

The World Economy and the Role of the IMF

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Mr. Governor,
 Governors,
 Excellencies,
 Ladies and Gentlemen,
 Dear Jarle Berge,

Let me tell you how honoured I feel to have been invited to join you in this very special occasion to honour a very admired and dear friend whose contribution to the missions of the IMF during the momentous years of his tenure has been outstanding and who, at the end of his tenure as Deputy-Governor of the Norges Bank, has accepted to come back to the Fund for a new mandate at this decisive moment.

While paying tribute to him, I would like also to express my deep appreciation and gratitude to the Nordic and Baltic countries group, which Jarle Berge represented in such a distinguished way, for their unwavering support and for the outstanding example they constantly give of a most generous contribution to the developing countries -- of principled positions and of a permanent option in favour of the multilateral approach -- to handle the problems of the world community. Generosity, principles and multilateralism: these are three commodities in short supply today, but they are as indispensable as ever.

“The World Economy and the Role of the IMF”: is a topic that would admirably fit as an academic contribution to a book to honour your participation in international financial cooperation over the last years. Alas, today, in March 2008, it is really impossible --at least for me -- to think, write or talk about it in a detached academic fashion. The precipitous course of globalization over the last two decades has been such, the maelstrom of the financial crisis we are just witnessing is so intense that all of us who have gained some experience in international financial affairs feel obliged to contribute in some way, including by expressing candidly their views to the search for solutions. The time for diplomatic understatements is over. The time is for candor and for speaking our mind, even if we can only have the ambition of contributing modestly to a worldwide debate about how best to contain the risks and to prepare for the rebuilding of a credible international financial system.

This is, I am sure, dear Jarle Berge, what you have in mind. You have not invited theologians to discuss about the sex of angels when Constantinopolis is under siege. Rather you have invited people inspired by the old tradition of Bretton Woods, sharing a common resolve to do their best to imagine and propose a new system less prone to catastrophes and moved by the basic common conviction that improved structures for monetary cooperation should be part of a new system to be built. The present crisis is a new and costly demonstration of the fact that the world needs a solid and credible central institution ready to face the unexpected and able to make sure that the risks are contained, the damage limited, and confidence re-established. We should go for nothing less. So allow me to use this exceptional opportunity to offer my contribution to the debate, even if I know pretty well that no ideal system could emerge from my reflections, as Minerva emerged with her helmet on her head, from the thigh of Jupiter.

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The world economy is in bad shape. Not many believe that the United States can escape a recession with its contagious effects around the world. But there are two more worrying questions: are we heading toward a recession or stagflation, this one creating for central banks and governments the kind of problems and headaches we thought, we left behind many years ago. Add to that a possibly even trickier question: the inter-action between the recessionary and inflationary factors at play and the consequences of the major financial crisis originating in the “subprime” compartment of the U.S. financial market and continuing to spread its devastating effects in the global system.

The coincidence of an economic and a financial crisis has no precedent in recent history and it calls for initiatives which hopefully could contain the risks of a deeper catastrophe. It also invites some reflections on three major questions more directly related to the IMF and its membership:

1. Could this financial crisis have been avoided and what remains to be done to consolidate our financial architecture?
2. Have we equipped the IMF with the instruments required in the financial world in which we live today?
3. Have we adapted its governance to the magnitude of the changes in its membership?

It is obvious that in these three fields, a lot remains to be done. Let us, then, ask ourselves how to:

- Complete the work on architecture,
- Provide the IMF with the proper jurisdiction and the needed instruments,
- Adapt its governance.

No less is needed to transform what appears today as a risk of the IMF becoming irrelevant in the efforts to build the strong monetary and financial multilateral institution the world so urgently needs.

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I - Complete the work on “architecture”

We can all feel a sense of frustration with the “subprime” crisis and its subsequent evolution, as it is typically the kind of crisis determined action by the membership, continuing the work initiated in the context of the Asian crisis, could have prevented. Remember what the purpose of the work initiated at that time was: basically to avoid with transparency, enhanced supervision, adoption and implementation of codes of good conduct, the occurrence of crisis in a national context which could, by contagion, affect the whole world economy. Of course, important work was completed expeditiously during that crisis. But you know: in general, crises are needed for serious reforms to be undertaken, but determination to persevere weakens with recovery and disappears -- or almost so -- when prosperity and euphoria are back. In this case, once again, history repeated itself!

