

How to equip the IMF for the crises of our time

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After each major financial crisis, from Latin America in the 1980s to Asia in the late 1990s, the International Monetary Fund experienced several reforms aimed at strengthening its ability to deal with the new challenges. The most recent crisis in advanced economies, in particular Europe, does not yet seem to have triggered a comparable movement for reform. The main discussions so far have been focused on the need to increase the IMF's financial resources and to reduce the conditionality for more rapid access to IMF financing. While these are certainly important issues, they may not be sufficient to equip the IMF better to restore stability in the current financial environment. This is especially significant in the face of shocks at the core of the system.

Recent events have shown that crises in advanced economies may develop in very different ways from those of past crises in developing or emerging economies. This suggests that the options available to the IMF may need to be rethought and updated, from several perspectives.

First, the time horizon of standard IMF programmes appears to be too short. As a rule, IMF funding is provided for three years, on the assumption that in the meantime existing imbalances will be corrected and access to capital markets fully restored. While this may be the case for small open economies with flexible exchange rates, recent experience suggests that more time can be required to implement a sustainable adjustment, especially for countries that are members of a monetary union and have accumulated large external deficits.

Second, and related to the above, the practice of taking countries in IMF programmes away from the markets for a few years and funding them entirely with official financing may not be appropriate for developed economies. The experience in Greece and now in Portugal shows that using all available official financing at the start of the programme may help solve the short-term liquidity problems but tends to raise doubts in the markets about countries' ability to stand on their own feet at the end of their IMF programme – especially if the imbalances have not been sufficiently reduced. The fear that at that point no additional financing would be available raises the risk of debt restructuring and discourages private market participants through self-fulfilling expectations.

Third, recent experience has shown that the conditions in advanced economies' programmes should include details of the specific structural policies that will be necessary to ensure the sustainability of the macroeconomic adjustment. As the Irish experience has shown, a thorough restructuring of the banking system is often a precondition for restoring market access over time. Given that these policies are often politically difficult to achieve, and are more prone to reform fatigue if they are spread over time, they need to be frontloaded and subject to rigorous monitoring. Fourth, debt restructuring in advanced economies has much more damaging effects than in developing countries. The impact on the countries themselves is greater, as a large part of the debt is held by residents and the contagion to the global financial system can be disruptive. On the other hand, advanced economies generally have substantial public and private wealth. Debt restructuring should thus be a last resort and avoided as far as possible, in particular by inserting in the conditions of the programme specific measures aimed at selling available assets and using the proceeds to reduce the debt.

Finally, the preferred creditor status of the IMF and other official creditors seems to have generated destabilising effects in financial markets, as the impact on private creditors of a possible debt restructuring tends to become larger the greater the size of the official financing. The special status of IMF finances has certainly been an important factor in ensuring that it receives sufficient resources from its shareholders. But in the current environment such a privileged status may

weaken the catalytic role of IMF resources and delay the return of programme countries to market financing. It may also weaken the incentives for stricter surveillance.

These are only a few examples of the many issues that the recent European crisis has brought to the fore. They are not easy to solve. But it is in the interest of the IMF, and its major shareholders, that they are effectively addressed in order to restore stability and improve the resilience of the international financial system.

Deep thinking and strong leadership are urgently required. In the old days this was provided by the Group of Seven leading economies. But since this forum decided to dissolve, and the G20 is not yet an adequate successor, the world seems dangerously without guidance. Not the best position to be in the midst of a financial crisis.

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