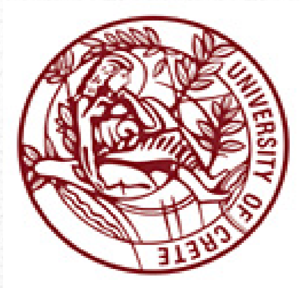

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The impact of the current financial crisis on the IMF policies

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Abstract

The main purpose of this paper is to present the Washington Consensus and to prove if the current crisis has affected the IMF's policy, based on the list of reforms that be formulated in Washington Consensus. The article firstly analyses the original Washington Consensus of ten reforms. Then, it gives a different interpretation of the term as liberal manifesto and it continues with the critique on this consensus. The paper also explains why the IMF's policy need reform and develops the points that IMF has changed. Afterwards, the article investigates if the current crisis has an impact in IMF's policies and produces its conclusions. Finally, the paper analyzes how the next financial crisis can be prevented and which role the IMF should play.

Introduction

The story started in the Spring of 1989 when John Williamson was testifying before a Congressional committee in favor of the Brady Plan. Williamson argued that it would be good policy to help the debtor countries overcome their debt burden now that they were making profound changes in economic policy. “I encountered rank disbelief in the Congressmen before whom I was testifying that there were any significant changes in economic policies and attitudes in process in Latin America” Williamson (2004) underlined. A few weeks later he gave a seminar at the Institute for Development Studies in England, where he made much the same argument. During the conference, it appeared the need for a background paper that would spell out the substance of the policy changes that were been interested in. That paper was entitled “What Washington Means by Policy Reform” and was sent to the ten authors who had agreed to write country studies for conference to try and make sure that they addressed a common set of issues in their papers. This paper identifies and discusses 10 policy instruments about whose proper deployment Washington can muster a reasonable degree of consensus. The Washington of this paper is both the political Washington of Congress and senior members of the administration and the technocratic Washington of the international financial institutions, the economic agencies of the U.S. government, the Federal Reserve Board, and the think tanks.

The list emphasized that policy was changing away from what had long been regarded as orthodox in developing countries—inflation tolerance, import substituting industrialization, and a leading role for the state—toward what had long been orthodox in OECD (Organization for Economic Cooperation and Development) countries—macroeconomic discipline, outward orientation, and the market economy. There was

certainly a heavy emphasis on liberalization, which reflected the fact that, in 1989, most Latin American countries had large and inefficient state owned enterprises and much repressive state regulation of private business, rather than some ideological belief in the minimal state that proscribed attempts to improve income distribution. The Washington Consensus has been accepted as common wisdom on policies for development and growth.

The Washington Consensus has been identified as a “neoliberal manifesto” and a debate was initiated as calls have been made for the establishment of alternative sets of economic development policies. Those who opposed the policies of the Washington Consensus proposed policies emphasizing social equity, safety nets and institutional development which, they alleged, were overlooked in the original Washington Consensus.

The aim of this paper is to exhibit the IMF policies (mentioning in essence the Washington Consensus) and to investigate if these policies have been changed as a result of the current financial crisis, a financial crisis that was created as a result of the IMF policies and the Washington Consensus.

Little things about International Monetary Fund (IMF)

The International Monetary Fund (IMF) is an international organization that was created on July 22, 1944 at the Bretton Woods Conference and came into existence on December 27, 1945 when 29 countries signed the Articles of Agreement. The International Monetary Fund was originally created as part of the Bretton Woods system exchange agreement. During the Great Depression, countries sharply raised barriers to foreign trade in an attempt to improve their failing economies. This led to the devaluation of national currencies and a decline in world trade. This breakdown in international monetary cooperation created a need for oversight. The representatives of 45 governments met in the Mount Washington Hotel in the area of Bretton Woods, New Hampshire in the United States, and agreed on a framework for international economic cooperation to establish post-World War II. The participating countries were concerned with the rebuilding of Europe and the global economic system after the war.

The IMF's stated goal was to stabilize exchange rates and assist the reconstruction of the world's international payment system post-World War II. Countries contribute money to a pool through a quota system from which countries with payment imbalances can borrow funds temporarily. Through this activity and others such as surveillance of its members' economies and policies, the IMF works to improve the economies of its member countries. The IMF describes itself as "an organization, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world." The organization's stated objectives are to promote international economic cooperation, international trade, employment, and exchange rate stability, including by making financial resources available to

member countries to meet balance of payments needs. Member countries of the IMF have access to information on the economic policies of all member countries, the opportunity to influence other members' economic policies, technical assistance in banking, fiscal affairs, and exchange matters, financial support in times of payment difficulties, and increased opportunities for trade and investment. Its headquarters are in Washington, D.C., United States.

In 1947, France became the first country to borrow from the IMF. The IMF's influence in the global economy steadily increased as it accumulated more members. The number of IMF member countries has more than quadrupled from the 44 states involved in its establishment, reflecting in particular the attainment of political independence by many African countries and more recently the 1991 dissolution of the Soviet Union because most countries in the Soviet Sphere of influence did not join the IMF.

The Bretton Woods system prevailed until 1971, when the U.S. government suspended the convertibility of the dollar (and dollar reserves held by other governments) into gold. This is known as the Nixon Shock. As of January 2012, the largest borrowers from the fund in order are Greece, Portugal, Ireland, Romania and Ukraine.

The IMF is led by a Managing Director, who is head of the staff and serves as Chairman of the Executive Board. The Managing Director is assisted by a First Deputy Managing Director and three other Deputy Managing Directors. Historically the IMF's managing director has been European and the president of the World Bank has been from the United States. However, this standard is increasingly being questioned and competition for these two posts may soon open up to include other qualified candidates from any part of the world. In 2011 the world's largest developing countries, the BRIC nations, issued a statement

declaring that the tradition of appointing a European as managing director undermined the legitimacy of the IMF and called for the appointment to be merit-based. The head of the IMF's European department is António Borges of Portugal, former deputy governor of the Bank of Portugal. He was elected in October 2010. Also, the previous Managing Director Dominique Strauss-Kahn resigned his position on May 18 and on June 28, 2011 Christine Lagarde was confirmed as Managing Director of the IMF for a five-year term starting on July 5, 2011.

Voting power in the IMF is based on a quota system. The IMF's quota system was created to raise funds for loans. Each IMF member country is assigned a quota, or contribution, that reflects the country's relative size in the global economy. Each member's quota also determines its relative voting power. Thus, financial contributions from member governments are linked to voting power in the organization. This system follows the logic of a shareholder-controlled organization: wealthy countries have more say in the making and revision of rules. Since decision making at the IMF reflects each member's relative economic position in the world, wealthier countries that provide more money to the fund have more influence in the IMF than poorer members that contribute less, nonetheless, the IMF focuses on redistribution.

The IMF works to foster global growth and economic stability. It provides policy advice and financing to members in economic difficulties and also works with developing nations to help them achieve macroeconomic stability. Upon initial IMF formation, its two primary functions were: to oversee the fixed exchange rate arrangements between countries, thus helping national governments manage their exchange rates and allowing these governments to prioritize economic growth, and to provide short-term capital to aid balance-of-payments. This assistance was meant to prevent the spread of international economic crises. The

Fund was also intended to help mend the pieces of the international economy post the Great Depression and World War II. The IMF's role was fundamentally altered after the floating exchange rates post 1971. It shifted to examining the economic policies of countries with IMF loan agreements to determine if a shortage of capital was due to economic fluctuations or economic policy. The IMF also researched what types of government policy would ensure economic recovery. The new challenge is to promote and implement policy that reduces the frequency of crises among the emerging market countries, especially the middle-income countries that are open to massive capital outflows. Rather than maintaining a position of oversight of only exchange rates, their function became one of "surveillance" of the overall macroeconomic performance of its member countries. Their role became a lot more active because the IMF now manages economic policy instead of just exchange rates. In addition, the IMF negotiates conditions on lending and loans under their policy of conditionality, which was established in the 1950s. The IMF is mandated to oversee the international monetary and financial system and monitor the economic and financial policies of its 188 member countries. This activity is known as surveillance and facilitates international cooperation. Since the demise of the Bretton Woods system of fixed exchange rates in the early 1970s, surveillance has evolved largely by way of changes in procedures rather than through the adoption of new obligations. The responsibilities of the Fund changed from those of guardian to those of overseer of members' policies. The Fund typically analyzes the appropriateness of each member country's economic and financial policies for achieving orderly economic growth, and assesses the consequences of these policies for other countries and for the global economy.