Let us analyze what has occurred, in the present case. Remarkably enough, this new crisis has developed almost exactly as the IMF “Global Financial Stability Reports” had warned us, publicly, in September 2006 and more extensively in April 2007. To pay tribute to

the solid analytical ability of the IMF staff, I would like to quote its language, even if, regrettably enough not much attention was paid to it when it was issued.

I quote: “A *large macroeconomic risk that loomed at the time of the September 2006 report was the weakening of the U.S. housing market and potential cross-border spillovers*”. After that, the text goes on mentioning that “*The fallout has so far been limited to a small number of lenders, **but could yet spread to the structured credit markets***”. Then, the “*chapter assesses the extent to which such a deterioration in the housing market would increase credit stress in the mortgage market, particularly in the “subprime” and related segments, **and how changes in the structures of the U.S. mortgage market -- including its securitization and distribution to a global investor base -- may have altered potential spillover risks...***”.

A detailed analysis of the overall markets picture follows, signalling in particular that “*competitive pressures and risk models may help to perpetuate risk-taking that, from an individual institution’s view, responds rationally to the current environment **but collectively could raise systemic risks**. A market correction, potentially triggered by a volatility shock, could be **amplified by leveraged positions and uncertainties about concentrations of risk exposures stemming from the rapid growth in innovative and complex products, some of which have rather illiquid secondary markets***”.

A very detailed paragraph follows assessing the deterioration in the U.S. “subprime” mortgage market and offering pertinent and precise reflections on: “What are the spillover risks?”

These are not ex-post analyses -- Monday morning, quarter-backing as they say in Washington -- but ex-ante warnings, sadly neglected. In a climate of euphoria, very limited action was taken and too late anyway to prevent these risks from materializing...

Where are we today? I am unable to say if the worst of the crisis is now behind us, but the damage done has been enormous, starting with the 2 to 3 million householders in the United States which have seen the dream of their life destroyed, not to mention all those around the world who will suffer the consequences of more restriction in credit availability, reduced employment and so on. Once again, the poorest will have paid for the consequences of the irresponsibility and greed on one side and the unpreparedness or reform fatigue on the other. Now, it is time for repair! And, for the IMF, to take the lead in what we could call the phase II of the architecture work prematurely put on the back burner. We all have, certainly, a few suggestions for what should be on the agenda for this reform and particularly the strengthening of prudential regimes, their extension to the variety of financial instruments still outside their realm, the needed disciplines in securitization and dissemination of newly created sophisticated instruments, the monitoring of liquidity of markets, the present regime and prerogatives attributed to the rating agencies, etc. The agenda will certainly be much longer.

Work should certainly start promptly on these items, but at the same time, we must recognize that there are plenty of aspects of that crisis which deserve further reflections and could require deeper adaptation of the system. On that also, the intellectual contribution of the IMF is required, and the membership should be ready for deeper changes, recognizing in particular that risks of crisis can be looming in all parts of the financial universe and no more only where we were used to expect them, in developing or emerging countries. This means to my humble judgement that the membership, before imposing to the IMF whatever reduction of the size of the staff, should ask itself if the Institution has the needed means to face the new dimension of its surveillance task.

Let's turn now to problems, identified since years, beyond the area of diagnosis and prevention of crisis, but which have remained unaddressed.

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II - Provide the IMF with the proper jurisdiction to address the issues of the new financial universe

With the end of exchange controls and the financial revolution at the end of the last century, we are no more in the fragmented universe our Founding Fathers had to deal with at the end of World War II. The fact is that over the last two decades, we have only partially adapted to that change.

In a world where monetary and financial issues are now permanently intertwined, where international financial crises can find their origin in the capital accounts more probably than in the current accounts -- something we know since the Mexican crisis of 1994–1995 -- it is more than time to define clearly the prerogatives and responsibilities of the IMF in the field of capital movements and their surveillance.

