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The IMF in a Changing World

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I Welcome and introduction

Ladies and Gentlemen,

On behalf of the Deutsche Bundesbank I would like to welcome you to the joint IMF-Bundesbank symposium. I would like to extend a warm welcome to the panellists and their chairs of today's event. It is a particular pleasure and honour for me to welcome Mr Rodrigo de Rato, the Managing Director of the IMF, who will give the keynote address of this symposium in a few moments.

Even though long planned in advance, I find this symposium is particularly timely. The role of the IMF continues to be the subject of lively public debate around the world – mostly supportive in industrialized countries, but recently also increasingly critical in Asia and Latin America. A medium-term strategy for the IMF is now also a key agenda item not only at the IMF itself but also at the G7/G8. Related to this discussion about the role of the IMF is also a debate – and I mention only the words exchange rate flexibility and global imbalances – about the evolution of the international monetary and financial system. Another important dimension in a rapidly changing world is the possible role of the IMF in low-income countries. All of these issues will feature prominently at the forthcoming G8 summit in Gleneagles in July and again at the annual meetings of the IMF and World Bank in September. On many issues a broad consensus has already been reached, on some issues the consensus formation is still work-in-progress. So it will be interesting to see to what extent this symposium will be able to reflect or may be even to advance the

current state of the international policy debate, and I am very pleased, not only on behalf of the Bundesbank, but on behalf of all participants that we have such a timely opportunity.

Our symposium is organized in three panels:

- in the first panel, we will discuss as to whether the international monetary system does function efficiently at present;
- the focus of the second panel will be on international financial stability and the respective contributions from national policies and international institutions;
- the third panel will concentrate on the role of the IMF in the international monetary and financial system: Can the IMF be a panacea for every problem?

II Functioning of the international monetary system

Over the last few years, the major challenge of promoting financial stability has come from the growing size of international capital flows and the greater use of new financial instruments and technology, particularly the increasing role of complex and leveraged instruments. Moreover, many emerging and developing countries become increasingly integrated in the global financial markets. Although financial globalisation is an important vehicle to foster economic growth, it does not come without risks.

First, the exchange rates of major currencies are prone to sharp short-term fluctuations. Moreover, it is not unusual that exchange rates substantially deviate from underlying fundamentals. This

insight has given rise to criticism and triggered important questions: Does the existence of overshooting and misalignment imply market failure? Should the key currency countries cooperate more closely on monetary matters?

A **second** risk of financial globalisation relates to the global pattern of current account imbalances that has reached unprecedented dimensions in recent years, so too have US gross external liabilities, and the accumulation of foreign reserves in East Asia.

- One school of thought believes that this pattern of current account imbalances does not pose a problem to the international monetary and financial system, but that "current account imbalances will be defused with little disruption"[1]. This argument refers to the marked increase of flexibility in domestic and international markets that has promoted the resolution of international imbalances and lessened the risk of a crisis.

- A second school of thought argues that the world has already arrived at a new arrangement which they have called the "new Bretton Woods system". Asian economies stabilise their currencies against the dollar in order to sell goods to the United States, and simultaneously lend the funds to pay for them. They suggest that the present situation could remain stable for a long while, for the benefit of all.

- A third group of analysts is more sceptical. They suggest that the current account and foreign reserve imbalances pose the risk of a disorderly currency movement and protectionist

[1] Alan Greenspan, Current Account Balances, Bundesbank Lecture, Berlin, February 2004.

pressures. Even more, the role of the US dollar as the key reserve currency could be brought into question.

I am keen to hear the views of the panellists on these issues and the role of the IMF. The key questions in this respect are: Is a new order for the international monetary system emerging? Does the IMF efficiently fulfil its mission to promote international monetary cooperation and its surveillance function over exchange rate policies?

III International financial stability – what contributions from national policies and international institutions?

