Barbro Wickman-Parak: The IMF's role – new thinking in the wake of the financial crisis

Speech by Ms Barbro Wickman-Parak, Deputy Governor of the Sveriges Riksbank, at a meeting at Global Challenge, Stockholm, 5 October 2012.

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I would like to thank Ms Maria Wallin Fredholm and Ms Emelie Mannefred, from the Riksbank's Financial Stability Department, for their assistance in the writing of this speech.

The 188 member countries of the International Monetary Fund (IMF) will gather in Tokyo for the Fund's annual meeting next week. When I began working with IMF issues at the Riksbank in 2007, my impression was that the IMF was suffering from an identity crisis. The Fund's lending to countries in crisis appeared to have played out its role and major staff cuts were underway. In short, the mood was rather subdued in the corridors of the IMF.

The financial crisis led to an abrupt change. The IMF was forced to quickly provide action programmes and funding for crisis countries. Before the crisis, the IMF's lending amounted to approximately USD 9 billion, the largest part of which went to Turkey. Today, the IMF's lending amounts to around USD 112 billion, and the absolute largest part of this sum now goes to countries in Europe. The media spotlight often falls on the Fund when it rides to the rescue with crisis-management measures like this. But the every-day, important and tireless surveillance work of the IMF seldom attracts any headlines.

The IMF continuously monitors all of its member countries, for example through its Article IV consultations. These include in-depth analyses of the development of the economy, points out risks and gives advice on areas such as fiscal policy, labour-market policy and monetary policy. The knowledge of individual countries that the IMF has built up during years of regular surveillance is a precondition for quickly being able to warn against and counteract risks and to launch tailor-made action programmes when countries need financial support.

The IMF extended its financial surveillance a number of years ago, but there is still more to be done. In the Nordic-Baltic IMF constituency,[1] of which Sweden forms a part, we have been a driving force on several important issues in this area. As a small, open economy with a large financial sector, Sweden has every reason to support the IMF in its efforts to develop its surveillance and analysis of financial risks at the global level. In my opinion, the IMF is the organisation that is best suited to taking responsibility for the surveillance of the global financial system.

The IMF's role as a global supervisor is one of the issues that will be discussed in Tokyo next week. And this is also what I will discuss in my speech here today. A new policy area, macroprudential policy, is emerging in the wake of the financial crisis. How this policy should actually be carried out in practice is a complicated issue and I believe that the IMF can play an important role in this context too.

The financial crisis revealed major problems

The era in which we were said to be living in the best of all possible worlds, popularly known as "The Great Moderation", came to a disastrous end in 2007. Following a long period of steady growth and stable low inflation, we had been lulled into the belief that this would never change. We believed that the financial markets were excellent at converting savings to loans and distributing risks so that they were taken by agents who both wanted and were able to

[1] The Nordic-Baltic constituency consists of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden.

bear them. The risks that were mainly discussed were the imbalances in the global economy in the form of countries with large current account surpluses and those with corresponding deficits. Those who raised questions about the stability of the global financial system and the risks relating to a rapid expansion of credit found it difficult to be heard in this situation.

The financial crisis brought into focus the inability of the international community to prevent and manage crises in the global financial system. There were several problems. First, there was a lack of knowledge about the links and the contagion risks in the financial system. Second, regulation and crisis management were handled at the national level, despite the rapid internationalisation of the financial markets. Third, surveillance focused on individual institutions and if these were stable separately it was often concluded that the system as a whole was stable. An important reason for these shortcomings was that there was an unclear allocation of roles and no organisation with an explicit mandate to oversee, identify and analyse risks in the global financial system.

The IMF was also criticised for its actions in the run-up to the financial crisis. The IMF's own independent review body, the Independent Evaluation Office (IEO), has said that before the crisis the IMF, like many others, was convinced that the risk of serious crises was practically non-existent.[2] This was apparent, for example, in the overconfidence in the health and resilience of the major financial institutions. Risks that are generally related to construction booms and financial innovations were toned down, as was the need for strong regulations to prevent such risks. It was not until the spring of 2008 that the IMF's Global Financial Stability Report warned against emerging vulnerabilities among the major financial institutions, but by that time the crisis was already a fact.

In response to the crisis, more distinct frameworks for the oversight and supervision of the financial system at the national and regional levels are now being developed. For example, in 2010 an agreement was reached between central banks, finance ministries and supervisory authorities in the Nordic-Baltic region on cooperation in the fields of financial stability, crisis management and crisis resolution. Intensive work is also underway at the European level to put an effective supervisory structure in place. It is good and important that interlinked regions arrive at their own solutions. But the financial systems are interlinked throughout the world, as illustrated not least by the recent crisis. It is thus also important to address the question of financial surveillance at the global level.

