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Working Paper — Digitized Version

The future of the IMF: how to prevent the next global financial crisis

Kiel Working Paper, No. 870

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Suggested Citation: Siebert, Horst (1998) : The future of the IMF: how to prevent the next global financial crisis, Kiel Working Paper, No. 870, Kiel Institute of World Economics (IfW), Kiel

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Kieler Arbeitspapiere

Kiel Working Papers

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THE FUTURE OF THE IMF — HOW TO PREVENT THE NEXT
GLOBAL FINANCIAL CRISIS

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ISSN 0342 - 0787

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Abstract

The paper analyzes how the next financial crisis can be prevented and which role the IMF should play. The paper distinguishes between the improvement of existing instruments and solving the moral hazard problem. Both issues are interrelated. The size of operation of the IMF creates a moral hazard problem. The IMF should credibly announce the ex-post rules for bridging a liquidity gap in order to set the right ex-ante incentives for the behavior of debtors and creditors. An institutional design for dealing with private and sovereign debt analogous to national bankruptcy rules has to be developed.

The IMF has not prevented the Mexican crisis, the IMF has not prevented the Asian crisis, so what can be done to prevent the next crisis? How can we prevent the next financial hurricane in the world economy?

1. Improving the given instruments

1. One line of attack is to improve the instruments being used. A first approach is a better national bank regulation. This must be done in the individual countries, but internationally defined minimum standards, such as the Basle Core Principles for Effective Banking Supervision, should be applied, one of them specifying capital adequacy requirements (Basle Capital Accord).¹ Information must be made available on whether international standards are actually implemented. It is also recommendable to introduce some national safety nets for groups of national or subnational banks where the safety net is able to absorb a financial crisis of an individual bank (or of some banks) and stop a bank run from beginning and from spreading. Take as an example the Deposit Insurance Fund (Einlagensicherungsfonds) of the private commercial banks in Germany.

2. A second point is to introduce more transparency. The following aspects are relevant:

— What type of data do we need? Apparently, it is difficult to distinguish a bubble in the financial markets from a healthy economic environment in which a capital inflow finances efficient capital accumulation. What are potential clues that a situation is not sustainable? A potential warning signal is a negative current account, if capital imports are used for consumption

Statement at the IMF-Bundesbank Symposium "The Role of the IMF in the Global Economy", July 2, 1998, Frankfurt.

* I appreciate critical comments from Rainer Schweickert.

¹ "... the target ratio of capital to weighted risk assets should be set at 8 percent of which the core capital will be at least 4 percent ...".

purposes or for non-investive government spending (such as social policies) or for non-productive private investment, if it is associated with a large budget deficit of the government, if it is associated with an excessive increase in the domestic money supply, and if it is associated with a diverging development of the nominal and the real exchange rate where real appreciation inevitably leads to a fundamental disequilibrium of the economy.

The Asian crisis has demonstrated that we need more accurate data on foreign-exchange reserves (are they swapped?), but in addition to macro-economic data we need more information on short-term private debt, especially on short-term debt of the private enterprise sector. Data must include the maturity structure of debt and its composition in terms of different currencies. Information should also cover the financial sector, for instance, in form of the consolidated balance sheet of the financial sector as a whole and of the major financial institutions (x percent of the market volume). Moreover, a measure of reserves adequacy should be developed indicating the necessary reserves in relation to total short-term debt. An important aspect of transparency is to what extent international banking rules including prudent standards have been adopted (see above).²

- When do we need data? In a world of a high mobility of portfolio capital, we need the data quickly. It creates uncertainty and instability if data on fundamentals are published with large time-lags and if markets have to guess rather than to know the data on fundamentals.

- Who is to provide the data? It is not satisfactory that the data are supplied by national governments. Information should be provided in a standardized form, it should get a stamp of approval from the IMF or other specialized

² An index indicating good or bad governance and allowing to rate countries with respect to their economic policy performance should be developed. It can be argued that this type of information should not be provided by the IMF in order not to endanger its working relationship with potential problem countries.

international organizations like the BIS. This secures comparability of the data, and it enhances credibility of the data. If countries are reluctant to provide the necessary data, there should be definite costs of non-compliance, for instance by making non-compliance public or by requiring compliance as a precondition for IMF support in case of a crisis.

3. A third point is to improve surveillance. But what does surveillance mean? What should the IMF actually do?

One approach is to provide more and better information to the markets and then rely on the fact that markets will require higher risk premiums from countries with a poorer economic performance. The problem remains that markets can overshoot due to expectations. In the long run, expectations moving away from the fundamentals will be corrected in the market process as soon as the fundamentals become apparent. The systematic answer is to have an intertemporal fix point of sustainability as an anchor for expectations. Whatever we can do institutionally to strengthen such an intertemporal fix point of sustainability, we should do.

