# Role of the IMF in the Global Financial Crisis

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More than two years on, the impact of the financial crisis that erupted in August 2007 is still being felt as the global economy emerges from the Great Recession. The crisis intensified dramatically after the bankruptcy of Lehman and the rescue of insurance giant AIG in September 2008, which narrowly avoided a near-simultaneous failure of multiple counterparties. The International Monetary Fund's early forecast of the severity of the resulting economic downturn (IMF 2008a) helped mobilize concerted official action to address quickly and forcefully these extraordinary economic and financial events by providing fiscal stimulus to sustain growth, as well as capital injections and guarantees to ease the credit crunch. Following the emergency summit of G20 leaders in Washington in November 2008, support packages for banks were put together in a hurry in the United States, Europe, and elsewhere to prevent the disorderly failure of systemically important institutions and to restore confidence in the financial system.

These unprecedented interventions prevented a meltdown and contributed significantly to signs of economic and financial stabilization since the spring of 2009.

In this article, I review the role of the IMF in the global crisis and argue that the Fund has emerged as a powerful institutional force, providing analysis and recommendations that have served as the basis

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of official action on several fronts. By contrast, the Fund was barking up the wrong tree when it focused its attention on the global imbalances and adopted the Surveillance Decision in the run-up to the crisis in 2006–07.

## IMF Policies and Reforms in Response to the Crisis

The Fund helped shape the global policy response through its policy advice and spot-on analysis of global economic and financial conditions, contributing to the process of modernizing the global financial architecture. It was also quick to adapt its own surveillance activities and lending policies in response to the crisis.

### *Lessons of the Crisis for IMF Surveillance*

The root cause of this crisis was the buildup of systemic risk due to regulatory and supervisory failure that was not adequately captured by the Fund's surveillance framework. The crisis has clearly demonstrated the need to improve the existing framework for assessing financial stability and to reinforce early warning capabilities in the advanced countries as well as globally. The global reach of the crisis also gave rise to calls for improved monitoring of cross-country spillover risks and their potential macroeconomic impact. At its October 2009 meeting, the International Monetary and Financial Committee (IMFC) recognized that a reassessment of the Fund's role was in order and called on the Fund to review its mandate "to cover the full range of macroeconomic and financial sector policies that bear on global stability, and to report back to the Committee by the time of the next Annual Meetings" in 2010 (IMFC, 2009a). At the Committee's request, the Fund distilled the initial lessons even as the crisis was still unfolding (IMF 2009a) and is in the process of revising its policies and governance accordingly.

### *Global Financial Stability*

The Fund's Global Financial Stability Report (GFSR), published semiannually since 2003, assesses key risks facing the global financial system highlighting policies that can help mitigate systemic risks and enhance financial stability. In the run-up to the crisis, the GFSR warned about rising credit and market risks associated with the growth in subprime mortgages embedded in complex, hard-to-price structured products (IMF 2006 and 2007a). Similarly, the World

Economic Outlook (WEO) flagged some early concerns about the risks of house price bubbles in the United States and the dangers from large current account deficits in emerging Europe (IMF 2007b). However, the focus of this advice was not sharp enough to prompt policy action, and policymakers in the still-booming global economy were less receptive to the warnings. The fact that the crisis originated in the advanced countries, normally outside the purview of the Fund's crisis prevention efforts, contributed to complacency. A more evenhanded surveillance would have enhanced the Fund's effectiveness and legitimacy by bringing about a better balance between peer protection and peer pressure.

