CHAPTER

Overview

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The global economy went through a period of unprecedented financial instability in 2008–09, accompanied by the worst global economic downturn and collapse in trade in many decades. No country escaped the reach of this economic storm. The IMF played a leading role in helping the membership deal with the immediate challenges posed by the crisis and work toward a new, strengthened global financial system. To address these challenges, the Fund focused its efforts on (1) providing policy advice and timely financial support that met members' needs, (2) analyzing what went wrong, with the aim of fortifying the financial system against a recurrence of crises down the road, and (3) assembling the building blocks of a new international financial architecture. At the same time, the crisis accelerated some elements of the Fund's work program and redirected resources toward the following areas: advancing surveillance priorities, reforming the Fund's lending framework, supporting low-income countries, increasing the Fund's activities in the area of capacity building, reforming the Fund's corporate governance, and augmenting the Fund's resources. Work toward modernizing the IMF, which accelerated in FY2008 with the Fund's restructuring exercise, continued in FY2009,[1] and other institutional work focused on strengthening internal accountability and transparency, revamping the institution's human resources function, and safeguarding the Fund's finances and other operations, as well as putting the institution on a stronger financial footing.

FROM FINANCIAL MARKET TURMOIL TO GLOBAL RECESSION

The seeds of the global crisis were sown during the years of high growth and low interest rates that bred excessive optimism and risk taking and spawned a broad range of failures—in market discipline, financial regulation, macroeconomic policies, and global oversight. During this period, the global financial system expanded massively, creating new instruments that appeared to offer higher rewards at lower risk. This was encouraged by a general belief in "light-touch" regulation based on the assumption that financial market discipline would root out reckless behavior and that financial innovation would spread risk, not concentrate it.

Both of these assumptions proved wrong, or at least misguided. The result was an unsustainable accumulation of external imbalances; major asset price bubbles in advanced and emerging market economies, especially in housing; a severe run-up in commodity prices; and an enormous buildup of leverage and risk in key financial systems, both inside and outside the formal banking system.

Understanding this crisis

Understanding the causes of the financial crisis is critical for restoring stability and, to avoid another crisis of this magnitude, building a sound global financial system. While the postmortem is likely to continue for many years, the IMF's initial analysis pointed to a failure in the global architecture in providing adequate warnings prior to the crisis, especially in the surveillance of systemically important advanced countries, and regulatory failures at a number of levels:

- excessive leverage and risk taking, driven by a long period of low real interest rates and high growth;
- shortcomings in the approach to domestic and international financial regulation;
- fragmented regulatory structures;
- inadequate disclosure of risks; and
- weaknesses in crisis management and bank resolution frameworks.

In general, financial regulators were not equipped to see the risk concentrations and flawed incentives behind the financial innovation boom. Neither market discipline nor regulation was able to contain the risks resulting from rapid innovation and increased leverage, which had been building up for years.

With respect to macroeconomic policy, policymakers failed to take sufficiently into account growing macroeconomic imbalances that contributed to the buildup of systemic risks in the financial system and in housing markets. Effective policy cooperation at the international level was not achieved, which compounded the risks inherent in the inability to spot growing vulnerabilities and cross-border links. Central banks focused mainly on inflation, not on risks associated with high asset prices and increased leverage. And financial supervisors were preoccupied with the formal banking sector, not with the risks building in the shadow financial system.

As a consequence, the spreading financial crisis advanced further and faster in FY2009 than expected, leading to an unprecedented contraction in global output and trade. The ramifications of the credit crunch and the sharp drop in asset prices were quickly passed on through banking systems to all sectors and countries in the global economy and were magnified by the collapse of consumer and business confidence.

Macroeconomic policy priorities in response to the crisis

Throughout FY2009, the Fund directed its resources toward meeting the immediate needs of members in terms of financing and policy advice. Many countries found themselves facing difficult financial or economic conditions owing to the sharp increase in food and fuel prices in 2007–08, which affected many middle- and low-income countries early in the financial year, or later because of the damage caused by spreading financial instability. As the financial crisis hit the real economy (trade, output, and employment) and spread to all corners of the globe, the Fund advocated the following urgent policy priorities, at both the national and international levels:

- *Repairing financial sector balance sheets*—forceful action to recapitalize banks and cleanse their balance sheets—was essential to get credit markets functioning and the global economy moving again. Until this was done, attempts to restore demand were likely to falter.

- *Recognizing the importance of monetary policy support*, as deemed appropriate to domestic conditions.