The other approach is an explicit role of the IMF in surveillance (Mussa 1997). This is a complex topic and the answer to this question very much depends on how the overall role of the IMF is defined. Unfortunately, the intertemporal fix point of sustainability is influenced by the incentive mechanisms including the moral hazard problem. An answer is that the IMF credibly defines its line of operation in case of a crisis, i.e. that the IMF specifies the rules when the early warning system is disregarded by a specific country. Defining the rules of the game credibly, strengthens the role of the early warning system. It helps to prevent or reduce the problem later on.

Following this line, a clear answer can be given on a specific issue: The IMF should not be a silent supervisor who deliberates with the country where a problem is developing behind closed doors. This involves the risk that not

enough is done to prevent the crisis. It is better to blow the whistle before the train crashes. It is better to allow a small crisis if, in this way, you can prevent a large one. The role as a silent supervisor brings the IMF itself into an untenable position: At first sight, it seems to immunize the IMF against criticism, but at second sight, it makes the IMF extremely vulnerable as an institution in the long run because secrecy undermines credibility. Of course, signaling more actively to the markets that a problem is developing is a very delicate task, and the IMF should not ignite the hurricane or reinforce it, but it also should not hold back information so that people are misdirected from searching shelter.

II. Solving the moral hazard problem

4. Crisis prevention is not simply an issue of improved national regulation of the financial sector, of more transparency and of better surveillance. It is not simply an issue of improving given policy instruments. It is not simply an issue of an improved hurricane watch. The hurricane is an economic phenomenon itself.

Transparency and surveillance are only credible in a game theoretic context if each country participating in a multilateral agreement knows what it has to expect eventually if a crisis occurs. It is a matter of whether a country has to bear the burden of an irresponsible economic policy itself or whether, in the worst of all cases, it can shift part or all of the burden to the IMF. Related to this is the question whether the private banks can also shift part of their losses to the IMF. Thus, we cannot prevent a crisis by more transparency and better surveillance alone if the most important questions of all remains unresolved, namely the moral hazard problem.

5. In order to solve the moral hazard problem, the role of the IMF has to be clearly defined. This, however, is difficult. Article I of the IMF statutes stating the purpose of the IMF mixes two different aspects, namely the short-term task "to shorten the duration and lessen the degree of disequilibrium in the balances of

payments" (section iv) and the longer term objective to "facilitate the expansion and balanced growth of international trade ..." (section ii) and to "promote exchange stability" (section iii).

The two basic credit tranche policies available to the Fund reflect these different targets. The initial Stand-by Arrangements served to alleviate temporary balance-of-payments disequilibria. The Extended Fund Facility created 1974 already aimed at the structural deficits. Since then, the IMF increased its lending to dealing with structural disequilibria with the concessional Enhanced Structural Adjustment Facility (since 1987) targeted at low-income countries and the Systemic Transformation Facility (from 1993 to 1995) targeted at transformation countries.

6. To define the short-term role of restoring a balance of payments equilibrium and the long-term role of exchange rate stability was relatively easy during the time of Bretton Woods when the main objective of the IMF was to bridge foreign currency shortages in a world of relatively stable exchange rates and when trade in goods and services was predominant as the major driving force of the balance of payments situation. With flexible exchange rates and with portfolio capital being the main determinant of short-term exchange rate movements, the task of defining the role of the IMF becomes more and more complex. The short-term and long-term roles are more intertwined. In a world with high portfolio mobility, currency runs can be a problem. Unfortunately, currency runs which are a short-run phenomenon have long-run causes.

7. The two roles of the IMF get into conflict: The short run approach requires to bridge a liquidity gap by providing liquidity. In this interpretation, the IMF is a fire brigade stopping a potential currency run to arise from a (short-run) liquidity problem. The more long-run approach is to prevent a currency run from devel-

oping; in this interpretation, the IMF undertakes precautionary policy.³ The IMF has taken over more and more the role of defining the long-run conditions for a sustainable situation by lending with conditionality. It thus transformed into a taskmaster of national economic policy defining a set of conditions when a credit is given. It has moved away from the short-run objective of bridging liquidity gaps.⁴

relative to what?

8. By switching in the two roles, the size of operation of the IMF has increased. Thus, we must raise the question what is the optimal size of operation? Here the moral hazard problem really comes in: The larger the size of operation, the more money the IMF takes into his hand, the weaker will be the incentive for governments to prevent problems. Thus, with a larger scale of operation, the balance between the short-term and the long-term function tilts in favor of the long-term, creating severe moral hazard problems. This is one reason why the IMF should think about scaling down its level of operation in the future. By strengthening the transparency and the surveillance before a crisis can fully develop there is less need for large scale operation.

9. The scale of operation also is related to another moral hazard problem: The larger the scale of operation and the bigger the role of the IMF, the lower the losses that the private lenders have to take. If private lenders can expect to be bailed out, they will not have a strong incentive to be cautious in giving credits. In order to solve this problem, we need an arrangement on how to handle private credits when private debtors and sovereign countries get into trouble.⁵

³ Besides the precautionary motive, the IMF argues that credits with conditionality imposed must be used as an incentive to obtain information. The Asian experience has shown that this argument is not valid.