The IMF has the obstacle of being unfamiliar with local economic conditions, cultures, and environments in the countries they are requiring policy reform. The Fund knows very little about what public spending on programs like public health and education actually means, especially in African countries, they have no feel for the impact that their proposed national budget will have on people. The economic advice the IMF gives might not always take into consideration the difference between what spending means on paper and how it felt by citizens.

Regarding to the criticism in IMF, one view is that conditionality undermines domestic political institutions. The recipient governments are sacrificing policy autonomy in exchange for funds, which can lead to public resentment of the local leadership for accepting and enforcing the IMF conditions. Political instability can result from more leadership turnover as political leaders are replaced in electoral backlashes. IMF conditions are often criticized for their bias against economic growth and reduce government services, thus increasing unemployment. Another criticism is that IMF programs are only designed to address poor governance, excessive government spending, excessive government intervention in markets, and too much state ownership. This assumes that this narrow range of issues represents the only possible problems; everything is standardized and differing contexts are ignored. A country may also be compelled to accept conditions it would not normally accept had they not been in a financial crisis in need of assistance.

Also, it is claimed that conditionalities retard social stability and hence inhibit the stated goals of the IMF, while Structural Adjustment Programs lead to an increase in poverty in recipient countries. The effects of Fund policies were anti-developmental. The deflationary effects of IMF programs quickly led to losses of output and employment in economies where incomes were low and unemployment was high. Moreover, it was

sometimes claimed that the burden of the deflationary effects was borne disproportionately by the poor. The IMF sometimes advocates “austerity programs,” cutting public spending and increasing taxes even when the economy is weak, in order to bring budgets closer to a balance, thus reducing budget deficits. Countries are often advised to lower their corporate tax rate. In Globalization and Its Discontents, Joseph E. Stiglitz, former chief economist and senior vice president at the World Bank, criticizes these policies. He argues that by converting to a more monetarist approach, the purpose of the fund is no longer valid, as it was designed to provide funds for countries to carry out Keynesian reflations, and that the IMF “was not participating in a conspiracy, but it was reflecting the interests and ideology of the Western financial community.”

In the case of monetary policy, the IMF advice at the outset of programs stressed the need for a significant initial and temporary tightening to arrest excessive exchange-rate depreciations that threatened both an acceleration of domestic inflation and the spread of contagion to other countries. Some prominent economists have argued that the weak financial systems and faltering domestic demand in those economies called for an easing rather than a tightening of monetary policy. Some have even suggested that an easier monetary policy would have led to a nominal appreciation of those currencies. Clearly there are circumstances where the tightening of monetary policy to resist some (perhaps significant) exchange-rate depreciation is not desirable, for example, after the United Kingdom exited from the Exchange Rate Mechanism in September 1992 or for Singapore and China in 1997-1998 (Mussa, M., Savastano, M., 2000, p.107).

The pre-crisis policy of IMF

a. Washington Consensus

The creation of the term "Washington Consensus", as the "father" of the term Williamson (1996, p. 15) explains, instituted in 1989, when the inventor of the term was invited to a US Congressional Committee to articulate his support for the Brady Plan. The Brady Plan was designed to address the debt crisis of the 1980s, when a number of countries, primarily in Latin America, confronted by high interest rates and low commodities prices, admitted their inability to service hundreds of billions of dollars of their commercial bank loans. It was a consensus formulated between 15th Street and 19th Street in Washington among members of the International Monetary Fund (IMF), the U.S. Treasury Department, and the World Bank. It argued that the keys to success in developing countries were three things: macro- stability, liberalization (lowering, tariff barriers and market deregulation) and privatization.

The term "Washington Consensus" was originally used to describe a list of ten reforms which were practically universally agreed in Washington to be desirable in most Latin American countries as of 1989 (Williamson, 2004-5, p.195). The term, as Williamson conceived it, was in principle geographically and historically specific, a lowest common denominator of the reforms that he judged "Washington" could agree were required in Latin America at the time. "To try and ensure that the country papers addressed a common set of issues, I listed what seemed to me to be the central areas of policy reform that most people in Washington thought were needed in most Latin American countries at that time. I labeled this the Washington Consensus", Williamson explains in his published paper.

Williamson (1990a) attempted to outline what would be regarded in Washington as constituting a desirable set of economic policy reforms to

stimulate development. The consensus signifies a reconsideration of what used to be traditional economic development advice: import substitution, nationalization, planning, and use of the inflation tax to raise savings. “Washington”, for Williamson, incorporated the International Monetary Fund (IMF), the World Bank, and the US executive branch, the Federal Reserve Board, the Inter-American Development Bank, those members of Congress interested in Latin America, and the think tanks concerned with economic policy: it is an amalgamation of political, administrative and technocratic Washington.

The Washington Consensus was intended to be a positive statement of the necessary set of policies and not a normative statement: “I tried to describe what was conventionally thought to be wise rather than what I thought was wise” (Williamson, 1993, p. 1329). As such, Williamson avoided any direct equity concerns and redistributive policies in formulating the Consensus since Washington, at the time, was not interested in equity. Equity could only be the derivative of achieving efficiency through a free market process.

In the following, it is pointed out the 10 reforms of the Washington Consensus based on Williamson (1990a, 1993, 2004–5).

The original consensus

In his paper (1990), Williamson asserted that there was a wide measure of agreement in Washington that the following ten policy actions were desirable in just about all the Latin American countries. The 10 topics deal with policy instruments rather than objectives or outcomes.

1. Budget deficits should be small enough to be financed without recourse to the inflation tax. Subsidies need to be reduced or eliminated.
2. Public expenditure should be redirected from politically sensitive areas that receive more resources than their economic

return can justify toward neglected fields with high economic returns and the potential to improve income distribution, such as primary education and health, subsidies, public investment and infrastructure.

3. Tax reform should reform so as to broaden the tax base and moderate marginal tax rates.

4. Financial liberalization, involving an ultimate objective of market-determined interest rates. Domestic financial markets should determine a country's interest rates. Positive real interest rates discourage capital flight and increase savings.

5. A unified exchange rate policy at a level sufficiently competitive to induce a rapid growth in non-traditional exports. Developing countries must adopt a "competitive" exchange rate that will bolster exports by making them cheaper abroad. A competitive real exchange rate is the first essential element of an "outward-oriented" economic policy, where the balance of payments constraint is overcome primarily by export growth rather than by import substitution.

6. Quantitative trade restrictions to be rapidly replaced by tariffs, which would be progressively reduced up to a uniform low rate in the range of 10 to 20 percent was achieved.

7. Abolition of barriers impeding the entry of foreign direct investment (FDI). Foreign investment can bring needed capital and skills and know-how, either producing goods needed for the domestic markets or contributing new exports, therefore should be encouraged.

8. Privatization of state enterprises. Privatization may help relieve the pressure on the government budget, both in the short run by the revenue produced by the sale of the enterprise and in the longer run

inasmuch as investment need no longer be financed by the government. Private industry operates more efficiently because managers either have a "direct personal stake in the profits of an enterprise or are accountable to those who do." So, the state-owned enterprises ought to be privatized.

9. Abolition of regulations (deregulation) that impede the entry of new firms or restrict competition. Excessive government regulation can promote corruption and discriminate against smaller enterprises that have minimal access to the higher reaches of the bureaucracy. Governments have to deregulate the economy. Productive activity may be regulated by legislation, by government decrees, and case-by-case decision making.

10. The provision of secure property rights, especially to the informal sector. Property rights must be enforced. Weak laws and poor judicial systems reduce incentives to save and accumulate wealth.

The list focused exclusively on what Latin American countries could do for themselves, not on the world conditions that would give them a reasonable chance of prospering. In that sense, it is an unbalanced list, for—especially in the short run—the prospects of these countries will also be heavily influenced by whether the world economy is growing or depressed, whether international liquidity is provided by U.S. Treasury bills or special drawing rights (SDR), and so on. The reason for the lack of balance is simply division of labor. The Washington Consensus was a product of its time, and so there was little recognition of institutional issues.

