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What the IMF can do in a financial crisis – and what not

NECESSARY ELEMENTS OF A RULE SYSTEM TO PREVENT FINANCIAL INSTABILITY

There is demand for an increased role of the IMF in the rules for financial stability. The essay argues that while the IMF can play the role of a watchdog, it cannot be the world's chief regulator. As a solution, some type of cooperation is needed among national regulators, similarly as among competition authorities. This can be done under the umbrella of the Financial Stability Forum. Especially cross-border banks require some form of cooperation among regulators, for instance within regulatory colleges.

It is open on which basic elements of an international rule system to prevent financial instability the countries of the world, among them the G-8 plus Brazil, India, China and others, can agree in the financial summits still to come. Countries assign different roles to their financial industry and to financial innovation in their economic strategies. In the past, they have used quite different approaches in the institutional arrangement of their financial industry and in financial supervision. In addition, the economic situation and structural conditions vary between countries. Of course, actually a major problem in drawing up a rule system for the financial industry is to prevent that countries take recourse to protectionism and repeat the mistakes of the 1930s when the world economy disintegrated. Instead, a promising avenue consists in the conclusion of the Doha round.

Drawing up a new financial order can be interpreted with principal-agent theory in which the principal - the politician - sets the rules and incentives but cannot observe the behavior of the agents - the financial institutions - , including their efforts and their options to avoid following the rules. As we know from principal-agent theory, it is a complicated task to write the rules.

It is conceivable that the experience of the 2008 financial crisis proves to be a sufficient impetus to agree on a new set of rules in which countries can find some general principles and concur on some technical points for financial systems: Balance sheet truth must hold. Financial institutions should not be allowed to take risks off the balance sheet through conduits. Capital adequacy requirements, i.e. a bank's capital in terms of shareholders' equity and retained earnings as a percentage of its risk weighted credit exposure, must take into account the long-run sustainability of a financial institution; a value of 10 percent seems appropriate. Such capital adequacy requirements have to adjust to adverse situations in the business cycle and in the interconnectedness of risk positions within the financial industry. They also have to be set higher for more risky activities. Thus, bank credits to hedge funds represent a higher systemic risk and therefore require higher ratios. Levers between debt and the bank's own equity should be limited; they should not exceed 12:1, a ratio in force in the US before 2004. It is most likely that to rely solely on aggregate ratios will not be sufficient to avoid financial instability. Besides looking at these ratios and interpreting them in a changing environment, regulators have to step in when they observe excessive increases in debt and credits (Smith

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and Walter 2008). In securization, the originator of a loan should retain part of the original risk, say 10 or 20 percent. It should be disclosed to the market who takes the first loss in securitization transactions and to what degree (Issing Committee 2008). Incentive systems for bank managers should be oriented at the long-run sustainability of a financial institution, i.e. its solvency. Prudent supervision has to become more effective. It must be put into a position to prevent systemic risk; it must have the instruments to avert systemic risks, for instance through stress tests. As an example, prudent supervision has to prevent a situation in which a country accumulates too much foreign debt (see Iceland and Hungary in 2008) or in which a country's banking industry accumulates too much risk exposure through loans to other countries.[1]

Rating agencies have to improve their ratings and should get out of consulting. The conflict of interest of rating agencies being paid by the issuers of the securities they actually rate has to be resolved without introducing new conflicts of interest, for instance being paid by investors. Financial supervision should compare the quality of ratings *ex-post*, for instance relating statistically initial ratings to subsequent defaults (Issing Committee 2008). A rating at a given moment of time cannot be sold as remaining constant under all conditions. Consequently, the role of ratings in the regulatory framework such as Basel II has to be revised. At the same time, regulators should not rely automatically on ratings. All financial institutions that have systemic importance should be subject to supervision. This also applies to investment funds operating inside banks, financial divisions of insurance companies and partly to hedge funds, i.e. the shadow banks. All financial institutions should disclose their risk; supervisors have to define risk disclosure requirements. The risk going together with new financial products should be made explicit. Transparency for derivatives has to be established. A clearing mechanism for derivatives and hedge funds has to be created, possibly by an industry agreement (Draghi 2008). Offshore markets not participating in the rules exhibit larger risks. Additional proposals include a credit register so that financial authorities are informed on the credits in the system; a world risk map is recommended so that it can be easily detected where risks accumulate (Issing Committee 2008). It is a matter of debate which new financial products regulators should be able to ban, for instance selling short in certain sectors. Certification of new financial products may prove a beauraucratic approach. All in all, the financial sector should not distance itself too much from the real economy. It is open how the financial industry will respond to the new rules (Smith and Walter, 2008).