In the second panel the discussion will be focussed on international financial stability and the respective contributions from national policies and international institutions. At the current junction, the benign prospects for global growth and inflation and strengthened balance sheet positions of financial institutions provide a positive backdrop for financial stability. Overall, risk premia and long-term interest rates are very low currently, which on its own is a positive indicator, but the question is: Are risks appropriately priced? Downside risks that have the potential to cause strains in financial systems do exist. In its recent Global Financial Stability Report the IMF warns that “the single most important risk factor for financial markets in good times is complacency”. Other risks include the untested risk management systems dealing with complex financial instruments, the risk transfer to the household sector and high and sometimes rising public and external debt levels in emerging market economies.

Against the backdrop of various risks that have emerged in recent years, what are the respective contributions from national policies and international institutions? In promoting financial stability, national policies should focus on sound macroeconomic policies. In addition, **sound institutions** are key to economic growth, as was highlighted by the G-20 last year. Presently another key question is whether we need more regulations or better ones to strengthen the supervision of the market for credit risk transfer. Should transparency be increased?

Currency mismatches are an important factor in triggering or aggravating financial crises in emerging market economies. Currency mismatches arise when borrowers incur foreign-currency liabilities to finance domestic activities. Some people, the so-called “original sin” school, traces currency mismatches to a fundamental inability of emerging markets to borrow abroad in their own currency. They recommend that IFIs should assume an intermediate role as issuers. Other people have countered that this reasoning is based on a misperception as to how capital markets work. Even large industrial countries do not issue in their own currency under foreign jurisdiction but issue domestically. At the G20 workshop in Ottawa last year, participants concluded that strong domestic financial markets are a key factor to reduce a country’s external vulnerability. The question emerges whether national authorities should do more to develop domestic local currency financial markets. Alternatively, should the IMF assume an intermediate role as issuer?

Capital account liberalisation is one of the most controversial and least understood policies of the day. Some people portray the

Fund as relentlessly pushing countries to open their capital markets prematurely, thereby making it the prime culprit in every financial crisis. It is an open question as to whether the Fund followed the right approach by emphasizing the benefits of greater access to global capital flows for recipient countries. As the Fund set up an International Capital Market Department and suggested the introduction of Collective Action Clauses, should the Fund have done more? Alternatively, should source countries do more to help to reduce the volatility of capital flows? Are there ways to stabilize the increasingly synchronized risk appetite cycle in global markets?

Some people claim that the mere existence of the Fund has led to an increase in international **debt crises**. Of course, this argument is obviously exaggerated as debt crises had happened many times before the Fund was established. However, in comparison to earlier decades, sovereign debt defaults have become more frequent in recent years. Accordingly, the Fund has been more frequently involved in sovereign debt restructurings. The key policy question is how pro-active the Fund should be in determining the outcome of the crisis resolution process.

The Fund has considerable leverage as it can determine the parameters for the negotiations between a sovereign and its private creditors through several channels, for example its debt sustainability analysis. Conflicts of interests can arise, particularly when the country's liabilities to the IMF itself are large and compete potentially with private claims for the country's debt servicing capacity. In view of the experience from sovereign debt crises, has the balance of power changed between sovereign

borrowers, private lenders and the IMF? What will be the future role of the IMF in sovereign debt restructurings? Do the IMF's own exposures to countries in an unsustainable debt situation pose risks to the IMF itself?

IV The IMF – panacea for every illness?

According to the IMF's Articles, the central mission of the Fund is to help member countries to overcome balance of payments crises. However, since Brazil and Uruguay were inflicted by crisis in 2002, no further **crisis** in major emerging market economies has occurred. Some observers even came to the conclusion that a crisis in emerging market economies is something of the past.

Although this appears to be a rather optimistic assessment, various regional initiatives were launched aimed at crisis prevention and resolution. In Europe, previously emerging countries have graduated to become members of the European Union. As Latin American countries have implemented many reforms over the last few years, the region – with some exceptions – now appears to be a much safer place financially. Emerging Asian countries – and to some extent also Russia – have massively accumulated foreign exchange reserves, thereby providing self-insurance against financial crisis. In addition, proposals are again on the agenda for a closer monetary and financial cooperation in East Asia, based on existing swap agreements under the Chiang Mai Initiative.

In view of improved fundamentals and the allegedly increasing role of regional assistance mechanism, the question has been

raised as to whether the lending function of the Fund is still needed. And this has led to the more provocative question: If IMF lending is no longer needed, why do we need the Fund at all?