It is worth to mentioning that the time that the adjustment measures required to mature is very important because it is linked to the question of expectations, the postponed expectations and aspirations of the public are

a major political concern (Marangos, 2009, p. 199). There is a potential incompatibility between the time that is necessary for structural adjustment and the social and political tolerance of the public experiencing years of sustained reduction in the standard of living. Thus, the pace and sequencing of reforms becomes a major issue for which the Washington Consensus did not make a recommendation.

Williamson's (1994, p. 20) response was the proposition that the best time to introduce the reforms is immediately after the reformative government takes power. An incoming government enjoys a "honeymoon period" during which the public will give it the benefit of the doubt and blame any sacrifices and difficulties on its predecessor. In all probability, this honeymoon will not last forever, hence decisive action is essential.

b. The Washington Consensus as a neoliberal manifesto

As Williamson (1996, p. 19) admitted he considers himself as a classical liberal in the tradition of John Locke, Adam Smith, and John Stuart Mill. The adherence of Williamson to the classical liberal position of "free markets", explains the construction of the Washington Consensus on the basis of market principles to economic development policy. Williamson would become the mouthpiece of the application of neoclassical economics to international development what Williamson names mainstream economics (Marangos, 2009, pp. 199-200).

An alternative interpretation of the Washington Consensus uses it as a synonym for neoliberalism or market fundamentalism (Williamson, 2004-5, p. 201). The "misinterpretation", as Williamson argues, of the Washington Consensus as a neoliberal manifesto defined the consensus as the set of economic policies implemented by Ronald Reagan and Margaret Thatcher under the inspiration of Friedrich Hayek and Milton Friedman. However, in this interpretation of the term, "Washington" as

an area of authority has expanded. The consensus was derived between 15th Street and 19th Street in Washington among the United States Treasury, the IMF and the World Bank, as well as some influential think tanks, a prominent majority of academics along with assorted editorialists and, most importantly, business interests (Naim, 2000, p. 91).

The neoliberal manifesto has been taken to imply that the policies to achieve economic growth in developing countries, as the experience of Latin America revealed, were: macroeconomic stability, fiscal austerity, market liberalization, privatization and "getting prices right" (Stiglitz, 2002, p. 53). It was assumed that fiscal discipline, accompanied by deregulation, trade liberalization and privatization would be sufficient to eliminate stagnation and launch economic growth in developing countries and in transition economies. The fashionable interpretation held that unfettered free markets, a reduced role for the state and integration into the international economy provided the best *modus operandi* for development (Levinson, 2000, p. 11). Washington made a concerted effort to shift policies worldwide towards monetarist, market-oriented, open, non-interventionist policies (Stewart, 1997, p. 63). The set of policies has evolved to describe an extreme and doctrinaire commitment to the belief that markets can solve all troubles, and this axiomatic conviction to be valid for all places and at all times. It is a "one-size-fits all" approach (Stiglitz, 2002, p. 34).

Needless to say, democratically elected governments are free and not required to adopt the consensus policies. These economies have freedom to choose the pace, sequence, direction, and add or remove policies in the consensus. Nevertheless, as long as they desire to borrow from the IMF and World Bank, reschedule their debt, or promote foreign investment, the world's financial markets require a specific set of policies on the part

of borrowing countries. Namely, their policies have to be consistent with the Washington Consensus (Marangos, 2009, p. 202).

In the following, the view of the Washington Consensus as a neoliberal manifesto is presented based on several economists such as Levinson (2000), Stiglitz (2000, 2002), in the order presented by Williamson in the original version.

1. Fiscal discipline: establish a balanced budget.
2. Public expenditure priorities: reduce government expenditure.
3. Tax reform: enact overall tax cuts and eliminate taxes raised in order to redistribute income.
4. Financial liberalization: market-determined interest rates.
5. Exchange rate policy: exchange rates ought to be fully convertible and freely floating.
6. Trade liberalization: establish free trade and eliminate protection measures and capital controls.
7. Foreign Direct Investment (FDI): abolish barriers to entry and exit for foreign firms.
8. Privatization: state enterprises should be privatized through vouchers.
9. Deregulation: eliminate entry and exit barriers and suppress regulations designed to protect the environment.
10. Property rights: it is stipulated that the Washington Consensus did not generally show any interest in institutions, including property rights.
11. Institution building: establish an independent central bank with the rule that the money supply should grow at a fixed rate consistent with monetarism.

12. Price liberalization: while price liberalization was not included in the Washington Consensus, the neoliberal manifesto requires immediate price liberalization.

Williamson has repeatedly maintained that the Washington Consensus was a lowest common denominator rather than a manifesto, not even close to a neoliberal manifesto. The Washington Consensus did not propose: slashing government expenditure so as to achieve a balanced budget, tax-slashing – there is no taxation phobia – especially those which redistribute income, exchange rates had to be either firmly fixed or freely floating, competitive moneys or that the money supply should grow at fixed rate (monetarism), abolishing capital controls, suppression of regulations designed to protect the environment, removal of incomes and industry policies and privatizing all state enterprises such as water. Instead, the Washington Consensus was in favor of monetary discipline, tax reform, trade liberalization, deregulation of entry and exit barriers. While it was true that privatization was derived from the neoliberal agenda it became part of the consensus, but nevertheless it mattered how privatization was done. Deregulation did not imply abolishing safety or environmental regulations or regulations governing prices in a non-competitive industry. In sum, the Washington Consensus was a set of policy reforms that reduced the role of government in the economy. Nonetheless, "this need for liberalization did not necessarily imply a swing to the opposite extreme of market fundamentalism and a minimalist role for government. . ." (Williamson, 2000, p. 256).

c. Criticism in Washington Consensus

The simplifying assumptions of the Washington Consensus made it an easy target for attack from economists who disputed the interpretation and outcomes of Latin American reforms, and also from social scientists who questioned the obsession with economic development and neglect of

social development. The Washington Consensus paid attention only to increasing real GDP (the total market value measured in constant prices of all goods and services produced within an economy during 1 year), while ignoring social indicators such as increasing living standards (a measurement of household welfare by including consumption, income, savings, employment, health, education, fertility, nutrition, housing and migration) and democratic-equitable-sustainable development (Marangos, 2009, p.200). It was true that Williamson avoided any direct equity concerns and redistributive policies in formulating the Consensus since Washington, at the time, was not interested in equity. According to his aspect, equity could only be the derivative of achieving efficiency through a free market process. Furthermore, Williamson felt that the Washington Consensus should be accepted across the political range, even by those who place more weight on equity.

Many of the ideas incorporated in the consensus were developed in response to the problems in Latin America, where governments had let to budgets get out of control while loose monetary policies had led to rampant inflation. A burst of growth in some of that region's countries in the decades immediately after World War II had not been sustained, allegedly because of excessive state intervention in the economy. The ideas that were developed to cope with problems arguably specific to Latin American countries subsequently had been deemed applicable to countries around the world. Capital market liberalization has been pushed despite the fact that there is no evidence showing it spurs economic growth. In other cases, the economic policies that evolved into the Washington Consensus and were introduced into developing countries "were not appropriate for countries in the early stages of development or early stages of transition" (Stiglitz, 2002, p. 16).

Stewart (1997, p. 68), a significant critic of the Washington Consensus, argued that consensus is a word "often used by those who would like their own views to be accepted. When Williamson firstly used the term Washington Consensus, he implied that everyone agreed with Washington, and further that this agreement indicated that Washington was right". While it is true that Latin American countries adopted the Washington Consensus formula, this acceptance did not mean that Washington was right. Washington institutions imposed their views on Latin America, and also on other countries, through policy conditionality. Whereas certain recommendations of the Washington Consensus were relevant for addressing the economic crises of Latin America in the 1980s and produced some improvements in economic policy management, like lower inflation, low budget deficits, reduced external debt and some economic growth, they were insufficient for achieving long term growth or even macroeconomic stability under different conditions (Stiglitz, 1998, p. 29). On the other hand, countries, such as East Asia and China, which did not follow the standard recipe of the consensus, indicated that the success could be achieved. The East Asian experience revealed that the success of these economies depended not on macroeconomic stability or privatization; but rather on a robust financial system in which the government played an increasing role in creating and maintaining a competitive economy, and on public investment in human capital and technology transfer (Marangos, 2009, p.202). China followed some policy recommendations of the Washington Consensus, such as macro-stability, but provided a productive environment for entrepreneurship and competition without privatization and liberalization. In contrast, Russia that followed perfectly the recommendations, privatized a large fraction of the economy without doing much to promote competition. The contrast

in performance could not be greater, with Russia's output substantially reduced, while China managed to sustain high growth rates.

