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Reestablishing stability : the role of the International Financial Institutions

I believe the title of the panel might be somewhat misleading. If one considers the IMF as the major IFIs concerned by financial stability, one has to recognize that, well before the present crisis erupted in August 2007, multilateral surveillance has been obviously deficient.

'Establishing' stability is therefore the real issue at stake. And past failures in this regard make the task daunting.

I shall divide my remarks in two sections :

1. The IMF and macroeconomic imbalances
2. The IMF and financial stability.

I – The IMF and macroeconomic imbalances

1. During the 15 or 20 first years of Bretton Woods,

the international monetary system worked reasonably well. The freedom of current payments was gradually established, thus helping the opening up of the trade markets. Weak currency countries had to adjust their economic policies in order to comply with the discipline of the 'fixed but adjustable' par value system closely monitored by the Fund. And the U.S. -whose currency was convertible in gold- kept its current account in surplus, while it exported large amounts of direct capital to provide the needed liquidity to the rest of the world.

2. But in the mid 60's things started to derail

and the system got entrenched into large imbalances financed by larger and larger capital flows. The sizeable current account and fiscal deficits in the U.S. -linked in part to the Vietnam war- led to systematic borrowing and the constitution of large dollar balances. We know the story too well : no real pressure was exerted by the IMF on the fiscal policy of the U.S. And, as the dollar was considered as the anchor of the system (because no one dared to revalue gold), it became uncompetitive and eventually broke its link with gold and devalued in 1971-72. It floated like many other currencies from 1973 onwards.

3. Did the floating exchange rate system contribute to a better financial stability ?

Unfortunately the answer is far from being an emphatic yes. In fact, the floating regime introduced a great deal of flexibility in the markets but it also facilitated lax fiscal and monetary policies, while it did not eliminate the problem of large and structural current imbalances. The inflationary crisis of the 70's reached extreme limits and was eventually curbed -not by the IMF's influence- but by a reversal of monetary policy in the U.S. in the early 80's. The last 10 years are perhaps the manifestation of the most intractable imbalances we ever observed. The U.S. installed itself in a systematic borrowing position (with huge deficits financed by the surpluses of a number of emerging countries and of Japan which in general pegged their currencies to the dollar). Did the IMF really influence the main actors of the system by prodding the U.S. into more reasonable household savings and the emerging countries into more domestic spending and more flexible exchange rates in order to avoid structural undervalued currencies ? The answer is unfortunately : No. Not because of incompetence or lack of vision but because major powers were not ready to subject their own policies to multilateral pressure.

II – The IMF and international financial stability

1. The derailing of the exchange rate system

(i.e. systematic depreciation of currencies in countries that are running structural current account surpluses) has contributed significantly to the emergence of the present crisis. The accumulation of reserves in emerging countries (about 3.5 trillion dollars against less than 1 trillion in 2000) has been a direct cause of the growth in global liquidity. Combined with lax monetary policies and extremely low interest rates, this process has facilitated the extension of imprudent risk taking with too low risk premia.

2. How could the IMF contribute to more financial stability ?

a) First of all, by being allowed to exercise symetrically (both on creditors and debtors) its full role in terms of macroeconomic surveillance (including, of course, monetary policy).
b) Secondly, by helping the well run emerging countries, through appropriate short term financial facilities, to face some of the consequences of the present credit crunch. The IMF has already been reactive in this field. It might have to think of other ways (major borrowing arrangements with surplus countries, SDR allocations…).
c) Thirdly, by participating in the 'new financial regulatory and surveillance system' that, I believe, is called for.

Because financial institutions are more and more global (and large), it would make a lot of sense to establish a more coordinated system of regulation and supervision. This is not to say that the IMF should become the 'standard setter' of this new architecture. I do not think it has the experience, the technical ability and the closeness with central banks to perform such a task. The major missions of such a global oversight system should be twofold : a 'standard setting' role (aiming at a coherent set of regulations internationally), as well as a 'macroprudential role' (i.e. detecting emerging systemic problems in the day to day functioning and evolution of the financial system as far as systemically important global banks are concerned).

I believe these tasks would be best performed by central banks and supervisors under the aegis of the BIS and Financial Stability Forum). This 'college' or 'council' should include all the relevant systemically important countries (i.e. China, India, Brazil, Mexico, Switzerland, Spain…). I also believe that the work and the findings of this new entity (that should, in my view, be established by a treaty or at least a binding MOU) should report periodically (once or twice a year) to a political body (inspired from the G20 and the IMFC), lest cooperation would fade away into meaningless talks.

The IMF should play, for its part, an essential role in this construction :

- it would contribute to the intellectual framework combining economic and macro financial factors ;

- it would be able –through the article IV process- to survey the implementation of the measures decided or envisaged at the global level (thus the need to integrate financial regulation in article IV consultations).

But for this to happen, one essential condition should be met : political will from all major actors (in this respect a more consistent and updated quota framework that would put at their true ranking large emerging countries could help).

This may seem to many as being too bold and somewhat naïve : but, given the extreme gravity of the present crisis, I wonder if this type of ‘new order’ is not becoming a ‘realistic’ proposal.

The difficulty of this exercise is not to ‘recreate’ abruptly an ideal equilibrium (this could entail dangerous procyclical effects), but to move gradually towards a better and more balanced functioning of the international monetary system.