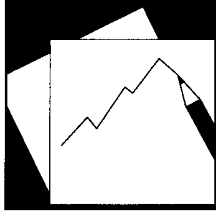
WP/08/262



IMF Working Paper

The Tasks Ahead

Research Department, under the direction of Olivier Blanchard

INTERNATIONAL MONETARY FUND

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November 2008

Abstract

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This note, prepared ahead of the G20 Summit (November 15), builds upon the points laid out in the Managing Director's letter to the Heads of State and Government (November 9). It lays out two tasks ahead for policy makers. Policies for now should cover: (i)implementing and coordinating policies to sustain demand; (ii) providing liquidity support to emerging economies; and (iii) protecting low-income countries. Longer term reforms of the financial architecture should touch upon: (i) the design of financial regulation; (ii) a better way of assessing systemic risk; and (iii) mechanisms for more effective actions for crisis prevention and resolution.

JEL Classification Numbers:

Keywords:

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I. Introduction

Global economic prospects have deteriorated further over the past month as the global financial crisis took a sharp turn for the worse. The financial crisis has undermined consumer and business confidence, triggering a sharp decline in domestic demand. Momentum continues to drop, with activity cooling further in the third quarter and confidence indicators for October falling to levels not seen in decades. In financial markets, despite the adoption of bold and comprehensive policy measures by major advanced economies, funding markets remain strained, reflecting the deep shock to confidence in counterparties. Deleveraging and forced asset sales continue unabated. These difficult financial conditions coupled with the slump in economic activity portend sharp increases in corporate defaults in advanced economies. Emerging economies have also come under severe strain, as seen in rising spreads on sovereign and corporate debt and serious pressures on exchange rates.

Given present policies, the world economy is projected to grow by 2¼ percent in 2009, down by some ¾ percentage points from the IMF's projection in last month's World Economic Outlook. This sharp slowdown in global activity is led by advanced economies, many of which are in or close to recession, with output projected to contract on an annual average basis in 2009, an outcome not seen since the 1970s. Growth in emerging economies is also slowing sharply, reflecting weakening global growth prospects and an abrupt reversal of capital inflows, although it is still projected to reach 5 percent in 2009. On the positive side, headline inflation is now receding rapidly across advanced and most emerging economies amid cooling activity and declining commodity prices. This has opened room for monetary policy responses, although deflation risks are starting to become a concern in some advanced economies.

Against this background, policy makers have two broad tasks ahead:

- Dealing with the immediate fallout of the financial crisis, including the adoption and coordination of policy responses to restore confidence and growth, while restoring financial sector soundness.

- Designing and implementing reforms so as to decrease the risk of such crises in the future.

II. Policies for Now

Implementing Policies to Sustain Demand

While taking measures to restore confidence in the financial system was essential, the focus must now be on policies aimed at sustaining aggregate demand. Recent policy actions in advanced countries to use the public balance sheet to recapitalize financial institutions, provide comprehensive government guarantees, and extend liquidity provision were important and necessary steps, and their swift and effective implementation will be crucial to restoring confidence. These measures are not sufficient, however, to halt the slide in output. Given the sharp drop in confidence, policy measures must be taken to support demand, reduce negative feedbacks between the real and financial sectors, and contain the risks of deflation. One path

to avoid is for each country to try to support demand for its domestic goods through higher tariffs or import quotas: the experience of the Great Depression shows all too clearly the catastrophic consequences of restrictive trade policies. The focus must instead be on expansionary monetary and fiscal policies.

Sharply lower inflation risks have opened room for further easing of macroeconomic policies, with a greater focus on fiscal stimulus. While some countries, notably in Europe and among emerging economies, still have some room to ease monetary policy, others have already decreased interest rates to very low levels and real rates are rising as inflation falls. Also, the impact of monetary easing may be curtailed while financial conditions remain disrupted. Fiscal expansion must, therefore, now play a central role in sustaining domestic demand. Such stimulus could include steps to improve public infrastructure, assist adjustments in housing and financial sectors, and boost activities that may have larger impacts on activity than general tax rebates. In order to increase the effectiveness of fiscal expansion and minimize leakages, policy efforts should apply broadly across advanced economies and emerging economies where low debt and disciplined policies in the past have provided sufficient policy space. Countries with greater vulnerabilities, or countries in the midst of a crisis, will however, need to address these weaknesses as part of the efforts to stabilize their situation and provide a basis for official support.

Providing Liquidity Support to Emerging Economies

Emerging economies have increasingly come under stress as financial deleveraging in the advanced countries has led to capital flow interruptions or reversals. Highly liquid markets that benefited in the past from large carry trade positions have been hit particularly hard, and exchange rate movements have been especially dramatic, with sharp depreciations registered in many emerging economies. As foreign investors have sought to reduce exposures to a broad swath of these economies—an effect amplified by the adverse spillovers from policy measures put in place in advanced economies—a number of countries are greatly suffering from sharp capital flow reversals or “sudden stops.” These liquidity strains could easily transform into solvency crises if not dealt with swiftly and effectively.