The IMF, an institution that adopted the Washington Consensus and its requirements, typically provides funds only if countries engage in policies like cutting deficits, raising taxes or raising interest rates that lead to a contraction of the economy. It is characteristic that the IMF has basically the same answers and solutions for every country. Also, the IMF was supposed to focus on crises providing liquidity in the form of loans to those countries facing an economic downturn and unable to stimulate aggregate demand with their own resources. The IMF was based on a recognition that markets often did not work well that they could in massive unemployment and might fail to make needed funds available to counties to help them restore their economies. But developing countries were always in need of need of help, so the IMF became a permanent part of life in most of the developing world.

In Globalization and Its Discontents, Joseph E. Stiglitz stated "a half century after its founding, it is clear that the IMF has failed in its mission. It has not done what it was supposed to do- provide funds for countries facing an economic downturn, to enable the country to restore itself to close to full employment. In spite of the fact that our understanding of economic processes has increased enormously during the last fifty years, and in spite of IMF's efforts during the past quarter century, crises around the world have been more frequent and (with the exception of the Great Depression) deeper. Worse, many of the policies that the IMF pushed, in particular, premature capital market liberalization, have contributed to global instability. And once a country was in crisis, IMF funds and programs not only failed to stabilize the situation but in many cases actually made matters worse, especially for the poor. The IMF failed in its original mission of promoting global stability…."

The result for many people has been poverty and for many countries social and political chaos. It has become increasingly clear not to just ordinary citizens but to policy makers as well, and not just those in the developing countries but those in the developed countries as well, that globalization as it has been practiced has not lived up to what its advocates promised it would accomplish- or to what it can and could do. In some cases it has not even resulted in growth, but when it has, it has not brought benefits to all. The net effect of the policies set by the Washington Consensus has all too often been to benefit the few at the expense of the many, the well-off at the expense of the poor. In many cases commercial interests and values have superseded concern for the environment, democracy, human rights and social justice.

The IMF, as result of these policies set, has made mistakes in all the areas it has been involved in: development, crisis management, and in countries making the transition from communism to capitalism. Structural adjustment programs did not bring sustained growth, in many countries excessive austerity stifled growth, successful economic programs require extreme care in sequencing- the order in which reforms occur- and pacing.in many countries, mistakes in sequencing and pacing led to rising unemployment and increased poverty. The collapse in Argentina in 2001 is one of the most recent of a series of failures over the past few years.

Why the IMF needs reform?

The ideas derived from the Washington Consensus had a huge influence on the economic reforms of many countries. The original 10 policy prescriptions of the Washington Consensus reigned unchallenged for only a short time. Changes in the international economic and political environment, as well as new domestic conditions in reforming countries, created problems that the original proponents of the consensus did not envision, thus forcing the search for new answers. These answers often complemented the recommendations of the Washington Consensus, but some also ran counter to them. Reforming governments everywhere saw how policy goals that just a few years, or even months, earlier had been identified as the final frontier of the reform process became mere preconditions for success. New, more complex, and more difficult goals were constantly added to the list of requirements for acceptable economic performance. Relatively, Moises Naim, the editor of Foreign Policy magazine, underlines "If this was a Washington Consensus, just imagine what a Washington Confusion would be like." What the Washington Consensus did not provide was a set of policies that would enable newly opened economies to cope more effectively with the consequences of globalization, especially in the financial sphere. Unfortunately, the relative simplicity and presumed reliability of the Washington Consensus were not reflected in the experience with market reforms during the 1990s. Policy makers often implemented an incomplete version of the model, and the results were quite different from what politicians had promised, the people had expected, and the IMF and World Bank's econometric models had predicted.

The concept of Washington consensus could result in forming of strategies and played an important role in shaping policies and the design of institutions. The monetary policy had one target, inflation, and one

instrument, the policy rate. So long as inflation was stable, the output gap was likely to be small and stable and monetary policy did its job. The fiscal policy played a secondary role, with political constraints sharply limiting its de facto usefulness. And the financial regulation was mostly outside the macroeconomic policy framework.

Stable and low inflation was presented as the primary, if not exclusive, mandate of central banks. This was the result of a coincidence between the reputational need of central bankers to focus on inflation rather than activity and the intellectual support for inflation targeting provided by the New Keynesian model. This divine coincidence implied that, even if policymakers cared very much about activity, the best they could do was to maintain stable inflation (Blanchard, O.J., Dell' Ariccia, G. & Mauro, P. ,2010, p.4). This applied whether the economy was affected by "animal spirits" or other shocks to consumer preferences, technology shocks, or even changes in the price of oil. The coincidence failed in the presence of further imperfections, further deviations from the benchmark, but the message remained: stable inflation is good in itself and good for economic activity. In practice, few central banks, if any, cared only about inflation. Most of them practiced "flexible inflation targeting," the return of inflation to a stable target, not right away, but over some horizon. Most of them allowed for shifts in headline inflation, such as those caused by rising oil prices, provided inflation expectations remained well anchored. And many of them paid attention to asset prices (house prices, stock prices, exchange rates) beyond their effects on inflation and showed concern about external sustainability and the risks associated with balance sheet effects. But they did this with some unease, and often with strong public denial.

The policy rate is a poor tool to deal with excess leverage, excessive risk taking, or apparent deviations of asset prices from fundamentals.

Even if a higher policy rate reduces some excessively high asset price, it is likely to do so at the cost of a larger output gap. Were there no other instrument, the central bank would indeed face a difficult task, and this has led a number of researchers to argue against reacting to perceived asset bubbles and other variables. But there are other instruments at the policymaker's disposal—call them cyclical regulatory tools. If leverage appears excessive, regulatory capital ratios can be increased; if liquidity appears too low, regulatory liquidity ratios can be introduced and, if needed, increased, to dampen housing prices, loan-to-value ratios can be decreased, to limit stock price increases, margin requirements can be increased. In this light, it seems better to use the policy rate primarily in response to aggregate activity and inflation and to use these specific instruments to deal with specific output composition, financing, or asset price issues.

In the aftermath of the Great Depression and following Keynes, fiscal policy had been seen as a—perhaps the—central macroeconomic policy tool. In the 1960s and 1970s, fiscal and monetary policy had roughly equal billing. In the past two decades, however, fiscal policy took a backseat to monetary policy. The reasons were many: first was wide skepticism about the effects of fiscal policy, itself largely based on Ricardian equivalence arguments. Second, if monetary policy could maintain a stable output gap, there was little reason to use another instrument. In that context, the abandonment of fiscal policy as a cyclical tool may have been the result of financial market developments that increased the effectiveness of monetary policy. Third, in advanced economies, the priority was to stabilize and possibly decrease typically high debt levels, in emerging market countries, the lack of depth of the domestic bond market limited the scope for countercyclical policy anyway. Fourth, lags in the design and the implementation of fiscal

policy, together with the short length of recessions, implied that fiscal measures were likely to come too late. Fifth, fiscal policy, much more than monetary policy, was likely to be distorted by political constraints (Blanchard, O.J., Dell' Ariccia, G. & Mauro, P. 2010, p. 5).

In practice, the focus was primarily on debt sustainability and on fiscal rules designed to achieve such sustainability. To the extent that policymakers took a long-term view, the focus in advanced economies was on prepositioning the fiscal accounts for the looming consequences of aging. In emerging market economies, the focus was on reducing the likelihood of default crises, but also on establishing institutional setups to constrain procyclical fiscal policies, so as to avoid boom-bust cycles. Automatic stabilizers could be left to play (at least in economies that did not face financing constraints), as they did not conflict with sustainability. Indeed, with the increase in the share of government in output as economies developed (Wagner's law), automatic stabilizers played a greater role.

It appears today that the world will likely avoid major deflation and thus avoid the deadly interaction of larger and larger deflation, higher and higher real interest rates, and a larger and larger output gap. But it is clear that the zero nominal interest rate bound has proven costly. Higher average inflation, and thus higher nominal interest rates to start with, would have made it possible to cut interest rates more, thereby probably reducing the drop in output and the deterioration of fiscal positions.

