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WE NEED MORE OVERSIGHT

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One important international institution that apparently was not heard much from, both before and at the peak of the financial market crisis, is the International Monetary Fund (IMF). But this is not entirely fair. Already at the end of March 2008 the IMF forecasted that banks would need to write off one trillion dollars worldwide. The IMF is indispensable in the opinion of many economists: without the IMF, financial markets cannot be properly supervised. In the following, we examine how the IMF's role in the world economy has changed dramatically since it was installed as a Bretton Woods institution in 1944. We also review key elements of the actual worldwide financial and economic crisis and suggest why the central banks and or national supervision entities alone are (and will be) unable to perform the function of supervising the financial markets. The reason lies in the global externalities produced by the banking sector under stress which go beyond the scope of national or even regional banking supervision institutions. These externalities call for the coordinated action of an international governmental agency, such as the IMF.

Recently, just before the 2008 IMF-World Bank Annual Meetings on October 11–13, IMF Managing Director Dominique Strauss-Kahn and his Deputy Managing Director, John Lipsky, issued a statement. The general tenor was cautiously optimistic. The world economy needs not necessarily slip into a deep recession if the central banks continue to succeed in providing the banks with sufficient liquidity at moderate interest rates; if solvent financial institutions receive the influx of capital they require without being nationalised; and if the modified rescue plan TARP, approved by the US Congress, is rapidly implemented by the US government. The US government's gigantic bail-out plan was not enthusiastically received by the IMF, but as it stated: "a non-perfect plan is better than no plan at all".

Before looking at the possible contribution of the IMF to overcoming the worldwide financial market crisis, a look at the history of this institution is in order. The IMF as well as the World Bank were created at the conference in Bretton Woods. The IMF then became a pillar of the post-war monetary system. In the gold-dollar standard that applied until 1971, parity adjustments *vis-à-vis* the US dollar was only allowed in cases of "fundamental disequilibrium in the balance of payments". Parity changes of more than ten percent had to be approved by the IMF. Member states were obliged to pay into the IMF in the form of gold and/or currency reserves in accordance with their national quotas. The main task of the IMF consisted in the granting of short-term credits for financing balance of payments deficits. That also did not change after 1973 when member states were given the freedom to determine their own exchange rate regimes.

As late as the 1990s, when the IMF assembled rescue packages to overcome the currency and financial market crises in Mexico (1994), Thailand (1997), Brazil (1998) and Russia (1999), the IMF seemed to be indispensable as an international fire brigade. However, even at the time critics warned that the sheer existence of such a fire brigade could lead to fires being set in the affected countries. A telling point in connection with the present banking crisis in the United States and Europe is that during the Asian financial crisis in the late 1990s, touched off by the bursting of a real-estate bubble, the IMF called for the rigorous closing of most financial institutes that had financed the real-estate sector, largely in the style of American investment banks.

In the new millennium much – though not everything – has changed. Since the collapse of the Argentine Currency Boards in 2001, there has been no single emerging economy that has even come close to encountering a balance of payments crisis. With the continuously declining share of "semi-fixed" exchange rate regimes in the world economy, the likelihood of speculative attacks has clearly declined. Only very recently a number of currencies of central and eastern European emerging

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economies have come under pressure. They are candidates for the euro and their likely qualification is tested by speculators, among other things, by their capability to maintain their respective exchange rates in the band provided by EMS II. The current step taken by the Argentinean government to nationalise the formerly private system of pensions undermines trust in the Argentinean currency. All in all, however, it appears that the quite successful commercialisation of the balance of payments equilibrium and the observable changes in behaviour of important players in the world economy may have rendered the old-style IMF (almost, if we think of the current problems which Pakistan has to face) superfluous.

The most important emerging economies today – in Asia: China and India, in Latin America: Brazil – have no need for (new) loans from the IMF. To the extent that these countries were at all debtors of the IMF, in the meantime they have paid back these loans. For years they have been accumulating currency reserves, above all China, to an extent that has long since exceeded the precautionary holdings of risk-averse central banks.

The IMF has decided – finally, one could say – to monitor more closely the exchange rate policies of its 185 member states in keeping with its surveillance tasks, and in bilateral ad-hoc consultations to publicly denounce manipulations of exchange rates and strategic currency market interventions. Obviously, as Strauss-Kahn and Lipsky have also determined, inflation has clearly re-emerged in the world economy – more strongly in the emerging than in the industrial economies – and the dramatic increases in the prices of oil and food have led to clearly worsened supply conditions in most member countries, at least until the middle of 2008. Since then, we observe that the pressure on the markets in concern has significantly eased. Especially the oil prices have come down substantially again. An important, if not decisive, explanatory factor here is the clear weakening of economic growth in the world economy in the wake of the financial market crisis. But now OPEC is ready to cut back the oil supply. They announced that the daily production would be reduced by 1.5 million barrels from November 1 onwards. How long then can the “baisse” of energy prices truly last? Also, the inflation trend in emerging economies could paradoxically even facilitate the supervisory function of the IMF: in light of rising inflation rates, China and other important emerging Asian

economies have in the meantime already made their exchange rate policies more flexible.