After the onset of the crisis, the Fund provided valuable policy recommendations for policymakers, regulators, and standard setters based on sharp analysis of the origins and likely consequences of the global financial crisis. The priorities identified in the GFSR were explicitly recognized in the G20 Communiqué at the Pittsburgh summit in September 2009. Proposed solutions were geared to resolving conflicts of interest, improving risk management, reducing procyclicality, filling information gaps, dealing with distressed assets, and unclogging the credit channel. The Fund stressed the need for policymakers to follow up on emergency policy responses to the crisis with macro-prudential and regulatory reforms aimed at making the global financial system less crisis-prone.[1] The key objectives are to broaden the perimeter of regulation to include all systemically important institutions (both banks and nonbanks), to keep track of leverage in the system, and to make monetary policy more responsive to asset bubbles.[2]

The Fund helped shape the policy response by analyzing the relative roles of demand and supply factors in explaining the sluggish pace of credit growth, estimating bank write-downs by region based on a common methodology, and assessing the impact of extraordinary government support through guarantees and recapitalization. Its analysis showed that the "originate and distribute" model of credit creation was a sound business model that stumbled

[1] The April 2009 issue of the GFSR discusses the sources of financial distress and provides policy advice on the short-term response to the financial crisis as well as the longer-term measures needed to make the global financial system more robust.

[2] See IMF (2009c) for an analysis of the role of monetary policy in preventing asset bubbles.

on poor implementation, as the risks were kept in structured investment vehicles (SIVs) instead of being widely spread. Restarting securitization markets would help unclog the credit channel by freeing-up bank balance sheets, while helping central banks exit from exceptional liquidity support provided by swapping (or buying outright) asset-backed securities. At the same time, the Fund also warned that the process of financial sector and household deleveraging has yet to run its course and that further write-downs are in store as losses are not yet fully recognized (IMF 2009b, 2009c).

## *Macro-Prudential Framework*

The failure of regulation to address the buildup of risks in the shadow banking system has amply demonstrated the need to expand the perimeter of regulation to a wider range of systemically important institutions and markets, including off–balance sheet derivatives that turned out to be so important in the recent crisis. The Fund has made important analytical contributions to the measurement of "interconnectedness" and systemic risk that can help define the perimeter of regulation, while warning against a "rush to regulate" in ways that unduly stifle innovation (IMF 2009d). To ensure a consistent approach to the perimeter of regulation, the information collection framework should be monitored through a globally coordinated mechanism, with a key role to be played by the Fund. As a member of the Financial Stability Board (FSB), it actively participates in its various working groups, notably on procyclicality and valuation, as well as in the working groups of the Basel Committee on Banking Supervision and other standard setting bodies involved in the ongoing revision of Basel II rules.

Excessive leverage and liquidity mismatches—the two key ingredients of systemic crises—are the defining characteristics of the recent financial crisis. The Fund's assessment of the preliminary lessons of the crisis appropriately emphasizes the primacy of financial supervision and regulation in preventing excessive leverage and easing liquidity constraints. However, traditional regulation that focuses exclusively on individual institutions and financial instruments needs to be supplemented by a macro-prudential approach that takes into account systemic and cyclical factors. There is a need to integrate monetary, fiscal, and regulatory policy into a macro-prudential policy framework that helps avoid the buildup of systemic risk during good times and the subsequent painful deleveraging process. Capital regulations requiring additional capital buffers during upswings would contribute to crisis prevention at the global level by discouraging the accumulation of risks and leverage and by creating a cushion that can be drawn upon in a downturn. Countercyclical capital requirements would thus tend to dampen, rather than amplify, future credit and asset bubbles.

The crisis demonstrated the need for prudential measures to reduce balance sheet mismatches and exposure to exchange rate risk, as well as other vulnerabilities associated with large capital inflows. A strong case can be made that, in addition to the envisaged expansion of the Fund's surveillance mandate beyond exchange rates to macro-financial stability, the Fund should be given a clearer mandate on financial flows and the capital account. As proposed by the Manuel Committee on IMF governance reform (IMF 2009e) an eventual amendment of Articles of Agreement should be considered to give the Fund jurisdiction over the capital account. Jurisdiction is not tantamount to liberalization: Just as it took half a century for Fund members to gradually liberalize current account transactions under Article VIII, full capital account liberalization might take a similarly long time. In the meantime, the Fund could usefully develop principles to underpin capital account liberalization and the use of capital controls.