Legitimacy is about influence, but also about being effective

Several bodies work with financial stability at the global level in different ways. These include the Financial Stability Board (FSB), the Basel Committee, the IMF and the G20. However, none of these bodies has any formal, overall responsibility for global financial stability.

As I have said, it became clear in connection with the crisis that the global public institutions were not strong enough and lacked momentum. The measures that were implemented, for example swap lines and liquidity lines,[3] were often initiated by central banks. Important decisions, for example the decision to triple the IMF's resources, were also taken by the G20 acting alone, despite the fact that many more countries were affected by these decisions. But the G20 took on a leading role in the crisis in the responsibility vacuum that prevailed. The G20 consists of 19 major countries and a representative of the EU. Although Sweden has always contributed financially to the IMF when this was needed, we were not allowed to

[2] See IEO (2011), "IMF Performance in the Run-Up to the Financial and Economic Crisis, IMF Surveillance 2004–2007".

[3] Swap lines entail two parties agreeing to exchange currencies with each other. One example from the crisis is the Riksbank's agreement with the Federal Reserve, through which the Riksbank was able to exchange Swedish krona for USD 10 billion. The aim of this was to increase the Riksbank's ability to offer dollar loans to borrowers in Sweden.

participate and influence the decisions this time; they filtered down to us from the G20 through the EU. The decisions were thus made by a small circle even though they affected all of the IMF's then 186 member countries.

In order for decisions that concern the global economy to have an impact and be implemented effectively, the countries affected by the decisions must feel that they can participate and that they are able to influence the decisions. Legitimacy is thus a precondition for effectiveness. The world cannot and should not be governed by only the largest and strongest countries. The cooperation between the countries of the world that is required to safeguard global financial stability should take place in strong and effective global institutions with a broad membership.

This is why an institution like the IMF is important to small countries like Sweden. It is a rule-based organisation that ensures the influence and equal treatment of the member countries. It is against this background that I believe the IMF is the organisation that is best suited to being responsible for overseeing, identifying and analysing risks in the global financial system.

Greater focus on financial surveillance

My view is that the IMF has taken several steps in the right direction in its work with financial surveillance during the years that I have followed its activities.

For example, the IMF has begun to integrate the analysis of financial stability with the traditional macroeconomic analysis of the member countries. Now, for instance, the financial economists of the IMF also take part in some of the annual country reviews (the Article IV consultations). The Baltic countries, among others, are able to testify to how effective this is. When Latvia experienced problems, the IMF was quickly able to put together a reform and support package thanks to its sound knowledge of the country. This shows that it is important to have knowledge of both the macroeconomic and financial developments, and seen in retrospect the Latvian programme is a good example of this.

A further major step forward is that the Financial Sector Assessment Programmes (FSAPs), which was previously voluntary, was made compulsory by a decision in 2010 for the 25 most systemically-important countries – including of course the United States, the United Kingdom, Japan and the Euro Area, but also Sweden. Oversight programmes of this type are highly systematic and entail assessing the financial system on the basis of a set of robustness criteria. The Governor of the Riksbank, Stefan Ingves, was by the way one of the architects of the FSAP programme during his time at the IMF. In this context it can be mentioned that before the crisis the United States did not think it needed an FSAP assessment, but such an assessment was conducted in 2010.

Another example of an attempt to integrate the macroeconomic analysis and the financial analysis is that since the autumn of 2011 the IMF has published a consolidated surveillance report in which the main messages from all of the surveillance reports are summarised together with recommendations on how to manage the risks.[4]

To further improve and strengthen the surveillance of the financial sector, the IMF recently presented a more detailed strategy for how to conduct this surveillance in the future. The aims of the strategy are for the IMF to improve its understanding of macro-financial relations, to become better at identifying contagion risks across national borders and to increase its cooperation with other organisations. This is no easy task and the work involved is far from complete. This is something that the IMF will need to develop on an ongoing basis.

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[4] This report was initially called the Consolidated Multilateral Surveillance Report (CMSR) but was renamed to "Global Policy Agenda" ahead of the 2012 Annual Meeting.

The Nordic-Baltic constituency has pushed for the IMF, alongside its surveillance of individual countries, to also regularly conduct the regional surveillance of countries with closely interlinked economies and financial systems. This is of course particularly relevant for Sweden as our banks have such large commitments in the other Nordic countries and in the Baltic countries. Although, as I mentioned above, our countries have increased their cooperation in the field of financial stability, a recurring and comprehensive regional analysis and examination of these issues would be of great value. Important steps have been taken in this direction and we are looking forward to an even sharper regional focus in the Fund's ongoing financial surveillance.

