The IMF and Its Future

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Let me begin by thanking you for inviting me to join you today, and thanking Miguel Fernández Ordóñez, Governor of the Banco de España, for organizing the event.

This is an interesting time to talk about the future of the IMF, because this is a time of great change, when the future of the International Monetary Fund—and of many other institutions—seems fluid and uncertain.

Of course, the IMF has lived through other uncertain and chaotic times. Indeed, the Fund was born out of the economic and political chaos of the period between the wars: the failed attempts to impose order on the global economy in the 1920s, the Great Depression, which followed that failure, and the World War that followed the depression.

The desire of the founding members of the IMF to avoid a repeat of this chaos explains the objectives that they gave to the Fund, reflected in the Articles of Agreement, to promote global financial stability and to help members to adjust their balance of payments "without resorting to measures destructive of national or international prosperity".

These objectives remain valid today, as we try to manage another chaotic period in the global economy. The question is how to do it, in a global economy which is very different from that of the 1940s.

In my view, the answer is twofold.

First, we must move quickly to help the world restore stability. This is a critical period, and decisions taken now will determine the future of the global economy—and of the Fund—for years to come. Therefore, I will use part of this speech to set out the Fund's policy advice for the next several months.

Second, we must look ahead and design a financial architecture to make the global economy calmer and less prone to economic and financial instability. I will make some suggestions as to what should be the Fund's role in that architecture.

Priorities for the Next Several Months

Let me begin by talking about the priorities for the next few months—for the Fund and for our members.

The global outlook continues to deteriorate. 2009 will be a very difficult year for the global economy and we do not see any recovery before the beginning of 2010 at the earliest.

To prevent a global depression, we need action in three areas. We need financial market measures, in order to get credit flowing again. We need fiscal measures, to offset the abrupt fall in private demand. We need liquidity support for emerging market countries, to reduce the adverse effects of the widespread capital outflows triggered by the financial crisis.

Governments around the world have endorsed this agenda, most recently at the Washington G-20 meeting in November. Many have begun to implement it. But the actions taken so far are not enough. We need more.

The Fund has a central role in helping governments in each of the three areas:

• by monitoring risks at the global level and providing timely technical advice on financial market issues;

• by deploying our expertise and experience on fiscal issues to help finance ministries find the best ways of calibrating and implementing fiscal stimulus;

• by helping emerging economies design good economic programs, and by providing sufficient finance to support them, with conditionality tailored to the goals of containing the crisis,.

Let me now give some more detail of the Fund's advice and proposals in each of these three areas.

First : Restoring Stability to Financial Markets

To restore confidence and stability, we need government intervention in the financial markets which is clear, comprehensive and cooperative between countries.

Government action needs to have a clear objective so that effective oversight of how public money is used is possible. This is still not always the case, and this lack of clarity goes some way to explaining the "bailout fatigue" which is a major political risk at the moment.

National plans need also to be comprehensive: they must contain guarantees to depositors and assurances to creditors that are sufficient to ensure that markets function. They should providing liquidity and support bank recapitalization. And they should promote loss recognition and to the removal of distressed assets from banks' balance sheets. The Fund's experience with more than 120 past crises underlines that both recapitalization and loss recognition are key.

This action should be coordinated, at the global level and at the regional level when appropriate.

I am somewhat worried about these plans. A lot has been announced but I sincerely believe that the follow up doesn't go fast enough.

Second : Supporting Aggregate Demand

Another priority is to support aggregate demand, in the face of what now looks to be a dramatic fall in consumer demand. As often for the Fund, the solution to global economic problems is mostly fiscal but with a twist—it is fiscal expansion, not fiscal contraction, that we need. And this has been advocated by the Fund a soon as last January in Davos.

Fiscal stimulus is now essential to restore global growth. The three key questions are: who should do it, how much stimulus, and how should it be done. The Fund will shortly publish a paper which sets out in detail our proposed fiscal policy strategy for the crisis. For now let me give a quick overview.