- *Delivering a global fiscal stimulus in 2009 and 2010.* The Fund encouraged those countries, both advanced and developing, with fiscal space available to use it to boost demand. The crisis highlighted the importance of fiscal space to ensure that countercyclical fiscal policy is possible during economic downturns. For the most part, countries have delivered on fiscal stimulus in 2009, and support needs to be sustained in 2010.

- *Significantly increasing official international financing,* especially to alleviate pressures on emerging markets and low-income countries. In April 2009, Group of Twenty (G-20) leaders agreed to triple the IMF's regular lending capacity to US$750 billion, at least doubling its concessional resources for low-income countries, and to expand global liquidity by US$250 billion through a general allocation of Special Drawing Rights (SDRs);[2] these measures were also endorsed by the Fund's policy advisory body, the International Monetary and Financial Committee (IMFC). This commitment helped boost confidence and needs to be complemented by implementing actions at the national level.

COUNTRY-SPECIFIC ASSISTANCE

During the first months of FY2009, the sharp increase in food and fuel prices was posing significant challenges to some low- and middle-income countries. Taking action to address these pressures, the Fund augmented financing under the Poverty Reduction and Growth Facility (PRGF) for a number of low-income countries, made the Exogenous Shocks Facility (ESF) more readily accessible, adjusted some programs to allow additional fiscal spending, and convened a public seminar to review the effects of the surge in commodity prices on the economies of low-income and emerging market countries. Later in 2008, the Executive Board reviewed transnational spillover and other effects of fiscal subsidies put in place in connection with surges in commodity prices.

As the financial crisis began to take on global dimensions, the IMF at midyear stepped up its assistance to members by providing expedited financial support, including by using its emergency financing mechanism (see Box 3.1). The Executive Board approved SDR 65.8 billion for 15 countries in the use of Fund resources under its traditional nonconcessional lending facilities and the newly established Flexible Credit Line (FCL) during the year (see Table 3.2). The Board also continued to approve new arrangements under the PRGF and ESF (see Table 3.3). As of April 30, 2009, the economic programs of 28 member countries were supported by Fund arrangements under these facilities, with commitments totaling SDR 1.8 billion, as compared with 25 member countries and SDR 1.1 billion at the end of FY2008.

A STRONGER ROLE FOR THE IMF

The Managing Director moved forward with fundamental changes in 2008 to reorient the strategic vision of the Fund and to boost the dynamism of Fund operations in response to the crisis. A further critical impetus came in November 2008 and again in April 2009 when G-20 leaders convened to promote broader economic cooperation and to mobilize a multilateral response to the crisis. Of particular note, the G-20 articulated, and committed to, the priority macro policy response required

Tobacco harvest in Malawi.

by the global community. These policies were consistent with the policy advice being espoused by the IMF. The G-20 "stressed the IMF's important role in crisis response" and that the IMF and the multilateral development banks "should have sufficient resources to play their role in overcoming the crisis."

By March 2009, the Executive Board had approved a number of major changes that significantly improve the nature, timeliness, and effectiveness of the Fund's response and permit it to respond decisively to the needs of the entire membership. In this respect, the IMF was thrust into the center of the economic policy debate and crisis resolution. This also led to decisions to boost the Fund's resources to give it the firepower to provide the necessary financial assistance to those countries seriously affected by the crisis.

Reform of the Fund's lending framework

In this context, the Executive Board advanced work to modernize the Fund's lending instruments in order to better tailor them to the evolving needs of member countries. This involved changes to the policy advice, conditionality, and financing terms. In March 2009, the Board approved a major overhaul of the Fund's lending framework, the culmination of numerous Board discussions and extensive staff work—which started in early 2008—to assess and determine the reforms that would best enable the Fund to fulfill its core mandate. The reforms approved included modernizing IMF program conditionality for all borrowers, introducing a new Flexible Credit Line for members with very strong fundamentals and policies, enhancing the flexibility of the Fund's traditional Stand-By Arrangement and concessional lending facilities, doubling normal access limits for both nonconcessional and concessional resources, simplifying cost and maturity structures of loans, and eliminating certain seldom-used facilities. The Executive Board approved the first arrangement, on a precautionary basis, under the Fund's new FCL to Mexico (SDR 31.5 billion) during FY2009; commitments to Poland (SDR 13.7 billion) and Colombia (SDR 7 billion) under the FCL, on a precautionary basis, were approved early in FY2010.

By enhancing instruments for lending, including precautionary lending, and modernizing the conditionality framework to ensure that conditions on the use of Fund resources are tailored to the strength of members' policies and fundamentals, the reforms aim to encourage members to approach the Fund early, thereby reducing the likelihood of crises or mitigating their ultimate costs. Together with a substantial increase in the Fund's resources, the reforms provide a strong platform from which the Fund can respond robustly to help members tackle the current as well as future crises.