The crisis has returned fiscal policy to center stage as a macroeconomic tool for two main reasons: first, to the extent that monetary policy, including credit and quantitative easing, had largely reached its limits, policymakers had little choice but to rely on fiscal policy. Second, from its early stages, the recession was expected to be long lasting, so that it

was clear that fiscal stimulus would have ample time to yield a beneficial impact despite implementation lags.

Just like financial intermediation itself, financial regulation has played a central role in the crisis. It contributed to the amplification effects that transformed the decrease in U.S. housing prices into a major world economic crisis. The limited perimeter of regulation gave incentives for banks to create off-balance-sheet entities to avoid some prudential rules and increase leverage. Regulatory arbitrage allowed financial institutions such as AIG to play by different rules from other financial intermediaries. Once the crisis started, rules aimed at guaranteeing the soundness of individual institutions worked against the stability of the system. Mark-to-market rules, when coupled with constant regulatory capital ratios, forced financial institutions to take dramatic measures to reduce their balance sheets, exacerbating fire sales and deleveraging.

As Blanchard characteristically said (2010, p. 11) “Identifying the flaws of existing policy is (relatively) easy. Defining a new macroeconomic policy framework is much harder. The bad news is that the crisis has made clear that macroeconomic policy must have many targets; the good news is that it has also reminded us that we have in fact many instruments, from “exotic” monetary policy to fiscal instruments, to regulatory instruments. It will take some time, and substantial research, to decide which instruments to allocate to which targets, between monetary, fiscal, and financial policies. What follows are explorations.”

Most of the elements of the pre-crisis consensus, including the major conclusions from macroeconomic theory, still hold. Among them, the ultimate targets remain output and inflation stability. The natural rate hypothesis holds, at least to a good enough approximation, and policymakers should not assume that there is a long-term trade-off between inflation and unemployment. Stable inflation must remain one of

the major goals of monetary policy. Fiscal sustainability is of the essence, not only for the long term, but also in affecting expectations in the short term.

There is a gulf between the rhetoric and reality of the IMF's role, a gulf that has been emerging since the fixed exchange rate system broke down in the early 1970s but which is proving increasingly hazardous. The growth of capital markets has rendered the organization impotent in industrialized countries. The world's richest economies neither borrow from the IMF nor are they required to follow its policy advice. Its role in the developing world is worrisomely unclear. The Mexican crisis was a case in point. The IMF proved wholly inadequate at crisis prevention (it did not foresee the Mexican debacle), and its attempts at crisis resolution were dangerously improvised (it pledged a disproportionate share of its liquid resources to Mexico, breaking all existing rules on the limits of financial support) (Minton-Beddoes, 1992, pp. 123-4).

The goals of the founders of the IMF were breathtakingly ambitious: to create a system that would foster prosperity through stable exchange rates and free trade. The IMF was a key part of the Bretton Woods vision crafted just after World War II. It would oversee the fixed exchange rate system and provide short - term support to countries facing financial difficulties. The institution they founded was designed to manage a system of fixed exchange rates predicated on a world of low capital mobility. The IMF initially had three basic functions: overseeing a world's system of pegged (but adjustable) exchange rates, promoting currency convertibility to foster international trade, and acting as lender of last resort for countries facing short term balance- of-payments crises. Half a century later, the world economy has changed beyond recognition. The breakdowns of the Bretton Woods system of fixed exchange rates in

the early 1970s, the removal of capital controls and, most important, technological and financial innovation have transformed global finance.

It is increasingly difficult to see how a system of fixed, quasi-fixed, or openly targeted exchange rates among the world's biggest economies could work. Many economists have argued that global capital markets are pushing the world toward one of two extremes: a system of floating rates or a single unified currency. Quasi - fixed regimes are simply no longer possible (Minton-Beddoes, 1992, pp. 130).

The mixed IMF record of success, ad hoc improvisations, and adaptations has led to calls for reform. But what sort? Combining the work of the IMF and the World Bank, as some have suggested, might be more efficient, but it would probably result in a loss of focus. The relatively small, disciplined IMF would become entangled in the bureaucratic sprawl of the World Bank.

Another suggestion is to reorient the IMF toward a more central position in economic policy coordination among major economies. The Bretton Woods Commission, an independent review panel of financial experts, stressed the need for greater economic convergence and stability among major economies and called for the IMF to focus again on international monetary issues, its original mandate. In particular, the commission felt the IMF should become a locus for coordinating exchange rate management, leading to a more formalized system of exchange rates.

As the global financial system is overwhelmingly market-driven, IMF has important roles to play in two main areas: mitigating the risks and failures of financial markets and integrating new players. Reducing risk requires better monitoring of capital flows and economic policy. This would allow the IMF to play a far greater role in crisis prevention, particularly in countries whose access to capital markets is more recent

and at greater risk. The IMF should promote the timely publishing of key economic indicators and rate countries on the quality of their economic statistics. Its judgments about economic policy should be made public. In essence, the IMF should become more like a public rating service, providing financial and economic analyses of stability and risk (Minton-Beddoes, 1992, p. 132).

The IMF's modification

The current global financial crisis, which began with the downturn of the U.S. subprime housing market in 2007, is testing the ability of the International Monetary Fund (IMF), in its role as the central international institution for oversight of the global monetary system. Though the IMF is unlikely to lend to the developed countries most affected by the crisis and must compete with other international financial institutions, such as the Bank for International Settlements, Financial Stability Forum (FSF), and the Organization for Economic Cooperation and Development (OECD), as a source of ideas and global macroeconomic policy coordination, the spillover effects of the crisis on emerging and less-developed economies gives the IMF an opportunity to reassert its role in the international economy on two key dimensions of the global financial crisis: (1) *immediate crisis management*, primarily balance of payments support to emerging market and less-developed countries, and (2) *long-term systemic reform of the international financial system.* The IMF's role should be to help it achieve macroeconomic stability and, where necessary, play a central role in working out debt (Weiss, 2009, p.1).

Generally, the role of the IMF has changed significantly since its founding in July 1944. As the global financial system has evolved over the decades, so has the IMF. From 1946 to 1973, the main purpose of the IMF was to manage the fixed system of international exchange rates agreed on at Bretton Woods. The U.S. dollar was fixed to gold at $35 per ounce and all other member countries' currencies were fixed to the dollar at different rates (Weiss, 2009, p.1). The IMF monitored the macroeconomic and exchange rate policies of member countries and helped countries overcome balance of payments crises with short-term loans that helped bring currencies back in line with their determined value. This system came to an abrupt end in 1973 when the United States

floated its currency and subsequently introduced the modern system of floating exchange rates. Over the past three decades, floating exchange rates and financial globalization have contributed to, in addition to substantial wealth and high levels of growth for many countries, an international economy marred by exchange rate volatility and semi-frequent financial crises. The IMF adapted to the end of the fixed-exchange rate system by becoming the lender of last resort for countries afflicted by such crises.

Current IMF operations and responsibilities can be grouped into three areas: surveillance, lending, and technical assistance (Weiss, 2009, p.5). Surveillance involves monitoring economic and financial developments and providing policy advice to member countries. Lending entails the provision of financial resources under specified conditions to assist a country experiencing balance of payments difficulties. Technical assistance includes help on designing or improving the quality and effectiveness of domestic policy-making.

The rise of emerging market countries over the past decade has created new challenges for the IMF. Many emerging market economies argue that their current stake in the IMF does not represent their role in the world economy. Several countries, particularly in East Asia and South America, believe that their new economic weight and status should afford them a larger quota and a greater voice at the institution. In addition, many poor countries believe that the IMF's quota system is prejudiced against them, giving them little voice even though they are the majority of the IMF's borrowers. In response to these concerns, the IMF embarked in 2006 on a reform process to increase the quota and voice of its emerging market country members.

While the IMF has struggled to define its role in the global economy, the global financial crisis has created an opportunity for the IMF to

reinvigorate itself and possibly play a substantial role in resolving, or at the least mitigating, the effects of the global downturn, on two fronts: (1) through immediate crisis management, primarily balance of payments support to emerging market and less-developed countries, and (2) contributing to long-term systemic reform of the international financial system.

