

Chapter 9

Perspectives on Co-operative Policy Solutions: The International Monetary Fund

Michele Fratianni, Kelley School of Business, Indiana University, and Università Politecnica delle Marche, Ancona, and John Pattison, G20 Research Group

The International Monetary Fund (IMF) was at the centre of the Bretton Woods architecture. With the end of the pegged exchange rate system in 1973, the IMF began transforming itself into a multi-product institution. The IMF of today is a far different institution than the organization envisioned by John Maynard Keynes and Harry Dexter White. It advises countries, assesses their economic policies, co-ordinates lenders in a debt crisis, provides information about member countries, gives emergency loans with conditions to economies in financial distress, promulgates standards, acts as a crisis manager, lends to developing countries at subsidized interest rates and provides technical assistance. The currency and banking crises of the 1990s tarnished IMF's brand name. Many critics claim that the IMF is doing too much; others opine that it is not doing enough. Proposals to reform the institution abound, ranging from one extreme solution of abolishing it altogether to the other extreme solution of transforming into a super Fund with the power to create monetary base, set financial regulations and enforce them worldwide (Fratianni 2003).

The IMF suffers from two basic shortcomings. The first is that it lacks focus. The strategy of becoming a multi-product institution reflects the search for a substantive mission, which is missing at present. On the positive side, the IMF has some legitimacy that derives from the fact that its existence is accepted by many countries around the world and by a corporate structure, management and balance sheet that permit large funding opportunities. In corporate parlance, the IMF is a "shell company," suitable for acquisition for new corporate purposes. The second shortcoming is the governance. Many critics have lamented the undue influence exerted by critical shareholders. The original group of five countries — the United States, Germany, Japan, France and the United Kingdom — control the agenda and are too powerful to mind the advice of the IMF. The Meltzer Commission (2000, 48) refers to the IMF "as a 'slush fund' to satisfy decisions of the G7 finance ministers or other groups of powerful members." The prospect of governance reform at the IMF is constrained by the reluctance of its major shareholders to shed voting power to other member countries and to delegate a significant amount of discretion to an international bureaucracy.

The ongoing financial crisis has brought to a temporary end a long period of financial liberalization. The housing shock and the consequent revelation of losses on subprime mortgages and other "toxic" assets have created massive negative spillovers, such as the freezing of the inter-bank market for maturities beyond 24 hours, the cessation of commercial paper markets issued by high-quality borrowers, the implosion of stock valuations and extreme gyrations in foreign exchange rates stemming from shifts in the carry trade and risk aversion. This environment may provide a unique opportunity for the IMF to acquire a new substantive role in the international financial architecture.

National Regulatory Competition versus a World Regulator

Before the Great Depression, the burden of financial crises fell directly on the affected parties; the taxpayer's deep pockets were seldom called upon. The experience of the Great Depression altered fundamentally the rules of the game. To avoid the large consequences on output and unemployment from financial crises, governments erected safety nets. But those safety nets altered the propensity of financial institutions to take risk with the expectations that prospective losses would be collectivized. Safety net and moral hazard are the horns of the dilemma for public policy. One cannot exist without the other. Deregulation and liberalization have contributed to a riskier environment. As economic rents are eroded by liberalization programs, financial institutions seek more profit opportunities. Unfamiliar with the unregulated environment, banks take excessive risk before finally learning the new risk management techniques and settling into a new equilibrium. Equally, regulators and supervisors tend to underestimate the consequences of deregulation on risk taking, especially in an environment of rapid growth in international liquid assets fuelled by a low interest rate policy.

