Strengthening the system: the need to adjust the IMF

As the G20 faces having to redesign financial crisis-management facilities at the global level, it may find that the most effective route is to adapt an existing instrument – the International Monetary Fund – to current policy challenges

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One day last year, a European official explained something to me. "It used to be that whenever I had to bail out a bank, I never worried about the taxpayers," he said. "Any political resistance or anxiety could be handled simply by reminding them that by preventing chaos in their financial system, we were using their money to save their own assets. But during the crisis of 2008, taxpayers saw us using their money to bail out foreigners. From now on we have to be mindful of a new political reality. Next time, we might not be able to do it." The underlying policy challenge is now pressing, not only in Europe but globally.

It should surprise no one that bitterness and resistance now surround the issue of saving large complex financial institutions (LCFIs) during systemic emergencies. Nor should it be a surprise that recent governmental actions have led to sovereign debt crises that require collaborative action to resolve. The situation reflects more choice and decision than accident or error. The states now represented around the G20 table did not stumble blindly into this 'new world'. After 1945, primarily for reasons of security, they expanded trade and investment flows across their borders. In the early 1970s, the exchange rate system designed to facilitate those flows broke down, so the states chose to reduce controls on ever larger cross-border movements of short-term capital. At various collaborative decision points since then, open markets for goods, services and capital have appeared to promise better economic and security outcomes than any feasible alternative. Only the wilfully blind were unaware that the necessary implication was deeper, and more intrusive, political cooperation in the years ahead.

In a national setting, that kind of cooperation ultimately entails the definitive and legitimate resolution of problems of collective action associated with periodic financial emergencies. It defines the very scope of government in the financial arena. But few were, and are, yet ready to countenance the same idea at the global level. So the realities of the now-common life are obfuscated by such terms as 'mutual adjustment', 'reliable collaboration' and, lately, 'global governance'.

Governments, by definition, exist to organise societies, oversee and redirect the benefits and the costs of living together, and otherwise promote the common social good. But the global society that has been evolving since 1945 is not yet ready to accept the rights and obligations associated with a shared future. A sense of solidarity, or at least inevitability, remains weak. And the common good is not yet fully recognised. But those benefiting most from a status quo defined by integrating markets will not willingly retreat, while those losing out lack both the power to roll back the status quo and an alternative vision for a better future.

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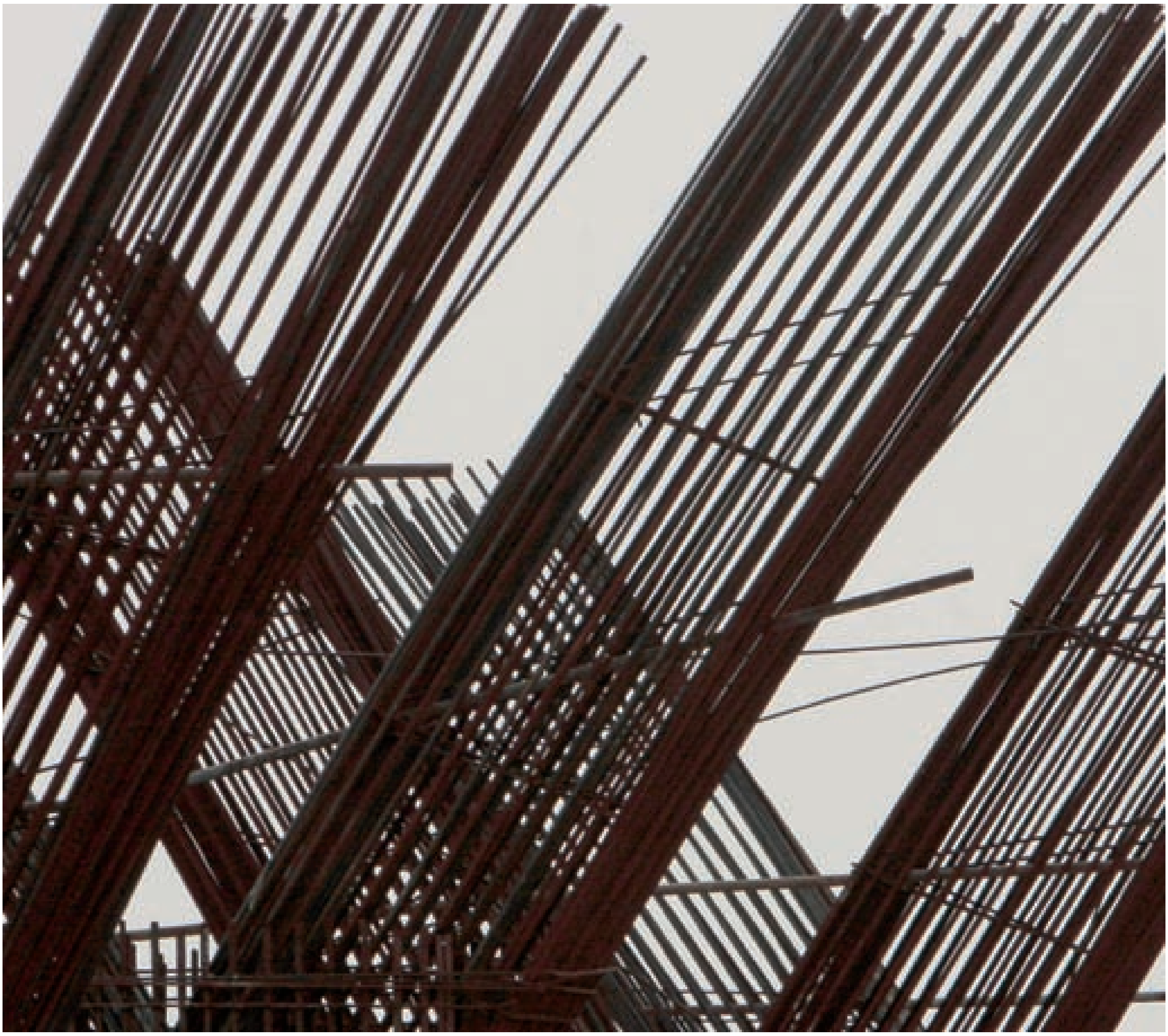
A gamble with global security