### *Financing*

As the Fund accurately predicted, emerging market countries (EMCs) were not able to decouple. The crisis that originated in the advanced countries had a significant impact on EMCs as risk aversion and flight to quality led to a dramatic drop in private capital flows. European emerging markets that relied on externally funded credit booms were particularly hard hit. IMF staff analysis indicated that refinancing needs of EMCs were set to rise from $1.7 trillion in 2008 to $1.8 trillion in 2009 and $2.0 trillion by 2012 (IMF 2009d). Rollover rates of 100 percent would be difficult to reach at a time when banks and institutional investors were trying to reduce the risk and leverage in their portfolios to maintain capital adequacy despite the losses suffered during the crisis. The large potential external financing gaps highlighted the need to ensure that the Fund had adequate resources to remain a credible stabilizing influence.

To contain the fallout of the crisis on EMCs, officials at the G20 summit in London in April 2009 pledged to triple the Fund's lending resources to $750 billion and agreed to a general SDR allocation of $250 billion. Armed with more resources, the Fund was quick to adapt its lending policies in response to the crisis. A new instrument, the Flexible Credit Line (FCL) was created to provide large, upfront financing on a precautionary basis and to better tailor conditionality to country circumstances. Countries with solid fundamentals and strong policies now have access to IMF financing on demand, with no conditionality, to address actual or potential balance-of-payments pressures. Together with increased lending limits, the new precautionary FCL provides insurance that helps strengthen market confidence about the country's ability to meet rollover needs and thus avoid a crisis. Mexico was the first country to benefit from the FCL in March 2009, with a $47 billion loan—the largest in the Fund's history—followed by Colombia and Poland.

Countries not eligible for the FCL could access IMF financing beyond the normal access limits under High-Access Precautionary Arrangements (HAPAs)—essentially precautionary standby arrangements with large and frontloaded access. The Fund's concessional lending capacity was doubled, in line with the G20 call for $6 billion in new lending to low-income countries over 2–3 years, with windfall profits from IMF gold sales helping to fund concessional lending.

### *Global Liquidity Provision*

In response to the crisis, central banks injected massive amounts of liquidity by broadening the range of accepted collateral and by lengthening the term of refinancing operations. However, nonreserve currency countries faced shortages of foreign exchange liquidity which threatened to further depress trade and international financial transactions. The general allocation of $250 billion of SDRs to Fund members in proportion to their quotas in August 2009 alleviated this bottleneck by providing such liquidity on a global scale.[3] Emerging market and developing countries as a group received about $100 billion of the new allocation. The size of this SDR alloca-

[3] Separately, a special one-time allocation of SDRs amounting to $34 billion was made to Fund members in September 2009, to correct for the fact that countries that joined the Fund after 1981 had never received an SDR allocation.

tion was unprecedented compared to the previously outstanding stock of just $33 billion of SDRs.

## *Exit Strategies from Exceptional Support*

With the difficult and uncertain outlook pointing to a protracted global recession, the IMF's managing director called for global fiscal stimulus in early 2008, thus helping the global economy avoid a Great Depression (IMF 2008b). The Fund also took the lead in providing thoughtful and timely papers on exit strategies from crisis-related measures to support economic activity and safeguard financial stability (IMF 2009f). Fiscal risks have risen substantially due to financial sector support, fiscal stimulus, and declines in the price of assets acquired from the private sector through swaps or outright purchases. Given their scale, these interventions could add significantly to public debt levels in the advanced countries. Now that a systemic collapse has been averted and markets are normalizing, attention is therefore focusing on exit strategies from exceptional support to safeguard fiscal sustainability and avoid a buildup of inflation pressures. World leaders at the G20 summit in Pittsburgh in September 2009 pledged to maintain policy support until a durable recovery was secured. The IMFC reiterated this pledge at its October 2009 meeting and instructed the Fund to report at its next meting in April 2010 on how best to coordinate exit strategies so as to avoid regulatory arbitrage and protectionist measures.