Capital flows require more analysis…

The question of whether capital flows should be deregulated or not was the subject of lively discussion in the 1990s before the outbreak of the Asian crisis. After the crisis, some countries believed that one of its causes was that certain countries were asked to liberalise capital flows too early. The issue has therefore been very sensitive since then. Today, however, most countries agree on the positive effects of free capital flows – that is that they contribute to increased economic growth by enabling resources to be used more efficiently.

The issue of free capital flows has now appeared on the IMF's agenda once again. The sudden stop in capital flows during the initial phases of the crisis and the subsequent rapid increase in capital inflows into emerging-market economies have focused attention on the problem of volatile capital flows. Massive inflows can lead to overheating and asset-price bubbles and as there are no clear guidelines a number of emerging-market economies have chosen to manage massive inflows by introducing a range of capital controls. The member countries have therefore given the Fund the task of drawing up guidelines on how countries should manage such capital flows. This work has been underway for the last 12 months and a proposal for a comprehensive framework will be discussed by the IMF's Executive Board at the end of October. According to the proposed guidelines, countries should in the first instance review their fiscal and monetary policies in order to manage or counteract major capital flows, and as a complement to this they should use various macroprudential-policy tools. As a final resort they may introduce capital controls. The idea is that the IMF should give advice on how these tools should be designed in order to be effective.

No organisation has played a clear role in the liberalisation of capital flows. This is a major difference compared to the liberalisation of trade, where the World Trade Organisation (WTO) played and still plays a prominent role. I think it is positive that the issue of capital flows is once again on the IMF's agenda as it is an important issue that requires careful analysis as volatile capital can cause serious problems.

…as clearly demonstrated by the crisis in our region

The need to analyse capital flows became clear in connection with the crisis in our region too. If capital flows had been systematically analysed prior to the crisis, we would have seen that capital flows to the Baltic countries were dominated by bank loans from Nordic parent banks to their Baltic subsidiaries and not, for example, by more sustainable direct investments. Perhaps this would have led the alarm bells to ring sooner and louder.

In our constituency we have carried out an empirical study of Iceland's and the Baltic countries' experience of capital flows and capital controls before and during the crisis. The aim of the report is to help the IMF to collect "best practices" but also to identify "bad practices". According to the study, there were clear shortcomings in the policies conducted in Iceland and the Baltic countries and in the supervision of the financial system throughout the region. However, even if the countries had managed to conduct a much tighter fiscal policy, they would still not have been able to do anything about the major capital inflows. Other tools would have been needed for this, for instance various kinds of macroprudential-policy tools.

If such tools had been made available at an early stage, it may have been possible to slow down the dramatic expansion of credit that proved to have such devastating consequences.

The IMF can play an important role in the work with macroprudential policy

Macroprudential policy has come increasingly to the fore in the effort to find ways of preventing crises in the future. Macroprudential policy entails *preventive* work aimed at analysing and counteracting risks in the financial system. This includes the development of methods and forms of cooperation to discover and assess potential threats to stability in the financial system. I believe that the surveillance- and analytical capacity of the IMF means that the organisation can play an active role in this context by systematically collecting, analysing and providing information on the lessons learned in different countries and regions. I also believe that the IMF can support the exchange of information between authorities on the development of methods and models in the field of systemic risks.

The range of possible tools and the division of responsibility between authorities and countries are now being discussed intensively within the framework of macroprudential policy. The tool that is attracting most attention at the moment consists of the countercyclical capital buffers that form part of the new Basel regulations. This means that the banks will be forced to hold more capital in periods when a credit boom risks triggering problems in the financial system. When the risks subsequently subside, the capital requirements can be eased. A tool that can be seen as a complement to the countercyclical buffers is variable risk weights for different types of loan. Another proposal is to introduce a mortgage cap, for example by limiting the size of the mortgage in relation to the market value of the property, as we have done in Sweden since the autumn of 2010.

But which tools are the most effective in which situations? It is hard to say. The area is relatively new and there is therefore a lack of experience and research in the field. This means that we will have to test our way forward for several years. There are a lot of reports that explain why macroprudential policy is needed and the tools it may entail. But not a lot has been written about how it should actually be conducted in practice. This is of course because the policy area is new and we still have a lot to learn. I believe that the IMF can contribute here too by increasing our knowledge about which tools are most appropriate in which situations and by issuing recommendations to countries on how they should actually conduct macroprudential policy and implement various tools.