Getting the fundamentals of the global economic and financial system right

The Fund also directed its energies toward understanding the sources, scope, and consequences of the crisis and strengthening collaboration with other international financial organizations, particularly the Financial Stability Board (FSB).[3] In early 2009, the IMF Executive Board discussed staff analysis, undertaken at the request of the IMFC, on the initial lessons from the crisis. Executive Directors stressed the preliminary nature of the discussion as well as the Fund's singular responsibility, given its mandate, to analyze the crisis and to work closely with other players—both national and international—to help restore global financial stability and economic growth.

Based on the range of views on the relative importance of the shortcomings identified (see above) as contributing to the crisis,

Workers gather at a job market in Nanchang, Jiangxi, China.

the Board saw the need for remedial actions across a broad front and at many levels, implying an ambitious agenda for policymakers and the need for coordinated action. The IMF identified four key areas, emanating in part from this review, to help prevent future crises: better regulation, better surveillance, better financing arrangements, and better international cooperation. The IMF has a key, although different, role to play in these areas and began work in FY2009 to address, or contribute where applicable to resolving, them:

- Better financial regulation and supervision, with priority on expanding the regulatory perimeter to encompass all activities that pose economy-wide and cross-border risks. Although not taking the lead on this issue, the Fund can monitor implementation of agreed outcomes through the surveillance process. The regulatory perimeter, or scope of regulation, needs to be expanded to encompass all activities that pose risks to domestic economies and foreign markets. Market discipline needs to be strengthened. Initiatives to reduce conflicts of interest among credit-rating agencies and improve investor due diligence are underway. Finally, central banks should review their frameworks for systemic liquidity provision. The infrastructure underlying key financial markets should also be improved.

- Financing arrangements that adapt to meet the evolving needs of members and the changing marketplace. IMF lending must continue to adapt so that it is better tailored to country circumstances and encourages countries to approach the Fund early.

- Better bilateral surveillance that focuses on systemic risks, looks at international spillovers, and aims at better integrating macroeconomic and financial sector work.

- Better international cooperation and multilateral surveillance. For the IMF, governance reform will be a critical component of reform for providing emerging markets and low-income countries with a greater sense of ownership and for fostering global policy cooperation. Endowing the IMF with a fully representative voice will lend it institutional legitimacy and credibility, thereby helping it to fulfill its mandate more effectively.

ADVANCING SURVEILLANCE PRIORITIES

Surveillance—the IMF's term for its oversight of the international financial system and monitoring of economic and financial policies of member countries—is one of the Fund's primary areas of responsibility. Responding to concerns raised by the global crisis, the Executive Board intensified its efforts in FY2009 to ensure the adequacy and effectiveness of the IMF's surveillance activities. In the context of the Fund's Triennial Surveillance Review, which was concluded in October 2008, the Board issued its first-ever Statement of Surveillance Priorities, which delineated four economic and four operational priorities for Fund surveillance through 2011. In their discussion at the conclusion of the review, Executive Directors broadly agreed on four priority areas for the Fund's surveillance over the next few years: risk assessment, macrofinancial linkages, multilateral perspective, and external stability and exchange rate assessments. In following up on the priorities identified, the Board held a seminar to review challenges in integrating financial sector issues into surveillance, and the Fund moved forward with its plans for closer collaboration with other organizations, including an early warning exercise, conducted jointly with the Financial Stability Board. In response to the need to reinforce ongoing data transparency initiatives, as revealed by the global crisis, the IMF created and chairs an interagency group that promotes a collaborative and global view of economic and financial data needs in light of the crisis. As its first action, the group created the Principal Global Indicators website, providing access to financial, governmental, external, and real sector data on G-20 economies. Finally, the Fund's ongoing bilateral, multilateral, and regional surveillance activities continued during the year, including efforts to increase the effectiveness of the Fund's Article IV consultation process.

MODERNIZING THE FUND

Though efforts to help members cope with the effects of the crisis and to lead efforts to restore stability to the global financial system clearly dominated the year's work, the IMF remained mindful of the need to continue its ongoing endeavors to modernize, which had intensified in FY2008. Reform of IMF governance, a key issue in FY2008, continued to occupy a prominent place on the agenda in FY2009. The Fund's membership began the process of implementing the quota and voice reform approved by the Board of Governors at the close of FY2008. The Executive Board formed a working group to direct and integrate the Fund's response to an Independent Evaluation Office (IEO) report on Fund governance, and Fund management appointed a special committee of eminent persons to make recommendations on Fund governance reform. The IMFC called in early April 2009 for an accelerated review of IMF quotas to enhance the voice of emerging markets and developing countries in the Fund. Fund staff developed a comprehensive plan to engage civil society and other stakeholders in the reform process.