Capital flows have been central both to the tremendous advances and prosperity of the past decades and to their crises. It was, then, natural for the international community to consider whether to extend the IMF mandate to include capital account liberalization, and to amend its jurisdiction to allow the Fund to promote this process. Indeed, 10 years ago, at the Annual Meetings in 1997, in Hong Kong, the membership acknowledged that it was time to add this new chapter to the Bretton Woods agreement. Since capital account liberalization is irreversibly under way, should we accept a haphazard, piecemeal, and potentially volatile process, or should the IMF help countries to manage the process in a way that enhances economic stability and growth? The Asian crises gave rise to second thoughts and even celebration of exchange controls, but in fact controls did not significantly reduce the negative impact of the crises. With the benefit of hindsight, we shouldn't hesitate now to revisit the issue, taking advantage of the lessons learned during the last years. Future global financial market integration would gain from taking place within a well-structured framework paying due regard to the stability and economic security of the countries concerned. Proper sequencing should be recommended. In particular, countries should avoid premature opening up to short-term borrowing; several countries suffered from this in the 1990s, having ignored IMF warnings.

The IMF has a major contribution to make in this field, provided it is accorded the same kind of jurisdiction it has for current account transactions. It could help countries in this process of liberalization to satisfy key prerequisites, prime among which are a sound macroeconomic framework, and a robust, well supervised financial system. This will necessarily take time; better to start right away. Even for a thousand mile journey, the first step must be taken.

This would be the proper way of bringing to an end a situation where the broadest volume of transactions escapes the legal surveillance of the Fund and a number of major financial powerhouses -- whose potential impact on their neighbours and on the soundness of the system is undeniable -- keep outside its monitoring operations. Only an integrated vision of monetary and financial development can provide our control tower with the analytical instruments to detect early enough the evidence of dangerous systemic developments. This

broadening of the scope of IMF jurisdiction calls for a parallel effort to renovate its surveillance and its financing instruments.

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III - Renovate the key instruments of the Fund

Surveillance, technical assistance and temporary balance of payment financing are the key tasks of the Fund. In view of the changes in the membership, their deep reshuffle would be in order also, particularly for surveillance and financial support to the poorest members.

1. Strengthen surveillance

As soon as an agreement will have taken place to that effect in the membership, the scope of surveillance will have to be broadened to the full balance of payments and a particular attention be devoted to the capital transactions. In the meantime, I would suggest a special concentration on the following fields:

- To reinforce the messages of the IMF, particularly on the major countries, given the systemic importance of their policies. I suggest that, in their case, the preliminary conclusions of staff missions be submitted to broader public debates, before their transmission to the Executive Board. With due precautions and the agreement and cooperation of the authorities, these discussions could be open to representatives of civil society organizations, academic circles, parliaments, and, in particular, regional partners, to provide the staff with a diversity of views and enrich their assessment, and also to increase the attention paid by the authorities to the Fund's conclusions.
- Second, more attention should be paid to long-term, structural developments which, if left unaddressed, can overtime create intractable rigidities and obstacles to growth. These include labour market rigidities, the consequences of demographic trends like ageing, and even the excessive accumulation of international reserves, such as we have been seeing in Asia. In this field, a closer cooperation with OECD would be in order.
- Third, a stronger attention to the soundness of financial institutions and the strength of prudential surveillance - Many lessons should be drawn in this respect from the present crisis.
- Fourth, still on surveillance, as far as developing countries are concerned, more precise analysis of their efforts and of the international support they receive, in their progress toward the MDGs, through a joint monitoring of the IMF and the World Bank.
- Last, of course, and obviously not the least, the inter-relations between countries and the systemic impact of policies - The growing and chronic global payments imbalances are an obvious case in point. This is an inescapable issue, even if the temptation is strong to bury our heads in the sand. For years we have proclaimed that both U.S. twin deficits and Asian accumulation of reserves are unsustainable; for years we have known that this imbalance will not be settled easily without a cooperative effort to facilitate what is becoming every day more difficult and hazardous if left to isolated actions. Let me enter a plea for the Fund to take the needed initiatives in this area. In a previous incarnation, before joining the Fund, I had the opportunity to be involved in the efforts of the G5 and G7 to address