By contrast, other people have suggested a more active role for the Fund before a crisis arises. They have suggested the introduction of new instruments for the Fund which, if accepted, would transform the IMF into an **insurance** arrangement with far-reaching consequences.

It is obvious from these highly controversial proposals that the Fund is currently being extensively assessed internally as well as by its shareholders and by third parties. The Fund's appropriate future role and priorities have been vividly discussed, the design and effectiveness of its instruments have been reviewed and a discussion has been opened up to strengthen internal management, finances and governance.

To be relevant, any discussion about the Fund's strategic direction must take into account the **financial risk to the Fund**. Recent patterns of IMF loan exposures have triggered concerns about excessive credit and risk concentration in the IMF's balance sheet. Exceptionally high access was often accompanied by prolonged use of Fund resources. Moreover, the IMF's share in some crisis countries' total external debt has reached unprecedented and systemically problematic levels. While the Fund's liquidity may not be constrained yet, its preferred creditor status is coming under increasing threat. Thus a key issue for further discussion is: How can financial risks to the Fund be reduced?

As Raghuram Rajan has recently indicated, the discussion about the **IMF lending role** is an issue about “rules versus discretion”. Many countries are now aiming at well-functioning, rules-based market economies. Why should the same principles not govern international financial relations as well? In view of the overarching rules of economic governance, it should be clear that Fund financing must not distort the functioning of the market mechanism. Fund policies should instead leave the market participants fully responsible for their own decisions.

Emergency cases may still occur, but Fund lending might be restricted to true emergency cases and not be used as an instrument without an emergency need. Under the strategic review, an important question is how the newly agreed framework for exceptionally large access to Fund credit could be strengthened in practice. In this vein, does the proposed introduction of **”exceptional precautionary arrangements”** contribute to a strengthening of market rules or rather a weakening? Would such a step towards imposing an insurer role on the IMF be compatible with the Fund’s “risk-free” liquidity financing mechanism that designates official reserves as the source of short-term Fund credit?

In February 2003 the IMF concluded that **exceptional access** should be reserved for truly exceptional cases, access limits must be strictly adhered to, and the four criteria for exceptional access must be fulfilled. Will the agreed principles pass future tests? Alternatively, should the Fund have a free hand in resolving crises?

The role of the Fund in **helping low-income countries** is also being hotly debated. Admittedly, the Fund has a role to play in contributing to macroeconomic stability as an essential requirement for sustained growth and, thus, for effective poverty reduction in low-income countries through surveillance, technical assistance and financial support. However, does this justify a long-term financial involvement of the Fund in these countries or should other development-oriented institutions accept chief responsibility? As a monetary institution, should the Fund not continue to focus on short-term adjustment needs?

Another key issue in the strategic review debate is **surveillance**. Many useful surveillance initiatives have already been launched in recent years, including Standards and Codes, ROSCs, FSAPs, and the increase in transparency. By strengthening bilateral, regional and multilateral surveillance, the Fund can make useful key contributions aimed at achieving and maintaining stability worldwide and thus bolstering growth. Fund surveillance increases transparency in financial markets and improves the functioning of the market mechanism. Based on profound experience gained from the different regions of the world, the Fund is an unbiased arbiter to give policy advice.

I am convinced that the IMF has done an excellent job so far in helping member countries adapt to a changing economic environment. In a process of trial and error, the Fund has become a more open and accountable institution and a major source of information for the general public and capital market participants. The future role and priorities of the Fund and its instruments should be carefully reviewed. A greater selectivity with regard to

functions and a sharper focus on the IMF's core mandate appear reasonable.

The participants of this symposium – which brings together academics, policy makers and market participants – have the privilege of being able to speak freely outside their regular job constraints. I hope they will make active use of this freedom. I am sure, divergent views will emerge among panellists which is why we have this symposium in the first place. Divergent views can be helpful to better understand the challenges we are facing, provided they are all expressed under a shared objective – namely to try to explain to us and to the broader public which medium-term direction the IMF should take.

But now I am very pleased to give the floor to Mr Rodrigo de Rato, who will give the keynote address for this symposium.

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