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The IMF and the International Monetary System: Lessons from the Crisis

Final Version

As Prepared for Delivery

1. Introduction

Ladies and gentlemen

First, I would like to thank you for the invitation. It is a great pleasure for me to deliver today's Per Jacobsson lecture. And it is also a special honour as I am the first German to deliver the lecture since Karl Otto Pöhl's appearance in 1992. He was also a former president of the Bundesbank at that time and he talked about "a new monetary order for Europe" – a subject that has recently gained new relevance, as you all know. In my view, it would indeed be necessary to come up with a new foundation for the European Monetary Union – either by significantly strengthening the current system of fiscal controls or by making a big step towards a closer political and economic union.

This, however, is not the subject that I have chosen for today's lecture. Given the fact that this lecture is dedicated to Per Jacobsson, the long-standing Chairman of the Board and Managing Director of the IMF, I would like to focus on global issues. Among the pressing issues at this level are imbalances that are reflected by diverging current account positions. This problem is also high on the agenda of the G20 framework to achieve strong, sustainable and balanced growth. At a more analytical level, the central mechanisms to reduce the imbalances are provided by the international monetary system. Thus, I would like to present my view on some of the relevant issues such as the current state of the international monetary system, the IMF's role within it and some proposals for reform that are currently being discussed.

2. The financial crisis as a catalyst for change

The international monetary system has always been the subject of not only intense discussions but also of profound change. Prior to World War I, capital flowed freely and the gold standard guaranteed stable exchange rates. Following the war, however, chaos emerged and led to a period of extensive capital controls that lasted until the beginning of World War II. Immediately after the war, a global system of fixed exchange rates was installed – the Bretton Woods System. It is here that the IMF makes its first appearance as a central institution of the international monetary system. Nevertheless, in 1973 the Bretton Woods System collapsed and the international monetary system changed its structure once more. The new system was based on three floating currencies, namely the US-$, the DM and the yen. Together with a liberalisation of capital flows, this arrangement guaranteed quasi-automatic adjustments of current account imbalances. As the IMF had been designed to assist countries with current account deficits, its role came under discussion. It subsequently regained some importance during the Latin American crises in the 1980s and the emerging market crises in the 1990s. Nevertheless, when the great moderation set in, the IMF, faced with demands to reduce its size, was in danger of losing its significance.

Then another crisis hit – a global financial crisis, followed by a sharp economic downturn. Given the severity of the crisis, we have to ask ourselves: has it brought us to a new crossroads in the evolution of the international monetary system and what are the implications for the IMF? What the crisis most certainly did do was to alter the external circumstances. First and foremost, it revealed a development that could be termed as a "globalisation of crises". This is relevant at two levels. First, it became apparent that an initially national crisis might very quickly assume a global character by spreading through closely linked financial systems. Second, the global financial system and the global real economy are so intertwined that a financial crisis can severely affect the real economy in both emerging and advanced economies. And regarding the relation between emerging and advanced economies, it is obvious that economic weights have shifted. Emerging economies acted as an important stabiliser at the height of the crisis, whereas major advanced economies are now facing a rather modest outlook for growth. At the same time, they no longer enjoy the status of doubt-free solvency.

What do these developments imply with regard to the role of the IMF? First of all, the crisis emphasised that the IMF is an indispensable global institution. It played a crucial role in fighting the financial crisis at a global level but also with regard to the sovereign debt crisis in Europe. Regarding the latter case, the decision to involve the IMF was correct, even though this step was preceded by intense discussions. Furthermore, the analytical input provided by the IMF is essential for increasing the resilience of the global economy to future crises. This is perhaps most obvious in the case of the G20 Framework for Growth where the Mutual Assessment Process benefits immensely from the IMF's expertise in high-quality cross-country analysis. However, it has to be acknowledged that the current crisis has not been a random event but can be traced back to specific causes such as inadequate institutional arrangements or mistakes made by market participants and policymakers alike. Thus, the ultimate objective should be to tackle the roots of the crisis instead of just creating ever more instruments to fight the symptoms. Against this backdrop, any attempt to enhance the IMF's capacity for crisis management has to be thoroughly assessed in terms of costs and benefits. I would like to elaborate on this point with regard to two key features of the international monetary system: the supply of international liquidity and the issue of exchange rate and capital flow regimes. Both features are part of the current debate: the first in the context of global financial safety nets and the second in the context of capital flow management. Let us begin with a few thoughts on global financial safety nets, a subject that is of direct relevance for the IMF.