On who should do it, fiscal stimulus should be undertaken widely. While each country will need to consider its own circumstances, because of trade relations, the more countries that engage in stimulus, the smaller will be the actions that any individual country will need. And of course it is politically easier for countries to act together than to act alone.

It is also important that all countries that can stimulate do so, because not every country can. There are some emerging market countries that have financing constraints—either high costs or inability to finance deficits at all—which mean that they need to contract their budgets rather than expand them. Others are constrained from fiscal stimulus by high levels of debt.

It is cases like these that explain why in some of the programs the Fund is supporting at the moment, we are calling for some fiscal retrenchment, despite our call for global fiscal stimulus. If there was fiscal room for maneuver in these program countries, we would say "use it". But often there is no room for maneuver. In fact, in the absence of Fund support, countries would have to contract even more, because financing is so tight.

But the fact that some countries—and these include some advanced economies as well as emerging economies—cannot or should not engage in fiscal stimulus, makes it all the more important that other advanced economies and some large emerging economies do their part. Some countries have already acted, but the world needs more.

This leads me to the second question: how much fiscal stimulus? Every day brings additional indications that the psychology of individuals, households and firms has changed sharply in the past year. The more profound that change, the greater the fiscal effort that will be needed to offset it and to restore confidence.

We are facing an unprecedented decline in output, we have evidence of substantial uncertainty limiting the effectiveness of some fiscal policy measures, and we anticipate that the negative growth effects will last for some time. For all of these reasons we are calling for stimulus measures that are large and diversified, and that will last longer than one or two quarters.

We think that a global fiscal stimulus should be about 2 percent of world GDP—1.2 trillion dollars—this may make a sizable difference to global growth prospects and substantially reduce the risks of a damaging global recession. But these 2 percent are an average, while some countries can't do anything, others have to do more.

On how fiscal stimulus should be done, a key criterion is to maximize the multiplier effect of different fiscal measures.

For example, actions taken to help troubled sectors like housing and finance may have disproportionately large effects because they can break the cycle of deleveraging.

Transfers to low-income households are important because they are most likely to face credit constraints and—relatedly—because they would be most likely to raise their spending. Some good examples would be greater provision of unemployment benefits, increased tax benefits for low-wage earners, and expansion of in-kind benefits covering basic needs such as food.

Since the slowdown is expected to be long lasting, investment spending, which typically has a longer gestation period than many other measures, becomes a more appropriate policy tool in the current circumstances.

Therefore, investment projects that are already in the works and can be implemented quickly, and those with good long-run justification and likely positive effects on expectations of future growth, like President-elect Obama's Manhattan Project for energy saving, are good ideas.

Temporary reductions in personal income and sales taxes could also be envisaged. But we would not recommend reduction in corporate tax rates, dividends and capital gains taxes or special incentives for businesses. These are likely to be ineffective and difficult to reverse.

At present, the most urgent need is for a strong foot on the accelerator of fiscal spending. But I don't want to leave you with the impression that the IMF has forgotten that good brakes are important too.

Even advanced economies need to keep an eye on fiscal sustainability, and guard against the risk of adverse reaction from financial markets. This is not likely to be an immediate problem, but we have seen that markets can react late and abruptly to perceived shifts in creditworthiness.

So a fiscal path that does not perturb markets one day may frighten them the next, leading to sharp adjustments in real interest rates which would undercut recovery programs and could cause financial instability.

The best way to avoid this is to match short-term stimulus with initiatives to credibly address fiscal sustainability concerns and strengthen medium-term frameworks, such as reform of pension systems over the medium-term. This would be the ideal fiscal combination for both the European Union and the United States.

Here again, I must admit that I am worried. Some countries have announced big things, but some are reluctant as if they couldn't see the magnitude of the crisis. And even where speeches acknowledge the need of big programs, like in most countries of the EU, the implementation seems to be far from the announced target.

I have said earlier that the IMF forecasts include a possible beginning of a recovery at the beginning of 2010. But there are, of course, a lot of downside risks. For this forecast to materialize, we need the correct policy—and especially, fiscal policy—to be implemented. And I do not see it is the case right now.