The overarching task for the G20 is to take the next steps in building a truly global society that recognises itself as such. In the midst of mounting financial crises, the choices before leaders and their constituents are clearer than ever. One choice culminates in *ex ante* intergovernmental agreements on fiscal burden-sharing during collective emergencies. Despite the crisis of 2008 and its aftermath, aligning all the relevant political forces appears too ambitious. Even Europeans still committed to the ideal of a single market face great difficulties in negotiating legitimate and effective arrangements in the shadow of imminent catastrophes. Perhaps ad hoc measures such as those deployed in 2008, and constructive ambiguity, can mitigate the moral hazards associated with any kind of emergency backstopping system, whether applied to LCFIs or to excessively indebted governments. But why gamble with global security in this way?

Two alternatives are under debate. One is to break up all LCFIs and ring-fence vulnerable national markets. Let financial institutions that desire to expand abroad establish fully capitalised subsidiaries capable of being efficiently wound up by host countries in an emergency. Alas, the idea is wise and elegant, but unrealistic. It discounts the political power of many financial institutions, and unjustifiably imagines that national authorities will give up the idea of sustaining globally competitive national champions, eschew greater reliance on foreign capital to meet domestic consumption and investment needs, and fully cooperate at crucial points in the implementation stage. Experimenting again with capital controls and living wills to facilitate cross-border bankruptcies seems to provide convenient substitutes, but they only render the core dilemma less transparent.

The other alternative is difficult, messy, inelegant and hardly foolproof. It aims to affirm a commitment to collaborative problem-solving, but to limit its scope



by raising LCFI capital requirements, cooperating more intensively on systemic risk supervision, reducing national reliance on debt-fuelled growth and expanding emergency standby facilities through intergovernmental instruments such as the European Stability Mechanism.

LCFIs are likely to remain in existence. The logic of intensive fiscal collaboration must eventually extend to the global level. There is no realistic escape from the necessity of fiscal burden-sharing during emergencies, and from limiting associated risks by deeply sharing supervisory responsibilities. The task ahead is not unprecedented.

Valuable vehicle for collaboration

In the post-1970s trade and investment-centred economic order, that same logic led member states to adapt the International Monetary Fund (IMF) to operate not simply as a technical advisory agency, but as a vehicle for fiscal collaboration and macroeconomic supervision. During various debt crises from the 1970s through the 1990s, it worked not perfectly, but reasonably well. The world of 1931 remained a distant memory.

Some say a better and more feasible objective now is to adapt earlier global experiments in emergency management, centred on networks of central banks. This would be fine if all that was needed were temporary liquidity facilities during foreseeable crises in an increasingly complex system. But such hopes were clearly dashed between 2007 and 2011. Sometimes, integrating financial markets requires confronting solvency problems that require fiscal responses. Routinely attempting to hide such responses though the operations of central banks could eventually produce a profound political backlash, and the kind of global monetary instability the world has been trying to avoid for the past 80 years.

Sooner or later, the G20 will find that the most promising path forward leads back to redesigning definitive crisis-management facilities at the global level, and then its members will ask themselves a simple question: why contemplate the difficult politics of inventing a brand-new instrument, when a tested instrument already exists in prototype?

It is time to adjust the IMF to current policy challenges. Its callable resources need to be expanded significantly, the political foundations upon which it rests need further rebalancing, and the legal obligations underpinning its surveillance authority need to be enhanced and reinforced. The pressures that have recently drawn attention to the Financial Stability Board and the European Financial Stability Facility are global pressures. A serious global instrument for financial stabilisation is required if the effort to build enduring social and political solidarity through integrating capital markets is to succeed. ◆

Reinforcement bars at a construction site in China. A global financial stabilisation instrument is needed to build social and political solidarity