A major systematic problem for an institutional arrangement is that in the long run, a bankruptcy procedure for financial institutions should be introduced in which the national governments credibly commit themselves not to bail banks out, if the worst case comes. An important element of such a rule is that in the case of failure the owners of the bank will lose their capital and that its managers will be replaced by the regulator. Due to the pervasive impact of a bank failure on the banking system and on the general public, it will be extremely difficult to give credibility to such a rule. Moreover, national governments have diverging interests. Without such a rule, however, the actual financial crisis will soon be forgotten and a cycle of pathological learning will start again. In any case, central banks and governments should be aware that without such a credible no bail-out rule, banks can view the massive injections of liquidity and the immense fiscal support packages by national governments as a strategic game in which they can determine the responses with which they can make the best out off the crisis. In order to prevent such a cat and mouse game, the governments must be competent to write a sustainable principle-agent contract.

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[1] For instance, BIZ data indicate that in the summer of 2008 German banks had claims of 21.3 billion euro on Icelandic banks, 769 billion euro on British customers 310.6 billion euro against Spanish customers.

Another issue of an international rule system consists in preventing national rule systems from being captured by the national political process, i.e. the financial system being used for political goals. Last but not least, international rules for the financial sector should prevent that a bubble arises if the rules allow an artificial financing of over-spending (over-consumption; over-investment) and that a bubble has no basis in real savings (as in the case of the US housing market - an origin of the actual crisis; Siebert 2008b) ; the US credit card sector may represent another example.

Yet a further important aspect of a financial rule system is that international spillovers are typical for the financial industry and in a financial crisis. In order to prevent that one country's solution represents another country's problem, some type of cooperation is needed. This does not apply to the European Union; it also holds internationally. Coordination among national regulatory authorities is needed similarly as among competition authorities. This can be done under the umbrella of the Financial Stability Forum which should attempt to open membership to emerging countries to ensure that the Financial Stability Forum does not appear as a rich men's club (Draghi 2008). Especially cross-border banks require some form of cooperation among regulators, for instance within regulatory colleges. The Bank for International Settlement can play the role of a standard setter. Standards should refer to the economic situation and the structure of the banking industry. They do not have to be completely uniform across countries.

Along another avenue, there is demand for an increased role of the IMF in the rules for financial stability. This Bretton Woods institution indeed represents an international forum where finance ministers and central bankers meet and where they can exchange views, for instance on crisis management. It is no question that the IMF can help those countries that experience balance of payments or currency problems as a consequence of financial crises, for instance if emerging countries are affected and need a credit. Moreover, the IMF's surveillance can monitor financial stability and the situation of the financial sector, needing data support from national supervisors and authorities and from the Financial Stability Forum. The IMF's Financial Sector Assessment Program, up to 2008 voluntary, should become mandatory for its members. It is conceivable that the IMF writes a joint report with the Financial Stability Forum on the status of the financial industry, pointing out potential problems (Draghi 2008). In its International Monetary and Financial Committee, it has the appropriate institutional forum where the expertise of the Financial Stability Forum can be brought to bear. The IMF can alert the public and hope that national supervisors will intervene.

However, the IMF has no sanctions at its disposal to stop national banking systems from running into trouble. To cede sovereignty in the area of prudential supervision, including concrete sanctions, to an international body like the IMF is unlikely to happen. It would mean giving a crucial policy instrument out of the nation's hand. Countries are reluctant to cede sovereignty to the IMF in light of the IMF's approach to the Asian currency crisis. Moreover, the IMF is not in a position to apply something like the polluter- pays-principle in the realm of financial instability when a country starts a financial bubble that artificially leads to national over-consumption and over-investment. In that case, the IMF would need strong sanctions against the financial "polluter". However, no sovereign state is prepared to hand over such sanctions to the IMF. Another crucial aspect is that any bail out will have to be backed by national tax money; states are unwilling to cede sovereignty in this realm. This even holds for the European Union. The French proposal to endow the IMF with more instruments and to turn it into an economic policy machine or an "economic government" meets the counterargument that the IMF has traditionally been a political institution, having been under US influence in the past. Political capture by other states would not represent an institutional improvement, although the French are good at political arrangements and have a preference for such approaches. The objections against an "economic government" in the euro area also apply to the

IMF. Thus, the IMF cannot play the role of the world's economy chief regulator. For the same reason, it cannot be the world's central bank; countries would rather not cede monetary authority to the IMF. In contrast, the IMF can be the world's monitor or watchdog. The solution has to lie in the co-operation among national regulators.

On an additional aspect: In the bonanza of national political rescue plans and the ensuing enthusiasm for anti-recession programs in the autumn of 2008, central banks must be on their guard that these activities do not erode their position of independence which they have gained from politics in the past. It would indeed be a historic irony of rule setting if the financial crisis would serve to politicize again the money-supply process.

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