Third : Providing Financial Support to Crisis-hit Countries

Providing financial support to countries hit by shocks to cushion their impact and hasten recovery is a traditional responsibility of the Fund.

In the current crisis we have been living up to that responsibility. The Fund has provided prompt and very substantial support for Hungary, Ukraine, Pakistan, and Iceland, and there will be more to come.

We are also closely monitoring the fallout from the global downturn on our low-income members. We have increased support to more than a dozen PRGF countries and stand ready to provide additional financial resources.

As the crisis is also revealing new types of needs, the Fund has created a new facility, designed to provide short term liquidity without conditionality beyond countries' already strong track records for those which qualify.

And the Fund is engaged in a thorough review of all aspects of its lending function-its instruments, the approach to conditionality, the amounts that countries can borrow, and their financial terms-to make sure these meet the needs of its members.

But if this crisis gets worse, the world is going to need to supply much more liquidity to affected countries. We have enough resources for now, but this can change quickly. The G-20's commitment to support Fund lending capacity is helpful, as is Japan's generous offer of $100 billion to add to the resources of the Fund.

I would urge other countries with large reserves to follow Japan's example. Now is the time for the world community to get together and provide the Fund with the means to address the challenges arising from a crisis which—for the first time—is a global crisis. A general increase of quotas is certainly necessary but it will take time, a quicker solution can rely on new SDRs.

I would also urge the major advanced economies to cofinance Fund loans—either directly or through balance of payments support in conjunction with Fund programs.

All this has to be done: restoring stability to financial markets, supporting aggregate demand, providing financial support to crisis-hit countries. Some significant steps forward have been made but I want to said it with some gravity: a lot remains to be done.

Policies to Avoid a Future Crisis

Let me now say something about the longer-term future of the IMF, and especially the Fund's role in the new financial architecture. Many changes are needed. Some of these may arise out of the G-20 process. Others are more directly within the control of the Fund.

First, there is now universal recognition of the need for changes in financial market regulation. Open financial systems provide tremendous economic benefits. National financial markets raise growth by lowering the cost of capital to firms while allowing individuals to choose their preferred spending path. International financial markets broaden the availability of capital to firms and the savings options to individuals. But all of this only works if there is good oversight. Much of this oversight and regulation will continue to be done at the national level. But given the globalization of financial markets, there also needs to greater international coordination.

This will mean an important role for international organizations. The Financial Stability Forum, the International Organization of Securities Commissions, the Basel Committee on Banking Supervision, and many other international and national organizations all have work to do.

And the IMF has a special role in this process, because it brings to the table an assessment of the linkages between financial sector and financial market rules and macroeconomic outcomes. This perspective is critical for designing oversight and regulatory frameworks.

Let me give you an example. It has become obvious that financial market regulations can be pro-cyclical in the same way that fiscal and monetary policy can be pro-cyclical. It has also become obvious that this is a big problem. But to fight this problem you need to understand not just the regulations but also the cycle and the linkages between the financial sector and the real sector. The Fund is uniquely placed to do this. There are a many institutions working on the financial sector, as well as many others working on the real economy, but only one stands at the corner of Wall Street and Main Street. This has been extensively proved during the last year. Because we took more than others into account the linkages between the financial sector and the real economy, IMF forecasts have always been much more pessimistic than the consensus and we have been harshly criticized for that. But at the end we were right.

At this point, let me digress for a moment to say that the Fund's capacity to understand and comment authoritatively on macro-financial linkages has been greatly enhanced by the work of some eminent Spanish citizens who have served the Fund.

Let me single out Rodrigo de Rato, who emphasized the importance of understanding macro-financial linkages, building on the work of his eminent predecessors, Michel Camdessus and Horst Koehler.

The Fund has also had two very eminent department directors from Spain. The late Manuel Guitián was an important intellectual leader in the Fund for many years. As Director of the Monetary and Exchange Affairs Department in the '90s, he pushed for a better integration of macro and financial-sector analysis.

