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700 19th Street, NW
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IMF Executive Board Discusses "Initial Lessons of the Crisis"

On February 25, 2009, the Executive Board of the International Monetary Fund (IMF) discussed staff reports regarding "Initial Lessons of the Crisis".

Background

Since the onset of the financial crisis, the Fund has been actively engaged in assessing the underlying causes of the turmoil and drawing lessons to promote financial stability. At the request of the International Monetary and Financial Committee, and of the Group of 20 leaders, the Fund has prepared a staff paper entitled "Initial Lessons of the Crisis," together with three companion papers providing more detail on financial regulation, macroeconomic policy, and global architecture. The papers convey the views of the staff, not necessarily those of the Executive Board, which are reflected in the assessment below.

The staff papers discussed by Executive Directors focus on prevention, rather than crisis management, and propose specific recommendations in response to the policy failures noted in these three areas to help reduce the likelihood of future such crises. On regulation, the paper recommends expanding the perimeter of regulation, reducing procyclicality, improving liquidity management, and strengthening disclosure practices. On macroeconomic policies, the papers suggest dealing with the build-up of systemic risks through pre-emptive policy responses, including to large imbalances and capital flows. Finally, the need to overcome the fragmentation of the surveillance expertise, policy responses, cross border regulation, and liquidity support form the basis of a proposed reform of the global architecture.

The staff papers highlight the important implications of the crisis for the role of the IMF. To help meet the associated challenges, wide-ranging reforms are underway. Most immediately, the Fund's lending framework (instruments, conditionality, and financial terms) is being reviewed to make sure it meets members' needs. An effort to ensure that the Fund's resources are adequate to give confidence it can meet financing needs from the crisis is also ongoing.

Executive Board Assessment

Today's discussion has provided a timely and important opportunity to try to draw initial lessons from the ongoing crisis. Executive Directors considered these staff reflections concise, yet comprehensive, with a host of stimulating, and at times controversial, recommendations. Directors stressed that the Fund, given its mandate, has a singular responsibility to analyze the crisis and to work closely with other players—both national and international—to help restore global financial stability and economic growth. However, Directors stressed that, given the broad range and complexity of the issues under consideration and the still unfolding crisis, today's discussion will necessarily be preliminary. Continued debate in greater detail will be required in subsequent Board meetings before we can reach a definitive view. Today's discussion nevertheless provides a very useful sketching of the landscape, particularly in areas where future work is needed.

The seeds of the crisis were sown during the years of high growth and low interest rates that bred excessive optimism and risk-taking and spawned a broad range of failures—in market discipline, financial regulation, macroeconomic policies, and global oversight. While Directors' views differed on the relative importance of each, Directors saw need for remedial actions across a broad front and at many levels, implying an ambitious agenda for policymakers and the need for coordinated action.

Financial regulation and supervision

The current financial crisis has its roots in the failure of market discipline in systemically important advanced countries, as misaligned incentives led to excessive leverage and risk-taking, new and complex financial instruments that were poorly understood, liquidity mismanagement, and, ultimately, increased systemic risk. Regulation and supervision failed to stem this excessive risk-taking, in part because of inadequate assessments of inter-linkages between regulated and non-regulated institutions and markets. When the crisis ensued, policy responses were hampered by fragmented regulatory structures, inadequate disclosures of risks, and weaknesses in crisis management and bank resolution frameworks, especially in dealing with cross border stress.

Directors suggested that a range of reform priorities could be usefully considered. First, the perimeter of regulation should be expanded to include a wider range of institutions and markets, and be underpinned by more effective cross-functional regulation and cooperation. Second, existing regulatory and institutional practices should be re-examined with a view to reducing procyclicality. Third, liquidity management practices and regulatory policies must also change to ensure that financial institutions maintain larger liquidity buffers. Fourth, strengthened public disclosure practices for systemically important financial institutions and markets should be a priority. Policymakers need to take the lead in translating disclosures into effective assessments of institutional and systemic risk, and incorporating this information into early warning frameworks and the formulation of macro-prudential policies. Fifth, cross-border and cross-functional regulation and cooperation should be improved and promote level playing fields across markets. Finally, national liquidity frameworks need to be strengthened, and, at the international level, enhanced mechanisms for providing cross-border liquidity are vital.