This reminds us that the Bretton Woods currency regime failed, at the beginning of the 1970s, not least because of the worldwide spread of inflation. For this reason a Bretton Woods II, as proposed several years ago by experts such as Stanford University's Ronald I. McKinnon and that has been temporarily attempted by several East Asian emerging economies by means of pegging their currencies to the US dollar – albeit at most only an approximation in practice – is no longer to be expected. What the experts intended was a renewed hardening of parities of important currencies to each other. It is also not difficult to imagine the conflicts between market and exchange-rate stabilisation as well as additional inflation risks and inefficiencies that would come from exchange rate targets and corresponding currency market interventions of the important central banks in the current, by-far-not-resolved financial crisis.

In the future we are more likely to see a scaled-down version of Robert A. Mundell's vision of a one-currency world economy. There will be significantly fewer currencies than at present because more regional currency unions – patterned after the European Monetary Union – will be established, as can already be observed in efforts in this direction in the Middle East, Asia (ASEAN) and in Latin America (Mercosur). The remaining currencies will then maintain largely flexible exchange rates with each other. In this case the possibilities of incurring severe balance of payments crises will be largely reduced. For this reason the IMF will have to take on new areas of responsibility.

Instead of the traditional monitoring of the performance of individual countries, it would be advisable for the IMF to instruct the governments of industrial, emerging and developing economies as to how economic policy should suitably react to global supply and demand shocks. Experience from the 1970s demonstrates that an expansive fiscal policy in connection with a (too) restrictive monetary and aggressive wage policy was precisely the wrong response to the two oil-price shocks. When an indispensable production factor such as energy becomes more expensive, it is imperative to restrict the price increase of the other factors if we wish to avoid an extended stagflation. What is needed is a cut-back of government borrowing on the capital markets, moderation in wage demands and possibly even a slightly inflationary

monetary policy that corrects the insufficiently moderate nominal wage agreements because such a policy reduces the increase of real wages.

Everything has become exceedingly more complicated – though we now have breathing space with regard to the above-mentioned worsening on the supply side – as we now have, in addition, a sharp decline in the prices of real estate not only in the United States but, for example, also in Britain, Spain and Ireland and because the world economy is at the brink of a huge recession. But the financial market crisis is the biggest problem facing economies today. It is still true that monetary policy and wage bargaining must respond in the way described above if a deep and long-lasting recession in the world economy is to be avoided. The gigantic fiscal efforts contained in the Paulson-Bernanke plan, TARP, to correct the balance sheets of US banks will boost capital market interest rates in the United States sooner or later. The same applies to the rescue packages decided by European governments. The fact that governments seem to be (at least temporarily) no longer – or not to the same extent as before – confronted with the above-described supply shocks will not alleviate the pressure on wage bargaining and monetary policy. In addition, there are problematic signal effects that are sent out by any bail-out. Such signal effects affect Europeans directly. The Maastricht Treaty contains a no bail-out clause *vis-à-vis* highly indebted member states in the euro area. Rescue packages like that of Paulson-Bernanke and, more recently, of European governments undermine this credibility.

It remains the responsibility of the IMF to monitor critically the development of world economic imbalances and to provide recommendations for action. A particular focal point in recent years has been the growing US current account deficit. The key element in this development is ultimately how the savings-investment gap in the United States in comparison to the rest of the world develops in the future. It is very likely that the private sector in the United States, under the pressure of the financial market crisis, will finally undertake significant savings efforts. A decline in private investments is to be expected in the first place because of the economic downswing, but one can also expect a rise in the financing costs for the medium- and long-term procurement of capital for US enterprises from outside sources. After all, foreign investors should ask for a higher risk premium in light of the experiences made in the new

millennium. That could, in principle, contribute to a reduction of the US current account deficit in connection with increased savings activity.

A countervailing factor, however, is that the procurement of equity capital on the stock market by large US banks as well as the huge borrowing of the American government in connection with the Paulson-Bernanke plan will draw much foreign capital into the country. The US financial centre now carries with it clearly higher risks, and, as stated above, foreign creditors will demand significantly higher compensation. All in all, a clear decline in imbalances in the world economy in the wake of the financial market crisis is hardly to be expected. Indeed, the IMF considers as a possibility an alarming weakening of capital flows to emerging and developing economies.

IMF director Strauss-Kahn recently proposed a “global dialogue” to cope with the financial market crisis and the persisting imbalances in the world economy. But such a dialogue will not be enough. Countries whose exchange rates have been manipulated should conclude binding target goals with the IMF regarding the swift dismantling of existing interventions. But the IMF must also take a more active role in surveilling the international financial markets and its participants. In a global world economy the national central banks and financial market authorities alone are clearly not up to this task. We Europeans have experienced this first-hand, for example, when Ireland attempted to go it alone in shoring up its banking system and as other countries then followed suit. But it could also be seen that the turmoil on the worldwide financial markets was fuelled temporarily by the transitory incapability of European governments to follow quickly the steps taken by the US government.

The fundamental reason for the inappropriateness of national or even regional supervision solutions is simple: the reason lies in the global externalities produced by the banking sector under stress which go beyond the scope of national or even regional banking supervision institutions. And, as the Irish case has shown, not only the banking sector but also autonomous action taken by national governments themselves gives rise to negative spillover effects. These externalities call for the coordinated action of an international governmental agency such as the IMF. The IMF has a “comparative advantage” in fulfilling this task given the fact that almost all relevant

countries in the world are members of this institution, that this institution has a successful tradition in monitoring economic policy around the world (see, for example, its regular publication, the “World Economic Outlook”) and finally because the IMF has a long-lasting record of multilateralism, which is what is most needed in the current crisis.