cooperatively a similar problem of global imbalances, efforts that became successful through the Plaza and Louvre agreements. These disciplines were -- to my regret -- abandoned. Now is the time for a similar effort, led this time by the IMF, as many of the key actors are not members of the G8, and more basically, because there is no other -- I insist, no other -- legitimate, global forum to tackle such a systemic problem. By the way, the G20 does not fit the bill, either. This is a situation where the comparative advantage of a multilateral institution with a global approach is obvious and where the mandate given to it by the international treaties should be permanently present in the minds of world leaders. Even if the task appears more difficult and complex than ever, I don't see any reason whatsoever to de-emphasize now the mission "to promote exchange stability" given to the IMF by the Article I of its Articles of Agreement.

2. Adapt the financing instruments to the needs of its members

While not being a development institution, the IMF must play its full part in the major undertaking of the international community at the beginning of this century: to significantly reduce poverty by promoting the fulfilment of the MDG and strong and sustainable growth in developing countries. On this subject, I would like to make a few remarks.

Contrary to pessimistic views frequently expressed, all continents, including Africa, can very significantly accelerate their progress toward the MDGs, and the international community has demonstrated a readiness to improve its contribution quantitatively and qualitatively. Even if a lot remains to be done, the decision taken for debt reduction in favour of the HIPC countries, the ODA pledge of additional 25 billions dollars yearly before 2010 and the decisions taken in the framework of the Development Assistance Committee to improve the quality of ODA contributions are, no doubt, important steps. They should encourage African countries in their reform efforts, and their progress, in turn, should lead donor countries to double this extra contribution of US\$ 25 billion for the subsequent period leading to 2015. These were the conclusions of the Commission for Africa I had the honour to be a member of. These commitments must be particularly present to our minds at a time debt reduction operations will no more contribute at the same level as in the recent years. This can appear as an ambitious program. It is not. It is, of course, amply within the possibilities of the international community and we should never forget that, by limiting their ambitions to a mere halving of the extreme poverty in the world, the MDGs are certainly far from what would be both necessary and feasible. Not to mention the fact that, alas, they ignore the enormous added cost of adaptation to climatic changes recently brought to the attention of the world community, by the 2007 Nobel Prize!

This very simple observation makes particularly pressing the need for all partners in development, but particularly for the IFIs, to concentrate all their means and leadership in exemplarily supporting the countries which make serious efforts for meeting the MDGs. This is of course primarily the task of the World Bank and of the Regional Development Banks (RDBs). They have a critical role to play during the next decade. But it is essential also that the IMF continue to demonstrate its full commitment to this task. Let me only stress the following points:

- The membership should reaffirm the mission of the IMF in support of its poorest members as an essential part of its purposes under the Articles, in response to the recurrent suggestion to consider them as the exclusive responsibility of "development institutions".

- Particular consideration should be given to the special circumstances of deprivation and dependence on external sources of public finance of the poorest countries. It has to be recognized that too many well designed and truly country-owned programs have failed, or did not deliver a great part of their promise, because their overall financing was too tightly defined and/or no contingency contributions were defined to compensate for delays or for the default of expected contributors. These considerations would suggest higher access to the concessional windows of the IMF. I know that current thinking could be in the opposite direction, but I beg to disagree. Having spent lot of time as a member of the Blair Commission, looking carefully at the detailed situation of many countries among the poorest, and analysing the reasons for suboptimal results of a number of earlier programs, I see it as thoroughly unrealistic to believe that the IMF could fulfil its tasks with a lower access to its concessional windows.

As recommended by the Commission for Africa, more effective and earlier contribution, as well as debt relief, should in particular be granted in the post conflict situations as well as in the case of external shocks such as sudden and dramatic falls in commodities prices or natural catastrophes. While suggesting, as I have just done, more boldness in responding to the financial needs of countries, I would in no way propose to relax the disciplines of conditionality, whatever one could say in the name of country ownership. In well designed programs, there is no such contradiction: conditionality only reflects the key actions recognized as necessary by the countries and the institutions together to maximize the chances of success of the programs. This does not preclude, of course, but on the contrary, underlines the importance of restricting conditionality to what is strictly necessary. I value very much the recent efforts in that direction.