Macroeconomic policies

Directors noted that an important lesson from the crisis is that not all asset booms are alike, and that their effect on systemic risk depends on the involvement and exposure of the financial sector. In that context, many Directors saw merit in expanding the mandate of monetary policy to explicitly include macro-financial stability, rather than just price stability. A number of other Directors, however, were of the view that monetary policy is too blunt an instrument to deal with asset-price and credit booms, and that overloading one instrument with too many different objectives must be avoided. Directors agreed that prudential regulation should play a central role in addressing credit booms. More generally, Directors recognized the merits of authorities adopting a broader macro-prudential view, and assigning a clear institutional mandate for macro-financial stability.

Directors generally considered that fiscal policy did not play a direct role in the run up to the crisis. Nevertheless, many Directors observed that, in many countries, budget deficits had not been reduced sufficiently during the boom years when revenues were high, and that consequently the available fiscal space to fight the crisis is more limited. Further, in several countries, the structure of taxation promoted leverage and debt financing—a bias that increases the vulnerability of the private sector to shocks. In that context, Directors looked forward to further work on this important, yet politically difficult, subject.

A number of Directors observed that global imbalances have played a role in the build-up of systemic risk, while a few Directors disagreed. Although financial integration has helped transmit these risks, the lesson is not that capital flows should be sharply curtailed. Rather, most Directors saw a need to revisit macroeconomic and structural policy responses to large imbalances, stressing consideration of financial and real spillovers, and to examine the scope for prudential measures to reduce systemic risk associated with capital flows.

Global architecture and the IMF

A key failure in the architecture is inadequate warnings prior to the crisis, including, albeit not only, by the Fund, especially in the surveillance of systemically important advanced countries. Even where risks were identified, too often they were expressed vaguely or were too muted to gain traction with policymakers. Directors generally considered that the Fund should have been more effective in identifying, communicating, and promoting coordinated responses to systemic risks to the global economy.

Accordingly, efforts to strengthen surveillance must intensify, with emphasis on covering all sources of systemic risk in an integrated manner, and further analysis of poorly understood issues. The tacit presumption that risks lie mainly in less mature markets should give way to surveillance of all types of systemic risk, in advanced and emerging market countries alike. In this connection, most Directors welcomed work under way toward a joint early warning exercise with the Financial Stability Forum. Many Directors also underscored the importance of, for the Fund, sharpening the FSAP—although some attached greater priority to more generally strengthening financial sector analysis in the context of bilateral surveillance. Greater attention should also be paid to large cross-border flows in surveillance activities. The importance of candid and independent staff analysis and recommendations for effective surveillance was underscored.

During the crisis, poorly defined rules or collaboration agreements among financial regulators on resolution and burden sharing led to fragmented policy responses and spillovers when institutions failed. While broadly agreeing that this problem should be addressed, Directors noted there are no easy solutions, given the need to share fiscal costs. Possible areas for improvement include: a renewed supervisory focus on globally active and systemically important financial institutions and markets; developing compatible bank resolution and information-sharing frameworks; and agreeing on minimum supervisory practices for the oversight of cross border firms.

A fourth fault line in the global architecture has been inadequate liquidity support and financing and insurance facilities to help countries weather the turbulence in global capital markets. While Directors noted that resolving this problem cannot be the responsibility of the Fund alone, efforts under way to double the Fund's lending capacity should go a long way toward providing a solution. Reforms of Fund lending instruments, conditionality, surcharges and commitment fees, and Fund governance are each also important issues in their own right. We have had separate Board discussions already on some of these topics and, for others, discussions will take place in the near future.

Many Directors stressed that the conclusions drawn about IMF governance in these papers should be recognized as the staff's views and not necessarily those of the Executive Board. They did not consider that the IMF's internal governance structure had prevented early detection of the crisis or its mitigation. Nevertheless, Directors believed that IMF governance reform is an important issue in its own right. In this context, they noted the importance of resuming work on quota and voice reform, although some Directors underscored that crisis-response work should remain the Fund's immediate priority. Directors looked forward to the opportunity to discuss the forthcoming report by the Trevor Manuel Committee.

In sum, today's preliminary discussion has given us much food for thought and further reflection. These lessons and staff recommendations for their implementation will both need to be followed up in various international fora, including most importantly at the Fund Board. Given the importance of achieving broad agreement on this wide range of issues, close collaboration with other concerned fora and intense dialogue among ourselves will be crucial in the period ahead.