A key message of the Fund's analysis is that exit strategies need to be clearly articulated and crisis-related assets and liabilities on public balance sheets be managed in a way that protects the long-term interests of taxpayers while allowing beneficiaries to return to viability soon. The Fund also has stressed the need to reestablish clarity in the policy assignments across public institutions, by transferring quasi-fiscal operations of the central bank to the government, so as to avoid any impairment of the central bank balance sheet that could affect its ability to implement monetary policy effectively.

## *Early Warning Exercise*

Looking beyond the crisis, in April 2009 the IMFC called on the Fund to improve its analysis of the macro-financial linkages and cross-border spillovers, and mandated the IMF and the FSB to collaborate in conducting Early Warning Exercises (IMFC 2009b). Working with the FSB, the Fund is in the process of refining the tools necessary to provide clear early warnings to members about the risks of future crises. In line with their respective roles, the Fund's macro-financial analysis incorporates information provided by the FSB on regulatory and supervisory issues.

The exercise is designed to detect underlying vulnerabilities, such as excessive leverage, risk concentrations, credit growth, currency and maturity mismatches, which could undermine financial stability (Ghosh, Ostry, and Tamirisa 2009). The objective is to communicate these risks to policymakers sufficiently early and convincingly to prompt corrective action that would help contain crisis risks. Typically these actions would consist of prudential measures, such as higher capital requirements or limits on unhedged foreign-exchange exposures, although tightening of macro policies might also be needed.

### *Financial Sector Stability Assessment*

The Financial Sector Stability Assessment (FSAP) was established a decade ago, in the aftermath of the Asian crisis, as a means of assessing the soundness of member countries' financial sectors. It is jointly run by the Fund and the World Bank, with joint teams conducting assessments in low-income and EMCs to help avoid duplication and ensure consistent advice by the two institutions. Over the past decade the vast majority of member countries have undergone FSAP assessments at least once; the United States and China are notable exceptions.

In an effort to better integrate stability assessments into Fund surveillance, greater flexibility was recently injected in FSAPs by clarifying the respective roles of the Fund and the Bank as focusing on stability and development aspects respectively, and by allowing more frequent stability assessments by the Fund if needed (IMF 2009g). A standardized "risk assessment matrix" is being introduced in FSAPs to help identify threats to financial sector stability and assess their likelihood and implications for macro-financial stability. Beyond these innovations, the Fund recently introduced cross-country, thematic staff papers focusing on cross-border issues and spillover risks.

## Global Imbalances and External Stability

The Fund's focus on the global imbalances and the rushed adoption of a revised Surveillance Decision in the run-up to the crisis were misplaced.

### *The Role of Global Imbalances in the Financial Crisis*

The role that the global imbalances played in causing the financial crisis has been hotly debated. My own view—which is not universally shared—is that they played a marginal role, if any. Unsustainable cross-border capital flows originated from surplus and deficit countries alike. For example, externally funded credit booms in emerging Europe originated both in advanced European countries with current account deficits, like France, Greece, and Italy, as in those with surpluses, like Austria, the Netherlands, and Sweden. Recent research also highlights the fact that investors in SIVs came from both surplus and deficit countries, and concludes that it was global banking flows, rather than global imbalances, that determined the geography of the financial crisis (Acharya and Schnabl 2009). It seems plausible that the low–interest rate environment associated with the "global savings glut" contributed to the crisis, by providing the "rocket scientists" in investment banks a strong incentive to structure complex synthetic assets that seemed to provide eye-popping risk-adjusted returns.[4] But where were the regulators and supervisors in all this? Where were the risk managers? And where was the investors' due diligence? In retrospect, the financial crisis was a failure of regulation and of market discipline that would not have been addressed by a correction in the global imbalances.