Governments can react to increased risk taking either by making the safety net less predictable or by tightening the regulatory regime or by a combination of both. The two polar cases of international regulation are national regulatory competition and a world regulator. The former has the disadvantage that the equilibrium solution may entail chasing the lowest common denominator, that is, a standard so low to make the financial system excessively prone to crises and taxpayer's bailouts. The latter — it is claimed — would not deviate from the “best” solution, whereas a national regulator in a regulatory cartel would be tempted to “cheat” or deviate from the cooperative equilibrium. But would an all-powerful world regulator be benevolent or effective? With limited accountability, a single authority may be tempted to set an excessive regulatory burden, one that would stymie competition, innovation and product differentiation. Furthermore, what are the means and procedures that would give a single authority an advantage in assessing risk in every corner of the world over the local regulatory authority? What would be the legitimacy of such an institution relative to national regulatory bodies that respond directly to national parliaments and ultimately to voters? Would it not be unmanageable for such a body to administer regulation and supervision to the global financial system? The answers to these questions all have one thing in common: the world regulator has the same appeal and limitations of a utopian world government.

The International Monetary Fund and the Co-ordinated Strategy

There is an intermediate approach to international regulation and supervision. This involves setting minimum international standards — e.g., the Basel II capital rules— and letting national bodies implement them; for an analysis of how standards can be created and extended to a large number of diverse participants, including those who were not part of the original standard setting process, see Pattison (2006). The establishment of international standards is an exercise in coordination, necessitated by the erosion of national borders in matters of banking and finance. This erosion, in turn, reduces the power of regulators to contain systemic risks and thus to protect consumers within their jurisdiction.

The international coordination of minimum national regulation and financial standards, together with transparent and reputable monitoring, promises to yield better

results than either national regulatory competition or a single supra-national regulatory agency. The political advantage of the co-ordinated solution is that it is consistent with the aspirations of many countries not to relinquish complete control of financial regulation to a non-accountable and unresponsive world regulator. There is a natural division of responsibilities in the coordinated solution. Standard setting must be global and stems from the activity of international standard setters. Standard implementation, on the other hand, is best left with the national authorities. There is no good alternative to vesting local regulatory and supervisory agencies with the task of enforcing international standards. This is for three reasons. First, as has been repeatedly mentioned, it is wishful thinking that national authorities may wither away or be superseded by a supra-national agency. Second, international standards are soft laws in the sense that they carry no legal standing in sovereign states. For standards to become legally binding, sovereign states must transform them into laws. The fact that laws remain the prerogative of nation states leads to the final consideration. Namely, oversight and supervision cannot be delegated to a distant and unaccountable international enforcer. Third, local financial systems differ in types of institutions, peculiarities of financial instruments in local markets and legal protections. Thus, domestic regulators enjoy an informational advantage over distant regulators in these matters.

The international coordination approach is neither easy nor fast. By the sheer number, size, complexity and financial importance of the players involved, progress will not be linear: crises will accelerate co-ordination and financial calms will slow it down. Local enforcement does not mean that the international community is impotent in encouraging proper enforcement. Here comes the first important role of the IMF: monitoring that local enforcement adheres to the standard instead of being captured by local interests. The second important role of the Fund would be to provide an international lending of last resort (ILOL) facility (Fратиanni and Pattison 2002). To accede to such a facility the borrowing country would have to be in good standing with the enforcement of local standards. The Meltzer Commission (2000) proposes to add the constraint that the IMF lend exclusively short term, at penalty rates and against good collateral to countries that meet specific standards. The main criticism of this recommendation is that, under prequalification, the ILOL agency may either lend too much to the qualifiers or too little to the non-qualifiers, instigating either moral hazard or welfare losses. The alternative of letting the IMF continue its practice of ex-post conditionality lending runs the risk that this agency may be too generous with the carrot of the subsidy to justify the conditions attached to its lending. Since neither solution is a first best solution, the ILOL agency could in practice use a combination of preconditionality and ex-post conditionality.

In Sum

The IMF has lost credibility as it has drifted into activities that were poorly articulated and inconsistent with the original mandate. To revitalize the IMF, the following two roles are proposed:

- to monitor that national regulators apply internationally agreed minimum regulatory and financial standards, and
- to provide a lending of last resort facility, partly based on borrowing countries being prequalified and partly on ex-post conditionality.

Both roles should be clearly spelled out and become part of the official mandate.

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