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IV - And now, let-s ask ourselves how to adapt the governance of the Fund to the universal ownership requirements

When thinking about the roots of the “malaise” one can identify in the membership of the IMF, the question of ownership emerges in two opposite but complementary ways: the excessive intrusiveness of the groups of major countries and -- at the opposite end -- the sense of insufficient recognition felt by many others, especially the countries with the lowest quotas.

The problem has been identified for a long time and explicitly recognized by the governing bodies, but their slowness in taking action has only added to the frustrations. The problem is serious. It is at the same time a question of fairness, but also, basically, of good governance, as all the new actors must take part to the management of the system for it to have the best chances to meet its challenges. The IMF must, then, address it -- decisively -- if it is to renovate itself, recover the authority it enjoyed earlier, and to restore the legitimacy, the importance of its new tasks make indispensable. Clearly, the responsibility for action lies here with the shareholders of the institution. It is by taking a few decisive steps in this field that the membership, and particularly its most influential members, will demonstrate their readiness to provide the world with the strong central financial Institution it now needs.

Knowing pretty well the hesitations such issues can generate, I will limit myself to mentioning four measures which could contribute to renovate, IMF governance in a participatory direction.

1. To bring to an end the debate on the distribution of quotas and the size and composition of the Executive Board

It is time now to conclude the complex debate on the quota calculation. It will require -- no doubt -- a great deal of spirit of compromise. A decision which would not cost a lot to anybody but which would give testimony of the common determination to improve the voice of the poorest would consist in restoring the proportion of total basic votes -- allocated to the smallest countries -- to their initial level of 11.3 percent while it has shrunk overtime to 2.1 percent.

The size and composition of the Board call also for significant changes reflecting, of course, the decision taken for the distribution of quotas. This reform should simultaneously respond to the new situation created by the progress of the European Union toward its integration, the growing importance in world economic terms of the emerging markets, and the difficult issue of "voice" of the poorest countries which still awaits a convincing response.

The size of the Executive Board is much less a problem than the distribution of its chairs. Even if -- during my tenure -- I never experienced major difficulties in making decision due to what is seen as an excessive number of chairs, I think that it would be preferable to reduce it from 24 to no more than 18 to 20 chairs. The key difficulty lies with the need to address the growing distortions between the new size of the economies, their respective quotas and the Board representation. No practical solution can be found, I am afraid, except if -- giving an exceptional demonstration of their commitment to this multilateral Institution, the European countries were to accept to reduce significantly their own representation. The present number of European chairs -- 8 out of 24 members -- no more makes sense. I would not see major problems in reducing even to one the number of European Executive Directors, like the United States, while providing of course the new chair with an appropriate number of Alternate Executive Directors to ensure that all the diversities of Europe are well taken on board. In view, nevertheless, of the very constructive and independent contribution many smaller European countries have provided the Fund with since its origin, it could be justified to adopt a compromise number of 4 while strengthening the present arrangements for the representation of ECB in the light of experience.

A similar concentration should take place among other chairs to avoid an excessive imbalance between major players -- the U.S., European, Chinese, Indian and Japanese chairs -- and others. This would overall allow a significant reduction in the size of the Executive Board and improve its efficiency, particularly if, on the occasion of such reform, the seniority and calibre of Directors were upgraded. The growing -- and indeed exceptional -- importance of their new role would amply justify that these positions be occupied by at least former Deputy Governors or Vice Ministers. And let me here express my admiration to the Nordic and Baltic countries for once again having been in a exemplary way by sending now to Washington the Deputy Governor of the Central Bank of Norway.

The change I have suggested here should be initiated, in the IMF and other international institutions, for the chances of its success to be maximized, by the European countries themselves, as part of a broader and well articulated package of world governance reforms. With its unique experience of regional governance, the E.U. holds here the keys of a change the world needs.