In the run-up to the crisis, the Fund stressed the need to rebalance growth across surplus and deficit countries as a means of avoiding an abrupt unwinding of global imbalances. The main concern was that a sudden loss of confidence, triggered by the accumulation of large U.S. external liabilities, could give rise to a massive sell-off of dollar assets, a sharp increase in U.S. interest rates, and a "hard landing" of the U.S. and global economy. Multilateral consultations involving the main players (United States, European Union, Japan, China, and Saudi Arabia), launched by the IMF in the spring of

[4] See Bernanke (2005) for a discussion of the global savings glut.

2006, resulted in a call for joint action to rebalance demand across regions mainly through fiscal adjustment in the United States and expansionary policies, including currency appreciation, in China and other surplus countries (IMF 2007c). The Fund's adoption of a revised Surveillance Decision in June 2007 (IMF 2007d), requiring the Fund to label currencies that deviated considerably from equilibrium as "fundamentally misaligned," increased the pressure on China to let its currency appreciate.

But gloomy predictions about disorderly dollar depreciation and sharply higher U.S. interest rates never materialized. On the contrary, as the financial crisis deepened after Lehman's failure, safe-haven flows underpinned the dollar as the global slump had a disproportionate, bigger-than-expected effect on the rest of the world. As it turned out, the much-feared hard landing for the U.S. and global economy was driven by *domestic* rather than external factors—namely, the housing correction and credit crunch. And U.S. interest rates declined rather than increased during the crisis. In contrast to the traditional view of global imbalances, the credit crunch was a *home-grown* crisis emanating from the U.S. housing correction that was magnified by loose lending standards and asset mispricing in the United States as well as by leverage and illiquidity in the global financial system.

The financial crisis shifted the focus of policymakers away from the global imbalances toward global policy stimulus and financial sector reform. At the same time, the Surveillance Decision was watered down through subsequent revisions to its application, and no currency was labeled "fundamentally misaligned." With the Federal Reserve buying U.S. assets to keep long-term interest rates low, the pressure on China to stop accumulating U.S. assets and let its currency appreciate eased considerably. The Decision itself is likely to be revised when it comes up for review in 2010.

## *Rethinking Inflation Targeting*

In the aftermath of the 1997–98 Asian crisis, which created the perception that currency pegs are crisis-prone, greater exchange rate flexibility became a standard feature of Fund advice with insufficient regard for country circumstances. Inflation targeting was recommended in highly dollarized economies like Costa Rica and in financially underdeveloped economies like the Ukraine, despite the limited effectiveness of the interest rate channel of monetary policy transmission. Even tiny economies like Guyana were urged to introduce greater exchange rate flexibility. As I have argued elsewhere (Xafa 2008), small economies—the bulk of IMF members—are better off with fixed exchange rates to a large stable anchor currency. In these economies, the scope for an independent monetary policy is limited by the rapid pass-through of exchange rate movements. Perhaps more importantly, however, exchange rate flexibility is likely to undermine financial stability. Take the example of Iceland, which went through a massive financial crisis in 2008–09. Under its inflation-targeting regime, large interest rate differentials between Iceland and low-interest currencies such as the euro could not be sustained without inviting large speculative capital inflows in search of yield and creating an incentive for domestic residents to borrow in foreign currencies. The resulting balance sheet mismatches magnified the shock of the large depreciation suffered as a result of the financial crisis.