This work was then taken forward by others, including most recently Jaime Caruana. As Director of the Fund's Monetary and Capital Markets Department, Jaime has also quietly but consistently made the right calls on many financial market issues, including the extent of financial sector losses. In doing so, he has added greatly to the Fund's credibility. Jaime will leave us in a few months to head the Bank of International Settlements, but I want to take this opportunity to thank him publicly for all of his work.

Let me now turn to another area where I expect the Fund's work to be stepped up. This is early warnings. The Fund's track record on identifying and warning about impending problems is better than most, but the complexities of the current global financial system call for a stronger response.

I do not believe in an automatic system with lights turning from green to orange and orange to red. It is too crude and some what bureaucratic. But I do believe in a system built on the strong foundations of the Fund's surveillance complemented by regular consultations-with the expanded FSF, with governments, with markets and with outside observers. We need a system with improved circulation of information and stronger links between national and global surveillance with emphasis on the regional level. This system will draw on the analytical methods that the Fund has designed to assess economic prospects and vulnerabilities, and which seasons this with judgment. I have no doubt that this will be much more accurate and reliable than most other rating systems currently used.

We already work along these lines for different parts of the world and, for instance, we are looking very seriously at the spillover risks in Central Europe.

But we need a system that both identifies risks and recommends remedies. For example, were such a system in place in 2005 it could not only have noted increased correlations across markets-which the Fund did-and identify risks from Special Investment Vehicles-which the Fund also did, though perhaps not loudly enough-but also come up with a remedy, such as raising capital requirements on Special Investment Vehicles.

I believe that Jaime Caruana will say more about our work in this area in his remarks at the next session. So I will not go further now, except to say that early warnings are useful only if the warnings are listened to. I perfectly understand that governments do not like to hear bad news for the future when the current sky seems still sunny. But early warnings without early reactions are useless. And that is why I told you earlier that I am worried about 2009 because today's reactions to the current crisis seem to me too weak in magnitude, poorly inspired in design and shaky in implementation.

Let me conclude with the G-20. I said earlier that some changes may arise out of this process. Well of course one of the major changes in the last month is that there *is* now a G-20 process, and that the G-20 is setting the agenda. Let me make two observations about this, and about its implications for the Fund.

First, it is entirely a good thing that heads of government and finance ministers are becoming deeply involved in the international effort to tackle this crisis. It would be even better if this high level involvement could be institutionalized, perhaps through regular meetings of a high level council of ministers capable of reaching agreements and implementing them.

Second, if there is to be a more permanent group there is the question of whether the G-20 has the right membership. Well, it is more representative than the G-7 or G-8, which is a good thing but it is still a relatively small "in-group"-and for every in-group there is an out-group. 166 countries, accounting for 40% of the world population, including large ones such as Spain, are not themselves members of the G-20.

So I think that the enhanced role for the G-20 needs to be accompanied by greater reliance on multilateral institutions with near universal membership, so that no country that wants to participate in the international system is left out.

I have already mentioned the special advantages that the IMF has in supplying a perspective on macro-financial linkages. Engagement by the Fund can also help to improve both the legitimacy and the effectiveness of decisions taken in smaller groups. From a governance standpoint, the Fund's near universal membership allows it to convey the views of more countries and reach out to more countries than other organizations. And when it comes to implementation, the Fund has the mandate and processes in place to assess policies adopted by different countries and to promote best practices, through its surveillance and technical assistance activities.

Of course, the Fund itself has to be representative as well as universal, and especially we need to see an increasing role for and responsiveness to emerging markets. Both the reform of Fund quotas and the broader governance reform that we are undertaking are very important for this.

A few words as conclusion

I said at the outset that this is a highly uncertain time. In these circumstances it is not surprising that the precise contours of Fund's current engagement and its future role are not clear. I don't worry about this. It doesn't really matter what the Fund's exact place is. What matters is that we make a useful contribution. We have the tools to do that. If we deploy them well, and help our members, then the IMF will have a good future. More importantly, it will be doing its job, and therefore give the world a better future.

All around the planet, the people of the world have reacted to the crisis with feelings going from surprise to anger and from anger to fear. It is our responsibility to help building a world based more on humanity and cooperation than on opacity and greed.

Thank you very much.