3. *Global Financial Safety Nets*

A core problem during the financial crisis was that money markets literally dried up and were no longer able to provide international liquidity. This particularly affected banks with foreign currency needs because banks usually do not have access to refinancing operations in foreign jurisdictions. Thus, they are dependent on the money market to obtain foreign currency funding. To counter this liquidity squeeze, central banks introduced ad hoc swap lines with other central banks as an emergency measure. The objective was to provide each other with the capacity to deliver foreign currency funding to the national banking systems. These measures proved to be successful in securing the supply of international liquidity.

At present, there are discussions as to whether the ad hoc swap lines should be replaced with a more permanent mechanism in which the IMF would play a central role. Leaving aside the details, such a mechanism would, in essence, enable the IMF to provide almost unlimited liquidity support without adequate conditionality or pricing. Taking this as a starting point, I would like to raise some objections to such an institutionalised financial safety net. Enabling the IMF to offer quasi-unlimited amounts of short-term liquidity would implicitly require a pre-commitment from central banks to cover the potential financing needs of the IMF in times of stress. However, to me, such a commitment seems undesirable and unrealistic, not least considering the resulting unwarranted interference with members' monetary policy as well as moral hazard issues.

Central banks' reaction to the systemic crisis has been swift, adequate and well coordinated. This flexible "case–by-case" approach has substantial merits: due to the resulting constructive ambiguity, agents cannot expect to be bailed out in any case. This in turn reduces incentives for risky behaviour. Also, the IMF is not a world central bank and not a lender of last resort. It cannot – and should not – be a "hub" for central bank swap lines. In those cases where central banks do not provide swap lines in a systemic crisis, the IMF is well placed with its existing instruments to cover liquidity needs while staying within its resource envelope.

More fundamentally, the main lesson of the financial crisis is that we need a better regulated financial market environment. This would be a *true* safety net for our societies and the international system.

In the same vein, the argument can be transferred to the financing side of the IMF. The idea of granting the IMF the option to issue SDR bonds to raise funds on capital markets is currently being discussed. This would replace the provision of foreign reserves via quota subscriptions. Such a step would, however, completely change the cooperative and monetary character of the IMF: the cooperative exchange of foreign reserves on a short-term basis – establishing the IMF's unique character as a monetary institution – would be lost. In that case, it would only be logical for central banks to withdraw from the IMF's financing mechanism altogether and leave the financial responsibility with the ministries of finance – just as it is the case for the World Bank. Introducing SDR bonds would – under current proposals – also extend the IMF's lending capacity further since there would be virtually no funding limits anymore, but member countries would in fact guarantee the amounts raised by bond issuance. We could end up with an IMF that works like a hedge fund which leverages its quota resources with large amounts of additional debt. At the same time, adjustment efforts in countries borrowing from the IMF could be impaired given the quasi-unlimited availability of Fund resources.

From a practical perspective, generating a secondary market for SDR bonds of sufficient critical mass liquidity would require substantial new SDR allocations and the use of SDRs – not only in the official but also in the private sector. This would influence global liquidity conditions and even interfere with the monetary policy of those central banks that issue the major reserve currencies. The IMF could also distort the risk assessment in international financial markets: it would pay the risk-free interest rate to finance itself and, as has been suggested by some commentators, invest those resources in risky assets of crisis countries. This would lower the refinancing costs of the countries in question. Unless balanced by strict *ex-post* conditionality, this would further undermine the principles of sound incentives necessary for a stable international system.