- *Immediate Crisis Management*

IMF rules stipulate that countries are allowed to borrow up to three times their quota over a three-year period, although this requirement has been breached on several occasions where the IMF has lent at much higher multiples of quota. At the IMF annual meetings in October 2008, Managing Director Strauss- Kahn announced that the IMF had activated its Emergency Financing Mechanism (EFM) to speed the normal process for loans to crisis-afflicted countries. The emergency mechanism enables rapid approval (usually within 48-72 hours) of IMF lending once an agreement has been reached between the IMF and the national government. As noted before, while normal IMF rules are that countries can only borrow three times the size of their respective quotas over three years, the Fund has shown the willingness in the past to lend higher amounts should the crisis require extraordinary amounts of assistance.

A second instrument that the IMF could use to provide financial assistance is its Exogenous Shock Facility (ESF). The ESF provides policy support and financial assistance to low-income countries facing exogenous shocks, events that are completely out of the national government's control. These could include commodity price changes (including oil and food), natural disasters, and conflicts and crises in neighboring countries that disrupt trade. The ESF was modified in 2008 to further increase the speed and flexibility of the IMF's response. Through the ESF, a country can immediately access up to 25 % of its

quota for each exogenous shock and an additional 75% of quota in phased disbursements over one to two years.

On October 29, 2008, the IMF announced that it plans on creating a new three month short-term lending facility aimed at middle income countries such as Mexico, South Korea, and Brazil. The IMF plans to set aside $100 billion for the new Short-Term Liquidity Facility (SLF). In an unprecedented departure from other IMF programs, SLF loans will have no policy conditionality. Under the SLF, countries with track records of sound policies, access to capital markets and sustainable debt burden can draw up to five times their IMF quota for three months and up to two additional three-month periods. To date, no country has drawn on the SLF. For many middle-income countries this is likely due to the associated stigma of accepting IMF assistance. Concerns have also been raised that by creating a new lending mechanism the IMF is dividing potential borrowers into those that qualify for the SLF and those that would be forced to accept regular IMF lending with its associated policy conditionality. To counter this stigma, some analysts have proposed coordinating an SLF package for several countries at the same time. Another option may be to coordinate an SLF loan with the newly created Federal Reserve swap arrangements for developing countries. On the same day that the IMF announced the SLF, the U.S. Federal Reserve approved $30 billion in reciprocal swap arrangements with four emerging market countries: Brazil, Korea, Mexico, and Singapore (Weiss, 2009, p.5).

At the 2009 Davos World Economic Forum, John Lipsky, the IMF's First Deputy Managing Director, said that to be able to effectively lend to all the potential countries affected by the crisis, the IMF should double its

lending resources to around $500 billion.[1] In addition to potential resources freed up by the sale of IMF gold reserves, two additional financing options for the IMF are seeking additional capital from its member countries and selling bonds. The government of Japan has agreed to lend the IMF $100 billion dollars and it is reported that the agreement is almost finalized.[2] According to Mr. Lipsky, the Japanese loan would be structured in a way that is similar to two IMF programs: the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB), which provide up to $50 billion in additional funding if the IMF were to exceed that amount available in its core resources. The second option would be for the IMF to issue bonds, which it has never done in its 60 year history. According to Mr. Lipsky, the IMF bonds would be sold to central banks and government agencies. According to economist and former IMF chief economist Michael Mussa, the United States and Europe blocked attempts by the IMF to issue bonds since it could potentially make the IMF less dependent on them for financial resources and thus less willing to take policy direction from them.[3] However, several other multilateral institutions such as the World Bank and the regional development banks routinely issue bonds to help finance their lending.

Lastly, economic conditions over the past decade have created a new class of bilateral creditors who could challenge the IMF's role as the lender of last resort. The rise of oil prices has created vast wealth among Middle Eastern countries and persistent trade surpluses in Asia have

[1] "As Contingency, IMF Aims to Double its Lendable Resources," IMF Survey Magazine: Policy, February 2, 2008.

[2] "IMF talks to borrow $100 billion from Japan almost completed," Japan Times, February 4, 2009.

[3] Bob Davis, "IMF Considers Issuing Bonds to Raise Money," Wall Street Journal, February 1, 2009.

created a new class of emerging creditors. These countries either have the foreign reserves to support their own currencies in a financial crisis, or they are a potential source of loans for other countries.

- *Reforming global macroeconomic surveillance*

Efforts are underway to expand the IMF's ability to conduct effective multilateral surveillance of the international economy. Also, there are efforts to increase cooperation with the international financial standard setters as the Financial Stability Forum (FSF), the Bank for International Settlements (BIS), as well as in various international working groups such as the Basel Committee on Banking Supervision and the Joint Forum on Risk Assessment and Capital in order IMF to play an constructive role in the broader reform of the global financial system. The deepening interconnectedness of the international economy may call for such increased cooperation between the IMF, which performs global macroeconomic surveillance, and the individual global financial regulatory bodies.

The IMF Articles of Agreement require (Article IV) that the IMF "oversee the international monetary system in order to ensure its effective operation" and to "oversee the compliance of each member with its obligations" to the Fund. In particular, "the Fund shall exercise firm surveillance over the exchange rate policies of member countries and shall adopt specific principles for the guidance of all members with respect to those policies." Countries are required to provide the IMF with information and to consult with the IMF upon its request. The IMF staff generally meets each year with each member country for "Article IV consultations" regarding the country's current fiscal and monetary policies, the state of its economy, its exchange rate situation, and other relevant concerns. The IMF's reports on its annual Article IV consultations with each country are presented to the IMF executive board

along with the staff's observations and recommendations about possible improvements in the country's economic policies and practices.

As the global financial system has become increasingly interconnected, the IMF has conducted multilateral surveillance beyond two bi-annual reports it produces, the World Economic Outlook and the Global Financial Stability Report, four regional reports, and regular IMF contributions to intergovernmental fora and committees, including the Group of Seven and Group of Twenty, and the Financial Stability Forum. These efforts at multilateral surveillance, however, have been criticized as being less than fully effective, too focused on bilateral issues, and not fully accounting for the risks of contagion that have been seen in the current crisis. Participants at an October 2008 IMF panel on the future of the IMF reiterated these concerns, adding that many developed countries have impeded the IMF's efforts at multilateral surveillance by largely ignoring IMF's bilateral surveillance of their own economies and not fully embracing the IMF's first attempt at multilateral consultations on global imbalances in 2006.

The after crisis policy of IMF

a. What have been learned from the crisis.

Stable inflation may be necessary, but is not sufficient. Inflation may be stable, and the output gap may nevertheless vary, leading to an obvious trade-off between the two. This is hard to prove empirically, as the output gap is not directly observable. What is clear, however, is that the behavior of inflation is much more complex than is assumed in previous simple models and that the economists understand the relationship between activity and inflation quite poorly, especially at low rates of inflation. Also, *low inflation limits the scope of monetary policy in deflationary recessions*. It is proved today that the world will likely avoid major deflation and thus avoid the deadly interaction of larger and larger deflation, higher and higher real interest rates, and a larger and larger output gap (Blanchard, O.J., Dell' Ariccia, G. & Mauro, P. 2010, p. 8).

Countercyclical fiscal policy is an important tool. The crisis has returned fiscal policy to center stage as a macroeconomic tool. It has also shown the importance of having "fiscal space". Some advanced economies that entered the crisis with high levels of debt and large unfunded liabilities have had limited ability to use fiscal policy. Similarly, those emerging market economies (e.g., some in eastern Europe) that ran highly pro-cyclical fiscal policies driven by consumption booms are now forced to cut spending and increase taxes despite unprecedented recessions. By contrast, many other emerging markets entered the crisis with lower levels of debt. This allowed them to use fiscal policy more aggressively without fiscal sustainability being called into question or ensuing sudden stops. The wide variety of approaches in terms of the measures undertaken has made it clear that there is a lot to know about the effects of fiscal policy, about the optimal composition of fiscal packages, about the use of spending increases versus tax decreases,

and the factors that underlie the sustainability of public debts, topics that had been less active areas of research before the crisis.

Regulation is not macroeconomically neutral. Just like financial intermediation itself, financial regulation has played a central role in the crisis. The limited perimeter of regulation gave incentives for banks to create off-balance-sheet entities to avoid some prudential rules and increase leverage. Regulatory arbitrage allowed financial institutions such as AIG to play by different rules from other financial intermediaries. Once the crisis started, rules aimed at guaranteeing the soundness of individual institutions worked against the stability of the system. Mark-to-market rules, when coupled with constant regulatory capital ratios, forced financial institutions to take dramatic measures to reduce their balance sheets, exacerbating fire sales and deleveraging.

b. Implications for the design of policy.