### *The Reserve Currency Status of the Dollar*

The United States enjoys a dominant position as supplier of financial assets globally because of the unique size, depth, and efficiency of U.S. capital markets (Xafa 2007, Cooper 2009). Unlike "sudden stops" in EMCs, there are no close substitutes to U.S. assets on the scale necessary to trigger a dollar crisis. The global financial crisis triggered a sell-off of risky assets, notably asset-backed securities and other structured products, but investors still regard U.S. Treasury paper as a risk-free asset that benefits from safe-haven flows. Indeed, the 10-year Treasury bond yield *declined* from 4.9 percent in February 2002, when the dollar peaked, to 4.6 percent in August 2007, when the financial crisis erupted, and to below 4 percent subsequently, indicating that the market attached a low probability to the abrupt adjustment scenario both before and after the crisis.

Longer-term, it is conceivable that the share of the dollar in global central bank reserves will diminish if the dollar continues to depreciate and the share of the United States in the global economy declines further. Credible exit strategies from exceptional U.S. fiscal and monetary policies to deal with the crisis would help avoid such an outcome. In any case, historical experience suggests that an abrupt and disruptive "tipping point," in which the dollar abruptly loses its reserve currency status, is unlikely to occur (Ghosh, Ostry, and Tsangarides 2010).

### *Reserves as Self-Insurance*

Although the global imbalances have taken a back seat to the issue of addressing the financial crisis and its aftermath, they are still viewed as a risk factor despite their sharp reduction during the current economic cycle. What the crisis has demonstrated is that the countries with the largest reserve cushions were the least affected by it. The Fund has cautioned against the risk of a further widening of global imbalances in response to a post-crisis scramble to accumulate precautionary reserves (Ghosh, Ostry, and Tsangarides 2010).

Alternatives to self-insurance include precautionary IMF facilities, such as the FCL, which make the Fund akin to a global central bank that provides ready access to foreign exchange to members in need. Obviously the FCL falls short of a lender of last resort function since only a handful of countries would qualify under its ex ante conditionality, which requires solid fundamentals and a proven track record of sound policies. On the other hand, any further relaxation of the rules governing access to Fund resources could put at risk the revolving nature of these resources. Another alternative to self-insurance is a greater role for synthetic reserve assets, such as the special drawing right.[5] Like gold, the SDR is no one's liability and thus does not require the reserve currency country to run current account deficits to enable other counties to accumulate precautionary reserves. And unlike gold, the SDR is "helicopter money" that can be created by fiat in response to global liquidity needs.

## Conclusion

The key role of the Fund is to identify contingent risks that threaten global economic and financial stability and to develop policy responses. With its global membership and its mandate to promote economic and financial stability, the Fund is uniquely placed to provide a forum for discussion of international economic issues and to help reach consensus on policy responses. Through its governing bodies (the Executive Board, the IMFC, and the

[5] The SDR was created by the IMF in 1969 as a supplementary reserve currency to help support the expansion of world trade and capital flows under the Bretton Woods fixed-exchange-rate system. The SDR is not a currency but is akin to a credit line since it is convertible to freely usable reserve currencies through voluntary exchanges between Fund members.

Board of Governors), the Fund facilitates international dialogue and helps forge a consensus that is reflected in the documents that are discussed by the Executive Board and released to the public. Its members' obligation to engage in bilateral and multilateral surveillance provides the means to integrate macro analysis with financial sector issues at the country, regional, and global levels.

In collaboration with other international fora with a stability mandate, including standard-setters and regulators, the Fund has supported the implementation of the policy lessons from the crisis with its analysis and monitoring. Surveillance notes prepared by the Fund staff for various international fora, including the G8 and G20, have provided the basis for key policy decisions at the global level. In the aftermath of the global crisis, the Fund's mandate is being transformed to include macro-prudential issues, and its role has been expanded to include monitoring the progress made toward a return to sustainable global growth and financial stability. For the Fund to be effective in this role, member countries must feel they have a stake and a voice. The transfer of at least 5 percent of voting power to underrepresented members by 2011, as agreed at the 2009 IMF annual meeting, is essential in this respect. Consideration should also be given to expanding the Fund's mandate to cover the capital account. But first, the Fund needs to distill the lessons of the crisis for its exchange rate advice.

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