Emerging economies need to be able to respond quickly to liquidity shortages since funding markets are quickly drying up. For countries with flexible exchange rate regimes, the exchange rate should be allowed to absorb some of the pressures arising from capital outflows. And countries with large reserve buffers should be willing to provide foreign currency liquidity as needed, including to maintain firms’ ability to trade and operate and to counter disorderly market conditions. At the same time, however, reserve currency countries should be willing to provide liquidity support to emerging economies with sound fundamentals facing large pressures in their external accounts. Recourse to such support through swap lines with major central banks, as has been done among advanced economies, can be an important step and could be extended. Similarly, efforts aimed at a regional pooling of international reserves, such as in Asia through bilateral swaps, provide a further backstop for individual countries facing significant pressures in their external accounts and could be broadened.

The Fund, for its part, has quickly moved to help emerging economies battered by the crisis and the sharp slowdown in advanced economies. As the crisis deepens and spreads, it can disburse more than $200 billion to support member countries facing financing shortfalls. Indeed, a number of countries have already sought financial support from the Fund. The Fund has also put in place an additional short-term liquidity facility (SLF). The SLF provides members with strong macroeconomic positions and records of consistent policy implementation large upfront access to Fund resources to help address short-term, self-correcting external liquidity pressures that give rise to balance of payments needs.

Given the potential size of capital outflows, however, markets may not be entirely confident that existing swap lines, the SLF, and Fund resources more generally, will be enough to address the problem at hand. To date, swap lines are available only to some emerging countries. The Fund's resources appear high in periods of calm, but look increasingly constrained as the situation turns. While the Fund can draw on additional resources through standing borrowing arrangements with members, there remains a serious question as to whether the cumulative pool of resources will be sufficient to meet the needs of members in the event that the financial crisis continues to spread. A more systematic approach to international liquidity provision is a high priority.

Protecting Low-Income Countries

Low-income countries are likely to be seriously hurt by the continuing financial crisis and deepening global downturn. Beyond the effects of slower growth in industrial trading partners, growth in low-income countries, notably in Africa, is likely to moderate through falling commodity prices as well as reduced transfers, including lower remittances and aid flows. In addition, capital account pressures are mounting for many countries through weaker foreign direct investment and some curtailment of credit lines from foreign banks. As access to international markets is scaled back, it is likely to disrupt the pace of economic activity, especially trade. Against this backdrop, the pressures from higher food prices have not significantly abated, given the more modest decline in (and slower pass-through from) food-related commodity prices, hurting disposable incomes for many importing countries. The Fund—working closely with the World Bank—continues to provide much-needed financial support to these countries, but it is also imperative that aid flows are maintained so that hard won gains in achieving the Millennium Development Goals are not jeopardized.

In this context, it is essential for the international community to signal its commitment to help countries faced with liquidity or other exogenous shocks, and more generally, to help countries adjust to new circumstances. Again, the resources of the Fund may be too limited for such a broad commitment to be credible. Over the longer run, consideration could be given to a large Fund quota increase and/or a new SDR allocation. These measures will, however, take time. In the meantime, the Fund could coordinate and manage the provision of international liquidity and external support. One option would be for the Fund to set up a new trust fund and/or new borrowing arrangements from countries with large reserve holdings (or to expand existing ones: the General Arrangement to Borrow and the New Arrangement to Borrow, though this would require more time). Another option would be for the Fund to

facilitate, on a co-financing basis, liquidity arrangements with major central banks and more traditional balance of payments support for adjustment programs with bilateral and multilateral partners.

III. Directions for Reforms

In terms of improving the global financial architecture, the crisis has made clear that new thinking and action are needed in at least three areas: (i) the design of financial regulation; (ii) a better way of assessing systemic risk; and (iii) mechanisms for more effective, coordinated actions, both to reduce the risk of crises, and to address them when they occur.

The Design of Financial Regulation

The crisis has shown the limits of the current regulatory and supervisory frameworks at both the domestic and international levels. Open financial markets can provide tremendous benefits by lowering the cost of capital, but effective regulation is needed realize this potential. Financial innovation and integration have increased the speed and extent to which shocks are being transmitted across asset classes and countries, and have blurred boundaries, including between systemic and non-systemic institutions. Regulation and supervision, however, remain geared at individual financial institutions and do not adequately consider the systemic and international aspects of financial markets participants' actions. And macro-prudential tools internalize insufficiently business and financial cycles to prevent the excessive buildup of leverage. The challenge is to design new rules and institutions that reduce systemic risks, improve financial intermediation, and properly adjust the perimeter of regulation and supervision, without imposing unnecessary burdens.