⁴ A misguided direction would be to create a new short-term facility to counter speculative capital flows as proposed by Camdessus in 1994 and discussed by Williamson (1996). Such an idea can only be borne in a mind frame of regulated exchange rates and "equilibrium exchange rates". Such an institutional setting is completely unrealistic.

⁵ Private debt and debt of a sovereign country are hard to distinguish. If private debt develops into a problem, the government may be forced to underwrite the private debt in order to prevent a currency run.

We do need an international rule system analogous to national bankruptcy rules such as chapter 11 specifying how illiquidity of private agents whose debt can cause a currency run has to be handled. The IMF should credibly pre-announce conditions for its interventions. It should establish rules on the involvement of private lenders which the IMF wants to be respected if it is supposed to intervene. It can specify such rules as a precondition for lending support in case of a crisis. Thus, the IMF could trigger standards written into an international agreement which have to be respected by sovereign states and private lenders when a liquidity crisis develops.

Since financial crises will be different with respect to size, structure and cause, only broad rules can be developed. Once a crisis erupts, the IMF has to act like a bankruptcy court judge (Sachs 1994, 1997; Minton-Beddoes 1995): A moratorium has to be declared, existing debt has to be restructured and working capital has to be arranged.⁶ Fresh working capital must have priority over obligations to previous creditors. Note that the bankruptcy rule system is only credible if in case of a crisis the IMF sticks to its role as a bankruptcy court judge.

The IMF takes over an *ex-post* role, but this *ex-post* role has an *ex-ante* impact by forming expectations and influencing credit and debt behavior. The announcement effect of a clear *ex-post* rule will be to reduce systemic risk *ex-ante*. This announcement effect should be reinforced by more transparency and by an improved early warning system. Countries should experience the costs of their unsound economic policy and of lingering problems early on. The costs of unsound economic policy should not jump upward immensely in a discontinuous way (or to infinity) if a problem develops. By having a sliding scale of the costs, for instance in terms of higher interest rates, the abrupt reversal of short-term capital flows can be reduced.

⁶ This would be different to the involuntary lending arrangements following outright defaults of developing countries in the 1980s which has been ineffective in attraction fresh money.

10. The role of the IMF as a disciplinarian of national policy raises another question, namely what the basis of legitimacy of the IMF is, when a very small team of country experts can specify important aspects of national politics as was done in the program for Korea (Feldstein 1998, Sachs 1994, 1997). In defining the role of the IMF, a line must be drawn somewhere which prevents the IMF from becoming the chief controller of national economic policy. The IMF can circumvent this problem of legitimacy by relying on market forces early on in its early warning system.

11. Even in the IMF role of bridging a liquidity gap, a complex moral hazard and incentive problem arises because the IMF cannot credibly play the role of a lender of last resort. There is a severe asymmetry to the national lender of last resort, in addition to the lacking rule system for bankruptcies of sovereign states. The national lender of last resort can print money and can thus stop a crisis. For the IMF, this is not possible. On the contrary, the IMF has a limited amount of capital and it can accentuate a currency problem, if it runs out of funds. The capital of the IMF of about 200 billion US-\$ is a trickle if an extended crisis develops, for instance if Japan would need financial assistance or if a group of more important countries would be involved in a financial crisis.⁷

12. Thus, the IMF should also rethink its role of lending. One possible line would be to charge a penalty rate if credit is provided and require collateral (Meltzer 1998). A penalty rate, which could be preannounced in the early warning system even if credits of the IMF are not applied for, would be an important signal to markets. Requiring collateral would be a strong incentive to private lenders to find appropriate forms in which assets can serve as collateral.

⁷ World trade is at about 5 trillion US-\$ per year, total imports of developing countries is 1.8 trillion US-\$ (IMF 1997), total external debt of low- and middle-income countries is at 2.1 trillion US-\$ (World Bank 1997), international claims by reporting banks outside the reporting region is at 1.1 trillion US-\$ (BIS 1998), problematic credits of the Japanese banking system in 1998 are estimated to one as high as 0.6 trillion US-\$ according to press reports.

13. Another aspect is the assignment problem among the IMF, the World Bank and the BIS. The IMF has moved into the area of structural adjustment which is the traditional domain of the World Bank. It now may intrude into the field of the BIS if it includes the regulation of banks into its agenda. The responsibilities should be more clearly delineated with the World Bank having structural adjustment and growth as its targets, the BIS dealing with financial markets and prudent standards and the IMF seeing its role in bridging liquidity gaps and being the bankruptcy judge.

14. I come back to my entry sentence: The IMF has not prevented the Mexican crisis, the IMF has not prevented the Asian crisis. The IMF must change the sanctions and the incentive system so that the next crisis is to be prevented. The IMF should concentrate more on ex-ante prevention; this can be done by clearly specifying the rules that will be applied ex-post. This means the IMF should focus its role on bridging situations where a liquidity problem exists.

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