Should the inflation target be raised? Achieving low inflation through central bank independence has been a historic accomplishment, especially in several emerging markets. Thus, answering these questions implies carefully revisiting the list of benefits and costs of inflation. The inflation tax is clearly distortionary, but so are the other, alternative, taxes. Many of the distortions from inflation come from a tax system that is not inflation neutral, for example, from nominal tax brackets or from the deductibility of nominal interest payments. These could be corrected, allowing for a higher optimal inflation rate. If higher inflation is associated with higher inflation volatility, indexed bonds can protect investors from inflation risk. Other distortions, such as the lower holdings of real money balances and a greater dispersion of relative prices, are more difficult to correct. Perhaps more important is the risk that higher inflation rates may induce changes in the structure of the economy that magnify inflation shocks and reduce the effectiveness of policy action.

Combining monetary and regulatory policy. The increasing trend toward separation of the two may well have to be reversed. If monetary and regulatory tools are to be combined, it follows that the traditional regulatory and prudential frameworks need to acquire a macroeconomic dimension. Measures reflecting system wide cyclical conditions will have to complement the traditional institution-level rules and supervision. As for monetary policy decisions, these macro-prudential measures should be updated on a regular and predictable basis to maximize their effectiveness through a credible and understood policy stance. The main challenge, here, is to find the right trade-off between a sophisticated system, fine-tuned to each marginal change in systemic risk, and an approach based on simple-to-communicate triggers and easy-to-implement rules.

Creating more fiscal space in good times. As reference to IMF's policy, it should provide liquidity more broadly and create more fiscal space in good times. A key lesson from the crisis is the desirability of fiscal space to run larger fiscal deficits when needed. There is an analogy here between the need for more fiscal space and the need for more nominal interest rate room, argued earlier (Blanchard, Dell & Mauro, 2010, p. 16). Had governments had more room to cut interest rates and to adopt a more expansionary fiscal stance, they would have been better able to fight the crisis. Still, the lesson from the crisis is clearly that target debt levels should be lower than those observed before the crisis. The policy implications for the next decade or two are that, when cyclical conditions permit, major fiscal adjustment is necessary and, should economic growth recover rapidly, it should be used to reduce debt-to-GDP ratios substantially, rather than to finance expenditure increases or tax cuts.

The recipe to create additional fiscal space in the years ahead and to ensure that economic booms translate into improved fiscal positions

rather than procyclical fiscal stimulus is not new, but it acquires greater relevance as a result of the crisis. Medium-term fiscal frameworks, credible commitments to reducing debt-to-GDP ratios, and fiscal rules (with escape clauses for recessions) can all help in this regard. Similarly, expenditure frameworks based on long-term revenue assessments help limit spending increases during booms. And eliminating explicit revenue earmarking for prespecified budget purposes would avoid automatic expenditure cuts when revenues fall. A further challenge, as governments come under greater pressure to display improved deficit and debt data are tempted to provide support to ailing sectors through guarantees or off-budget operations, is to ensure that all public sector operations are transparently reflected in fiscal data and that well-designed budget processes reduce policymakers' incentives to postpone needed adjustment.

Designing better automatic fiscal stabilizers. It would be worth to designing better automatic fiscal stabilizers. The exception of this crisis confirms the problems with discretionary fiscal measures: they come too late to fight a standard recession. There is, thus, a strong case for improving automatic stabilizers. One must distinguish here between truly automatic stabilizers—that is, those that by their very nature imply a procyclical decrease in transfers or increase in tax revenues—and rules that allow some transfers or taxes to vary based on prespecified triggers tied to the state of the economic cycle. The first type of automatic stabilizer comes from the combination of rigid government expenditures with an elasticity of revenues with respect to output of approximately one, from the existence of social insurance programs (defined-benefit pension and unemployment benefit systems fall into this category), and from the progressive nature of income taxes. The main ways to increase their macroeconomic effect would be to increase the size of government or (to

a lesser extent) to make taxes more progressive or to make social insurance programs more generous. However, reforms along these lines would be warranted only if they were based on a broader set of equity and efficiency objectives, rather than motivated simply by the desire to stabilize the economy. The second type of automatic stabilizer appears more promising. This type does not carry the costs mentioned above and can be applied to tax or expenditure items with large multipliers. On the tax side, one can think of temporary tax policies targeted at low-income households, such as a flat, refundable tax rebate, a percentage reduction in a taxpayer's liability, or tax policies affecting firms, such as cyclical investment tax credits. On the expenditure side, one can think of temporary transfers targeted at low-income or liquidity-constrained households. These taxes or transfers would be triggered by the crossing of a threshold by a macro variable. The most natural variable, GDP, is available only with a delay. This points to labor market variables, such as employment or unemployment. How to define the relevant threshold, and which taxes or transfers to make contingent, are issues economists must work on.

c. Final conclusions.

Some of IMF' functions have changed, but the original goals remain surprisingly unaltered. Certainly the IMF no longer presides over a system of fixed exchange rates, since no such system exists. But it still aims to monitor the world's monetary system and provide financial support (with policy conditions attached) to needy economies (Minton-Beddoes, 1992, p. 126).

Most of the elements of the pre-crisis consensus, including the major conclusions from macroeconomic theory, still hold. Among them, the ultimate targets remain output and inflation stability. The natural rate hypothesis holds, at least to a good enough approximation, and

policymakers should not assume that there is a long-term trade-off between inflation and unemployment. Stable inflation must remain one of the major goals of monetary policy. Fiscal sustainability is of the essence, not only for the long term, but also in affecting expectations in the short term inflation (Blanchard, Dell' Ariccia & Mauro, 2010, p.10).

In many ways, the general policy framework of IMF should remain the same. The ultimate goals should be to achieve a stable output gap and stable inflation. But the crisis has made clear that policymakers have to watch many targets, including the composition of output, the behavior of asset prices, and the leverage of different agents. It has also made clear that they have potentially many more instruments at their disposal than they used before the crisis. The challenge is to learn how to use these instruments in the best way. The combination of traditional monetary policy and regulation tools, and the design of better automatic stabilizers for fiscal policy, are two promising routes.

What could be done?

A financial system should provide society with the means of matching savings and investment so as to transform today's resources into tomorrow's consumption—and to do this efficiently and safely. Ultimately, a smoothly functioning financial system should help to produce stable and sustainable economic growth. In the run-up to the crisis, some of these goals were not met—behavior of market participants, policy makers, regulators and supervisors, and others interacted in ways that gave rise to extreme instability, resulting in levels of government intervention into the private sector of advanced economies that have not been experienced since the Great Depression.

The financial crisis unfolded in an environment where financial institutions and other investors were excessively optimistic about asset prices and risk against a backdrop of low nominal interest rates. Indeed, in the five to six years prior to the crisis several trends signaled that the financial system was becoming more vulnerable. First, while not a determining factor in which countries were hit by the crisis, a rapid expansion of the financial sector was evident in many countries. Some of this was spurred by high levels of household borrowing for the purchase of real estate, some of which was based on a loosening of underwriting standards. Second, reliance on nondeposit-based funding became prevalent in the banking systems of the subsequently hardest hit countries. In part, this development was linked with a need to finance structured credit instruments held in off-balance sheet vehicles. Third, in the banking sector of many countries, trading account income, as well as commission and fee income, rose while net interest income from the traditional banking business was lackluster. Using traditional measures of leverage of banks' balance sheets, overall banking system leverage was

either elevated or grew rapidly in the advanced countries that suffered the most.

While there were many causes to the crisis, the crisis illustrated that regulation and supervision were inadequate for the risks that were undertaken by the market. The regulatory reforms that are emerging in policy discussions are aimed at moving the overall financial system to a lower point on the risk/return tradeoff—lowering risks, raising costs, and thus, most likely, lowering returns earned by the sector. Ideally, on economic efficiency grounds, this would be best accomplished by establishing price-based incentives for important parts of the financial system to avoid extreme systemic risks—essentially by making it more expensive for institutions to do so. Alternatives, albeit less preferable, would involve outright quantity constraints on positions, the size and scope of activities, or even limits on the types of instruments that can be purchased or sold. In various venues, both approaches are under discussion. In short, what needs to occur is that *sensible and better* regulation is designed, implemented, and enforced—a Goldilocks solution—not too little, nor too much, but just right to do the job of preventing problems where markets fail to operate properly (Kodres and Narain, 2010, p.5).