Sharpening the IMF's focus on, and increasing its attention to, low-income countries (LICs), an area of significant emphasis in recent years, took on particular urgency in FY2009 as a result of, first, the spike in food and fuel prices in the first half of 2008, which put developing countries particularly at risk, and later, the spillover effects of the global instability in financial markets, which originated in advanced economies but eventually spread to the rest of the world, including low-income countries (the "third wave" of the crisis), when they had barely had time to recover after the abatement of food and fuel prices. The Board reconsidered the Fund's work in low-income countries during the year, articulating a mission statement for its work in such countries, and discussed proposed reforms for its concessional lending instruments to tailor them more closely to evolving LIC needs as the crisis unfolded.

Efforts have been ongoing for several years to improve the targeting of the IMF's capacity-building activities—the training and technical assistance it provides to member countries to enhance their technical and other capabilities—and ensure that they deliver maximum impact while employing Fund resources as effectively as possible. The Board reviewed both the Fund's training program and its technical assistance activities during the year, supporting decentralization of training through greater use of regional training and technical assistance facilities as both cost-effective and necessary for added flexibility, and endorsing substantial reforms in provision of technical assistance that were initiated as part of the Fund's FY2008 refocusing exercise. It also approved a new policy under which member countries would be charged graduated fees for use of the Fund's capacity-building services, and the Fund undertook new fundraising efforts to support its capacity-building activities and announced plans to open new regional technical assistance centers in Africa, Central Asia, and Central America.

FINANCES, ORGANIZATION, AND ACCOUNTABILITY

Major reforms initiated in FY2008 as part of the IMF's restructuring transformed the Fund into a leaner, refocused institution in FY2009. In the area of Fund financing, the Executive Board's agreement on a new income model for the Fund, approved by the Board of Governors early in the financial year, paved the way for diversification of the IMF's sources of income, chiefly through the broadening of the Fund's investment authority. Efforts to implement the IMF's reformed income and expenditure framework, modified in FY2008 to put the Fund on a sounder and more sustainable financial footing, also continued in FY2009. Greater than expected savings, largely from factors related to the FY2008 refocusing exercise, helped generate a substantial underrun of the FY2009 administrative budget, which the Executive Board authorized to be carried over to FY2010.

The Fund's human resources activities faced an additional challenge in FY2009 resulting from increased demands on Fund staff related to the global crisis, even as the staff size was decreasing in connection with the restructuring exercise initiated in FY2008. A hiring freeze in place as FY2009 began gave way to intensified recruitment efforts in the second half of the financial year, as a greater-than-targeted number of staff separations under the restructuring left room in the budget to recruit permanent staff even within the new, lower staffing levels. This offered the opportunity as well to update the skills mix among staff to help accommodate shifting demands on the Fund's workforce resulting in part from the global crisis. The recruitment effort also contributed to progress in regard to diversity at the Fund, which showed improvement in FY2009, particularly in the areas of gender balance and representation of underrepresented regions. In its continuing effort to maintain a framework for its human resources activities with sufficient flexibility to meet its evolving business needs, the Fund pressed forward with its human capital management project, designed to streamline human resources processes and simplify policies, and introduced a more systematic approach to succession management and leadership development as the financial year drew to a close.

Building on work begun in previous years, IMF activities in FY2009 continued the trend in the institution toward greater accountability, openness, and transparency. Responding to a IEO evaluation of Fund governance that identified a gap in this regard, the Executive Board introduced an accountability framework for the Fund's management, with work underway to identify performance criteria, processes to be used, and ways to link assessments to incentives. A confidential Integrity Hotline, established in June 2008, enables staff and others to report, on an anonymous or identified basis, allegations of staff misconduct, which are followed up by the Ethics Office. With Board approval, the hotline's coverage was extended shortly thereafter to include (though with a different follow-up mechanism) the Managing Director and Executive Directors. The Independent Evaluation Office continued to pursue its mission of conducting independent and objective evaluations of IMF policies and activities. In addition to Board discussions during the year surrounding the IEO assessment of IMF governance and Fund management's implementation plan in response to the IEO's assessment of structural conditionality in IMF-supported programs, the IEO issued an evaluation of the Fund's involvement in international trade policy issues at the end of FY2009. As part of ongoing efforts to strengthen the evaluation and management of risk, the Board was briefed on transitional risks arising from the Fund's downsizing and restructuring and reviewed an advisory committee report on risk management. Finally, the 2009 report on implementation of the Fund's transparency policy showed improvement on a number of measures of institutional transparency, including the publication rates for documents in several categories.