2. Reform the procedures for the selection of management

The rules and practices for the appointment of the Managing Director of the IMF, as well as of the President of the World Bank, should also be changed. Both Europe and the United States should renounce their present archaic “privileges” and a new system enacted whenever one of these two positions opens again. This would, no doubt, reinforce the “legitimacy” of the two institutions.

3. Make more explicit the real political responsibilities

The membership shouldn’t miss this opportunity also to decisively clarify the distribution of responsibilities within the Fund and between the Fund and the constellation of informal bodies including all the Gs which have proliferated overtime with not only time consuming consequences but also undue interference, confusion and disorder. The basic requirement would be, of course, to satisfy the demands of world public opinion for citizens to be more involved, through their legitimate representatives, in the decisions taken at the world level. A reform proposed years ago -- the introduction of a supreme decision-making body for the IMF -- would respond to this demand. It would consist in implementing (finally!) a decision adopted on the occasion of the Jamaica amendment of the Articles of Agreement in 1976 and transferring to a “Council” -- which would be a political decision making body -- the major strategic decisions presently in the hands of the Executive Board which remains a body of a technical nature. The Council would replace the present International Monetary and Financial Committee, which enjoys only a consultative role. This change would strongly signal the importance of the involvement of national authorities in the decision making process and would symbolize on their part a stronger readiness to take into account the systemic dimension of their responsibilities.

It would also offer the advantage of mitigating somewhat the technocratic appearance of the Fund as its governing body would become of a political nature, the institutional setting being then in a better harmony with the practice. Needless to say that such “college”, working on the basis of the staff analysis and of Executive Board deliberations, and with the same distribution of chairs, would be the ideal place to discuss the policies needed. Also, with the proper membership, it could address global payments imbalances and financial architecture reform, and provide the “Global governance group” whose creation I would like to propose in a little while, with all the needed elements to provide the system with basic orientations and leadership, without requiring the creation of a permanent and cumbersome secretariat. Far from leading to an undue politicization of the two institutions, this would place responsibilities squarely where they belong, namely with governments and Central Banks.

These reforms, nevertheless, would be insufficient if the global system of world governance, at its highest level, was not adapted in the same spirit.

4. Lay down the first cornerstones of a more participatory world governance

Beyond the financial crisis we are talking about, we must take into account the fact that our globalized world, where almost all new problems have a world-wide dimension, has no credible and legitimate governance structure to address them in their real dimension. The attempt to respond to this need through the G5 or G8 meetings is clearly insufficient and raises major legitimacy questions.

Drawing the lessons of the experience of recent years, we could propose, in this regard, that each G8 meeting be coupled, now, on a systematic basis with an “extended meeting” to which all heads of State and Governments from the countries represented in the new “council” should be invited. This would be a way to progressively substitute a “Global governance group” of say 18 to 20 members, to the present G8. No doubt its pronouncements would carry more credibility and influence than those adopted now on the occasion of the yearly G8 summits.

Provided such meetings were prepared with the active participation of the two Bretton Woods institutions and of all the countries of the new constituencies, this would provide a good representation of the entire membership of 185 countries. As it could be attended also by the Secretary General of the United Nations and by the heads of the relevant multilateral organizations, it would offer a way of establishing a clear and stronger link between the multinational institutions and world leaders. This could be a good way to address properly the broader issue of world economic governance, far from the illusion of promoting some utopian world government, but with the more limited, but necessary, ambition of finding a global response to inescapable global problems.

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Time has now come for me to conclude. I have not been able to come back to a few of my favourite topics including the need to explicitly recognize the role of the IMF as the lender of last resort of the system, and to reopen discussions about the SDR and the role it could play in last resort circumstances. I would have liked also to mention the need of periodic increases of quotas to keep the size of the Institution in a credible relationship with the size of the world economy and to allow the countries engaging in difficult reforms to benefit from a strong temporary financial support...

Talking about the needed actions to face the present challenges, I finally talked more about the membership responsibilities than about those of the IMF itself. This reflects the experience we all share that, whatever the work of the institution and the excellence of its staff, the IMF cannot fulfil its immense responsibilities without the constant support of its membership; a membership which has always been able, in difficult times, to demonstrate its full commitment to the purposes of this institution.

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