The underlying philosophy of regulation changed with the crisis—policymakers recognize that prudential regulation to ensure the safety and soundness of individual institutions will not be sufficient to address systemic risks. The IMF is playing a key role in the development of financial regulation and its implementation by national authorities. The IMF serves as a forum to ensure that reform efforts are sustained, coordinated, and globally consistent. The IMF with its knowledge of members' financial systems and experience in monitoring global standards and codes is uniquely positioned to help ensure that a

redesigned financial system benefits all its members, not just some. It is able to see the pros and cons of different regulatory structures, what has worked well, and what has not, and can help translate this into practical regulation. The IMF could advise countries about where best the country could place a mandate for financial stability, depending on its current financial architecture. The IMF may thus be able help to minimize collateral damage to households and firms that would otherwise occur if the reform of the financial system fails to occur or does so in an uncoordinated way, leading to an unleveled playing field. Through its surveillance activities, the IMF can help to bring peer pressure to bear on those countries that fail to conform to international best practice.

To help foster a more stable global financial system, the IMF will need to refine its surveillance of the financial system using a more global approach—including by looking at the connections between the financial system and the macroeconomy —so-called macrofinancial linkages—and to remove data gaps that inhibit observance of various linkages. IMF policy advice is being strengthened by enhancing the interaction between multilateral and bilateral surveillance and through more targeted technical assistance in the areas of supervision, regulation, and crisis management. Assessment of contingent fiscal liabilities to the financial sector and their impact on systemic risk is becoming a particular focus (Kodres and Narain, 2010, p.17).

The IMF already contributes to ongoing discussions on regulatory reform through its interactions with the financial sector standard setters (Basel Committee on Banking Supervision, the International Organization of Securities Commissions, International Accounting Standards Board, and the International Association of Deposit Insurers). The IMF has been increasingly interacting with the FSB and the BIS on topics of mutual interest. The roles of these bodies will become further

intertwined as the FSB helps advance the agenda for international financial regulatory changes, the BIS collects data and performs research, and the IMF brings to bear its members experience, tracking and encouraging the implementation of new standards and regulatory changes through its surveillance activities and technical assistance.

The IMF has not prevented the Mexican crisis, the IMF has not prevented the Asian crisis and also it has not predicted and prevented the current financial crisis, so what can be done to prevent the next crisis? How can we prevent the next financial hurricane in the world economy?

I. Improving the given instruments.

1. One line of attack is to improve the instruments being used. A first approach is a *better national bank regulation*. Information must be made available on whether international standards are actually implemented. It is also recommendable to introduce some national safety nets for groups of national or subnational banks where the safety net is able to absorb a financial crisis of an individual bank (or of some banks) and stop a bank run from beginning and from spreading. Take as an example the Deposit Insurance Fund (Einlagensicherungsfonds) of the private commercial banks in Germany (Siebert, 1998, p. 1).

2. A second point is to introduce more *transparency*. But, what type of data do we need? Data must include the maturity structure of debt and its composition in terms of different currencies. Information should also cover the financial sector, for instance, in form of the consolidated balance sheet of the financial sector as a whole and of the major financial institutions. And when do we need data? In a world of a high mobility of portfolio capital, we need the data quickly. It creates uncertainty and instability if data on fundamentals are published with large time-lags and if markets have to guess rather than to know the data on fundamentals.

And finally, who is to provide the data? It is not satisfactory that the data are supplied by national governments. Information should be provided in a standardized form, it should get a stamp of approval from the IMF or other specialized international organizations like the BIS. This secures comparability of the data, and it enhances credibility of the data. If countries are reluctant to provide the necessary data, there should be definite costs of non-compliance, for instance by making non-compliance public or by requiring compliance as a precondition for IMF support in case of a crisis.

3. A third point is to improve *surveillance*. But what does surveillance mean? What should the IMF actually do? One approach is to provide more and better information to the markets and then rely on the fact that markets will require higher risk premiums from countries with a poorer economic performance. The problem remains markets can overshoot due to expectations. In the long run, expectations moving away from the fundamentals will be corrected in the market process as soon as the fundamentals become apparent. The systematic answer is to have an intertemporal fix point of sustainability as an anchor for expectations. The other approach is an explicit role of the IMF in surveillance. The IMF should not be a silent supervisor who deliberates with the country where a problem is developing behind closed doors (Siebert, 1998, p. 3).

II. Solving the moral hazard problem.

4. In order to solve the *moral hazard problem*, the role of the IMF has to be clearly defined. To define the short-term role of restoring a balance of payments equilibrium and the long-term role of exchange rate stability was relatively easy during the time of Bretton Woods when the main objective of the IMF was to bridge foreign currency shortages in a world of relatively stable exchange rates and when trade in goods and services

was predominant as the major driving force of the balance of payments situation. With flexible exchange rates and with portfolio capital being the main determinant of short-term exchange rate movements, the task of defining the role of the IMF becomes more and more complex. The short-term and long-term roles are more intertwined. In a world with high portfolio mobility, currency runs can be a problem. Unfortunately, currency runs which are a short-run phenomenon have long-run causes.

5. By switching in the two roles, the *size of operation of the IMF* has increased. Thus, we must raise the question what is the optimal size of operation? Here the moral hazard problem really comes in: The larger the size of operation, the more money the IMF takes into his hand, the weaker will be the incentive for governments to prevent problems. Thus, with a larger scale of operation, the balance between the short-term and the long-term function tilts in favor of the long-term, creating severe moral hazard problems. This is one reason why the IMF should think about scaling down its level of operation in the future. By strengthening the transparency and the surveillance before a crisis can fully develop there is less need for large scale operation. The scale of operation also is related to another moral hazard problem: The larger the scale of operation and the bigger the role of the IMF, the lower the losses that the private lenders have to take. If private lenders can expect to be bailed out, they will not have a strong incentive to be cautious in giving credits. In order to solve this problem, we need an arrangement on how to handle private credits when private debtors and sovereign countries get into trouble.

6. The IMF should also rethink its role of lending. One possible line would be to charge a penalty rate if credit is provided and require collateral. A penalty rate, which could be preannounced in the early warning system even if credits of the IMF are not applied for, would be an important signal to markets. Requiring collateral would be a strong

incentive to private lenders to find appropriate forms in which assets can serve as collateral.

8. The IMF has not prevented the Mexican crisis, the IMF has not prevented the Asian crisis and also it has not prevented and predicted the current financial crisis. The IMF must change the sanctions and the incentive system so that the next crisis is to be prevented. The IMF should concentrate more on ex-ante prevention. This can be done by clearly specifying the rules that will be applied ex-post. This means the IMF should focus its role on bridging situations where a liquidity problem exists.

Conclusion

The framework of IMF policies, before the current financial crisis, was based on a set of reforms that had been called “Washington Consensus”. The creation of the term “Washington Consensus”, as the “father” of the term Williamson (1996, p. 15) explains, instituted in 1989 when the inventor of the term was invited to a US Congressional Committee to articulate his support for the Brady Plan. The Brady Plan was designed to address the debt crisis of the 1980s, when a number of countries, primarily in Latin America, confronted by high interest rates and low commodities prices, admitted their inability to service hundreds of billions of dollars of their commercial bank loans. “Washington”, for Williamson, incorporated the International Monetary Fund (IMF), the World Bank, and the US executive branch, the Federal Reserve Board, the Inter-American Development Bank, those members of Congress interested in Latin America, and the think tanks concerned with economic policy: it is an amalgamation of political, administrative and technocratic Washington. Moreover, the Washington Consensus has been identified as a “neoliberal manifesto”. Some of IMF’ functions have changed, but the original goals remain surprisingly unaltered. Most of the elements of the pre-crisis consensus, including the major conclusions from macroeconomic theory, still hold. Among them, the ultimate targets remain output and inflation stability. In many ways, the general policy framework of IMF should remain the same. The combination of traditional monetary policy and regulation tools, and the design of better automatic stabilizers for fiscal policy, are two promising routes. To help foster a more stable global financial system, the IMF will need to refine its surveillance, transparency and regulation of the financial system.

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