New and better national rules are necessary, at both the individual institution and macroeconomic level. Higher capital and liquidity requirements are needed to make financial institutions more resilient to risk, especially those with high connectedness. Counter-cyclical macro-prudential rules appear to be a promising way to reduce the buildup of systemic risks, particularly if some regulators have responsibility for overall financial stability. Improvements in the robustness of the financial infrastructure to counterparty failure, including through greater use of centralized clearing houses and organized exchanges, and the development of stronger frameworks for the resolution of individual institutions, especially cross-border, should lead to less spillovers. Supervisory structures for rating agencies and risk management need to be revisited to enhance market discipline. Better incentive and executive compensation schemes can be introduced to limit excessive risk taking and too much focus on short term returns.

Increased financial integration, high capital mobility and the presence of global financial institutions call, however, for more globally coordinated supervisory and regulatory frameworks. The crisis has clearly underscored the tension between globally active financial institutions and nationally bounded regulators and supervisors. The tension exists with regard to both risk prevention and crisis resolution and is most evident in the resolution of global banks headquartered in relatively small countries.

New rules are needed, but more information is equally important. The new rules will require much new thinking, building on the work already done by the FSF, and will need to include areas that have been left out so far. But better and more consistent rules across countries, financial institutions, and activities, are not enough. More and better information will be needed for markets and authorities to better assess any build up of systemic risks. This requires reviewing transparency, disclosure and reporting rules. Information requirements will also need to cover a much larger set of institutions, from insurance companies to hedge funds and to off-balance sheet entities.

And there has to be more effective implementation. More common and consistent practices are needed. While disseminating best supervisory practices—as the Fund and other agencies already do—helps, the crisis has underlined the importance of assessing the ultimate actions by national authorities. Much of the apparatus for such assessments is already in place, including at the Fund (e.g., FSAPs, ROSCs, and Article IV consultations), but, resources permitting, the intensity and frequency of this surveillance will need to be stepped up and red flags should be raised more promptly when deficiencies arise.

The Design of More Effective Early Warning Systems

The crisis has made clear the enormous costs of not identifying risks early enough. Private market discipline failed in many respects, while multilateral surveillance was too scattered and warnings at times too coded. A more effective approach to detect impending dangers to the world economy will require close cooperation among key policy makers as a way of bringing together the scatter of international and national macrofinancial information and expertise. Only by working across organizations, one can hope to connect the dots (across financial institutions, markets, and countries), clearly articulate risks, and propose practical remedies.

The starting point for any early warning system must be better information on global financial and economic developments and better collaboration across institutions. In particular, the monitoring of large financial conglomerates with major cross-border activities and of cross-border derivative positions will need to be stepped up. Better risk assessment will also mean strengthening macro-financial analysis and enhancing work on early warning systems. Consistent with the core mandate of the Fund to promote global financial stability, we have already begun strengthening our early warning capabilities. There are technical challenges, though. More research is needed on the linkages between financial sector and macroeconomic performance (for instance, on the relationship between monetary policy and risk taking). And new and better operational tools need to be developed for macro-financial surveillance. We are therefore eager to strengthen our collaboration with others involved in this area.

Early warning and surveillance work will also need to find the right incentive balance between countries voluntarily engaging in assessments and making them mandatory. Models to consider vary between “name and shame”, “comply or explain”, and binding commitments to act. In this respect, the Fund’s various multilateral and bilateral assessments could be used more systematically to examine macro-prudential risks and progress in the implementation of multilaterally agreed principles, standards, and actions. There will be a need, however, to

consider stronger requirements on member regulators and authorities to participate, more streamlined processes, and improved means of dissemination, while recognizing the tension inherent in the official sector's functions of whistle blower and crisis preventer.

The Need for More Effective, Coordinated Actions

The crisis has shown how costly lack of coordination can be. While close technical contacts among key policy making agencies can help identify remedies when serious risks are diagnosed, follow up requires the engagement of top policy-makers, without which any international effort is doomed. Effectiveness in turn calls for a group of key policymakers small enough to be able to take coordinated decisions, but large enough to be representative of a range of perspectives. To reflect the reality in global financial and economic markets, the group's composition needs to go beyond the major advanced countries, but might stop short of broader ministerial groups. Regardless, for the group to be able to internalize and respond effectively to anticipated risks, members should have direct influence over macroeconomic policies, regulation, and crisis management (including the provision of financial support) in their home jurisdictions.

This group could be supported by one or several organizations to gather information, distill policy implications, and monitor policy implementation. For example, the World Bank would serve as a hub in bringing its analysis to bear on development issues. The FSF—expanded to cover the larger emerging market countries—could serve as a hub in a broader network of standard setters and regulators. The Fund could act as a hub in an early warning and response system, bringing together its own analysis of macro-financial risks and spillovers with the detailed information and perspectives provided by national financial stability authorities and international agencies such as the BIS. The key point is that there be some form of coordination, so that recommendations can lead to decisions and be translated into action by national-level authorities.