The IMF's Articles of Agreement should reflect a clearer surveillance mandate

One way to strengthen the IMF's surveillance is to ensure that the IMF's Articles of Agreement cover what the Fund actually does. According to the articles that set the frameworks for the IMF's work, the Fund's bilateral financial surveillance should ensure that "Each member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The articles were written in a different era and, as we have seen, the IMF has been carrying out financial surveillance and analysis that is broader than stipulated in the articles for a number of years now.

The modernisation and clarification of the IMF's articles is now needed to enable the Fund to fully take on the task of supervising the global financial system, but this will require a long process. However, a first step towards a more formal mandate was taken in July 2012 when the IMF's Executive Board adopted the Integrated Surveillance Decision (ISD). This agreement stipulates, for example, that the Fund's bilateral surveillance should be conducted on the basis of a broader perspective than set out in the articles. The links between countries and how their economic policies can affect the global economy should now be included in the surveillance. The ISD thus underlines the multilateral dimension of the Fund's bilateral surveillance.

It is positive that there is now a board decision on how the IMF should work. But the long-term goal should still be to change the Articles of Agreement so that they reflect what the IMF actually does. This is also an issue that we are pursuing in our constituency. Until financial stability is covered by the articles, the members will have no obligation to discuss financial stability issues with the IMF and even less of an obligation to explain their choices in cases where they do not follow the Fund's recommendations.

Summary and concluding remarks

As I said earlier, it is important to clarify the IMF's role in the surveillance of the global financial system. My view is that the IMF is an institution that is well equipped to perform an independent and stringent analysis of the international financial system. An important aspect to discuss in this context is how to make the best use of the Fund's risk analyses, advice and recommendations.

First, it is important for the IMF to present clear and focused recommendations on global financial stability that are not too general. The IMF's consolidated surveillance report has this aim. The report is wide ranging and may easily become toothless, but it has the potential to play a greater role in this context.

Second, the IMF's advice and recommendations will be ineffectual if the member countries do not comply with them. The follow-up of these recommendations must therefore be improved. The IMF has now said that the follow-up of advice and recommendations will become a permanent feature of the annual country reviews. Sweden welcomes this initiative and looks forward to its full implementation. The follow-up could also comprise recommendations on macroprudential policy, which would also help to achieve the aim of global financial stability.

Third, moral suasion is the only tool that the IMF can use to influence things. It is perhaps also logical that this is the case. International organisations seldom have any other mechanisms for exerting pressure. It is therefore important that the Fund is able to "speak truth to power" even when speaking to large and powerful countries if it is to have any chance at all to influence things.[5]

The notion that the global financial system was largely invulnerable was, as I have said, firmly refuted by the outbreak of the financial crisis. The crisis clearly demonstrated that the surveillance of the global financial system was inadequate and one of the reasons for this was an unclear division of roles between various international bodies.

This led to the G20 assuming a leading role and many important and necessary decisions were taken, but this was done on an ad hoc basis by a limited number of countries. This is a problem; such decisions should be taken in a legitimate way for their impact to be effective. All of this has led to the idea of setting up some form of predetermined structure for how to act when a potential crisis is identified. The IMF staff recently attempted to concretise the possible form of such a structure. This was presented as a global stabilisation mechanism in which the IMF would act as kind of whistle-blower by using its surveillance activities to identify events that risk triggering market unease, which in turn could lead to problems in the financial system. In addition, the IMF could propose measures that aim to reduce the risk of problems spreading from country to country, mediate contacts between countries and central banks to arrange swap lines, involve regional financing arrangements and, of course, also provide loans itself.[6] However, proposals of this type find it difficult to "take off". This because

[5] This is also taken up as a recommendation in the IEO's report; see IEO (2011), "IMF Performance in the Run-Up to the Financial and Economic Crisis, IMF Surveillance 2004–2007".

[6] Proposals for the build-up of an international structure for the financial system are also presented in the Palais Royal Report, which was published in early 2011. This report was written by 18 former central bank governors

although the economy is globalised, policy remains largely national. Governments want to retain their national sovereignty and central banks their independence.

So, to sum up, many good proposals are now under discussion and we need to continue to clearly pursue our issues here. But building supranational structures is complicated, as the on going development of institutions in the euro area reminds us. And there it is a question of "only" 17 countries and governments that have to compromise and reach agreement. Of course this process becomes even more difficult if a lot more countries are involved. However, I believe that issues like this will continue to arise in the period ahead, unless globalisation declines and the trend is towards more protectionism. Every new crisis will give impetus to the debate, and perhaps resistance will eventually be overcome.

and finance ministers, see Palais-Royal Initiative (2011), "Reform of the International Monetary System: A Cooperative Approach for the Twenty First Century".