To sum up, the objective of making the international financial system more stable is welcome and the IMF's contribution to this end is appreciated. However, to me it seems questionable whether a "structured", i.e. standardised approach to global financial safety nets makes sense compared with a more flexible case-by-case approach, which has proven very effective in the recent crisis. I am also not convinced of the need to again change facilities, which have only recently been introduced and already modified, or to invent ever more IMF facilities. In particular, I would not like quasi-unlimited and unconditional IMF "short-term liquidity lines" which would *de facto* rely on access to reserve currency central banks on demand to have any market credibility. For me, it is hard to imagine subsuming independent central banks under IMF crisis management coordination. Every crisis is different and needs different crisis managers.

4. Management of capital flows

Disruptions in the supply of international liquidity were undoubtedly a serious problem during the crisis. Recently, however, another aspect of the international monetary system has drawn some attention: capital flows. In the wake of the crisis, some emerging markets have experienced very high inflows of foreign capital. These inflows not only bear the threat of sudden reversals but might also contribute to the build-up of unsustainable bubbles.

Consequently, leaders of the G20 called for national, regional and multilateral responses to limit the risks associated with excessive volatility in international capital flows. The management of these flows plays a crucial role in the current G20 work programme on the International Monetary System. To be sure, the main objective of capital flow management is to enhance national and global financial stability. As long as stability is ensured, free movement of capital should remain the ultimate objective.

However, in circumstances of high and volatile capital flows, it is also clear that countries need room for manoeuvre to formulate their own policy mix against the background of country-specific circumstances in order to enhance financial stability. At the global level, it would be helpful in this regard to have a common understanding about the aims, benefits and limitations of an active capital flow management. This understanding should recognise that capital flow management measures should never be used to buttress unsustainable or distortionary policies and thus delay necessary adjustments in the economy. Capital flow measures should therefore never substitute sound monetary, fiscal or other regulatory policies, but rather be used in extreme situations to add to their effectiveness in the pursuit of stability. In addition, whenever capital flow measures are applied, they should be predictable, temporary, reversible, targeted and transparent.

What could the IMF's role be with regard to capital flow management? In close cooperation with the Bank for International Settlements, the IMF should play an enhanced role in the global monitoring of capital flows. In close cooperation with other relevant financial institutions, it should prioritise closing data gaps on global capital flows. While its members can benefit substantially from the technical expertise of the Fund in advising appropriate policy responses to volatile capital flows, the Fund's role can hardly go any further than that. It is hard to imagine that it is either feasible or desirable for the IMF to assume the role of an “umpire” over capital flows.

5. Conclusion

To wrap up my speech, let me summarise the main points. The current crisis has been devastating and it is most certainly warranted to have the necessary instruments to manage such a crisis. In my view, recent experience shows that this is already the case. The liquidity squeeze has been effectively managed with the existing set of instruments. There is no demand and no need for the IMF to act as a world central bank or as a global lender of last resort. The IMF’s principal strengths and role in the international division of labour is undoubtedly its analytical capacity which is ever more important to serve as an input to international crisis prevention and crisis management.

Regarding the organisation of the international monetary system in general, the first observation is that it has largely remained robust during the crisis. However, large internal and external imbalances exist and have to be addressed. This is a problem with global ramifications which requires a cooperative approach at the global level. Consequently, the G20 has introduced a framework to achieve strong, sustainable and balanced growth. In the current challenging phase, it is even more important that individual economies contribute to global stability. Some economies with large current account surpluses, such as China, have to remove structural deficiencies that limit internal demand. At the same time, they have to grant their currencies more flexibility and work towards full convertibility. Countries with large current account deficits should consolidate their public finances as quickly as possible. But even countries with balanced current accounts can contribute to global stability. A case in point is the European Monetary Union. Here, a swift and sustainable solution for the sovereign debt crisis would be beneficial not only at the national or regional but also at the international level. We are faced with global challenges that require a global response to which all of us have to contribute.