programs with European countries despite the improvements claimed.

But more importantly, emergency lending could create more problems than it solves. When the scale is large, it can endanger the financial integrity of the IMF. It is not always easy to determine if a crisis is one of liquidity rather than insolvency. Argentina and Russia ended up in default while receiving IMF support on grounds that they were facing liquidity crises, and there is no guarantee that Greece will now be able to avoid default. Since the IMF does not enjoy *de jure* preferred creditor status, when the scale of operations is large, it can get badly hurt in the event of a messy default and asset grab race by creditors.

Unequal Burden Sharing Between Creditors and Debtors

Since the IMF crisis lending is effectively designed to keep countries current on debt payments to international creditors and to maintain an open capital account, it often leads to an unequal burden-sharing between creditors and debtors. Commercial debt gets replaced by debt to the IMF which is often more difficult to renegotiate. Private debt gets dumped on the public sector – sovereign debt invariably rises after financial crises resulting from excessive build up of debt by the private sector. All these create moral hazard and prevent the operation of market discipline, because they allow investors and creditors to escape without bearing the full consequences of the risks they have undertaken.

IMF's Main Task Should Be Crisis Prevention

Because of the problems posed by bailout operations, the primary task of the Fund should be crisis prevention rather than crisis lending. This calls for a significant improvement in the quality of the Fund's financial and economic surveillance. It also calls for a reform of its members' obligations so as to bring about a reasonable degree of multilateral discipline over macroeconomic, exchange rate and financial policies to its creditors. The rationale for multilateral discipline is much stronger in money and finance than in any other area of global economic interdependence, including trade, since adverse external spillovers from monetary and financial policies in systemically important countries tend to be much more damaging.

Orderly Debt Workout Mechanism Is Urgently Needed

But even with radical reforms in these areas, financial crises with global ramifications will continue to occur. Emergency lending is not the only and even the best way of dealing with them. Orderly debt work-out procedures based on widely recognized principles of insolvency designed to secure the involvement of private lenders and investors in crisis resolution are both more equitable between debtors and creditors and between private and official lenders, and more effective from the point of view of their impact on the behaviour of lenders and investors and, hence, on financial stability.

It is quite astounding that the international community has been unwilling to put in place such mechanisms despite rapidly growing international debtor-creditor relationships, still continuing to address sovereign debt crises in an *ad hoc* manner.

Reform of IMF and Global Monetary System: The Key Issues

The South Centre report takes up these issues in the reform of the IMF and the international monetary system. It starts by examining the record of the IMF in early warning and crisis prevention and makes an assessment of whether its recent attempts for soul searching in financial market analysis and policy advice constitute a break from market fundamentalism – the so-called Washington Consensus.

This is followed by a discussion of the main difficulties encountered in securing effective and even-handed surveillance and multilateral discipline over macroeconomic, exchange rates and financial policies of IMF members and possible modifications to existing modalities and obligations. Possible benefits of independent surveillance are assessed and the scope for binding obligations regarding exchange rates and balance-of -payments adjustment are examined. It is argued that not only should IMF members retain the right to exercise control over capital flows, but the Fund should encourage them to do so when and as needed, through its lending programs and Article IV consultations.

The report then looks at the instability of the international reserves system based on the dollar and discusses possible alternatives, notably the role that could be played by the Special Drawing Rights (SDRs). It is argued that a move away from the dollar-based reserves system towards SDRs would help reduce trade imbalances and improve international monetary stability by providing a certain degree of policy discipline to the US. It would also help DEEs, *inter alia*, by reducing the need for self insurance and the associated costs.

The report then discusses crisis intervention by the IMF, its objectives and impact on financial stability. It is argued that if instability and crises cannot be prevented, it would be better to respond to them by combining mandatory mechanisms to involve private creditors and investors in crisis resolution with emergency lending designed to maintain a high level of income and employment than by large scale lending to bail them out. This is one of the most important ingredients of the reforms needed to strengthen the capacity and competence of the IMF in crisis prevention. Otherwise, the IMF may increasingly become a quasi-international lender-of-last-resort without the requisite capacity and power of oversight and this will likely do more harm than good.

The report concludes that the international monetary system needs to be restored with the primary objective of preventing instability and crises and the missing components should now be evident. A genuine reform requires considerable reflection and debate in the international community in search of viable and effective solutions. It also presupposes recognition of the problems.

However, some of the most important issues such as enforceable exchange rate and adjustment obligations, the international reserves system and orderly sovereign debt workout mechanisms are not squarely on the agenda of the G20 and the IMF.

Developing countries have a particular stake in this endeavour given their vulnerability and limited capacity to respond to shocks. If major countries do not support the establishment of an orderly and equitable international monetary and financial system, developing countries should find ways and means of protecting themselves and looking after their interests through regional mechanisms.

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