09/5 As Prepared for Delivery

Multilateralism and the Role of the International Monetary Fund in the Global Financial Crisis

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April 23, 2009

Good afternoon, it's a pleasure to be here. I would like to use this opportunity to talk to you about multilateralism, the need for global cooperation in macroeconomic and financial sector policies. We all know that decisions taken by countries in isolation may end up harming the global economy. This is the classic problem of coordination, and the problems become most glaring during time of economic distress.

One of the key lessons of the Great Depression was that a lack of cooperation and a retreat to isolationism can make things worse, dramatically worse. The unprecedented collapse in global activity in the 1930s also had dire social and political consequences, and contributed to the outbreak of a disastrous war that left millions dead and a whole continent in ruins. When world leaders met in Bretton Woods in 1944, they vowed never to repeat the errors of the past. They embraced multilateralism and a cooperative approach to economic and financial policies.

The IMF was born in Bretton Woods, forged in the furnace of this multilateral idealism, and endowed with a mandate to oversee the global financial system and to act as a lender of last resort to members with balance of payments needs. It stands right at the heart of macroeconomic and financial sector policy coordination.

Over sixty years later, although the contours of the world financial system would be unrecognizable to the Bretton Woods delegates, the IMF remains as central as ever. But it took the worst financial crisis since the Great Depression for this to be made manifest.

As the process of globalization and international financial integration accelerated over the past decade or so, it might seem obvious that the multilateral institutions usefulness would be growing alongside.

But the reality was different. Eighteen months ago, the institution was facing a progressive loss in its relevance and its legitimacy. Perhaps a victim of its own success, a global boom and the specter of economic crises fading further into memory left the institution somewhat unmoored. People were openly questioning the usefulness and relevance—and indeed the very future—of the Fund. We went through much soul searching. We went through a painful downsizing.

What can I say? Eighteen months seems like a lifetime! In that time, we have been in the midst of an economic crisis that originated in the U.S. housing market, immediately infected the advanced economies, and then spread like wildfire to every corner of the world.

As the dust settles, we are learning a few core lessons. We are learning that links between the real economy and the financial sector are deep-rooted and complex, and that the world economy is interconnected in more ways than we had imagined. We are also learning that a multilateral solution is essential, and that the IMF has a central role to play. It is an international institution ideally placed to address financing and liquidity problems at a global level, and to conduct candid, independent, and evenhanded surveillance. I will address these issues in turn.

Effectiveness as a firefighter

This crisis has shown that while firefighters might seem useless in good times, they have a major role to play when things turn sour—especially in a crisis as deep and broad as this one.

The IMF is helping emerging markets cope with the sudden stop in capital inflows. These countries had achieved impressive gains in growth and convergence. Unfortunately, for some countries, especially in Eastern Europe, these gains were associated with large current account deficits and heavy reliance on external financing. But other affected countries had sound policies and solid fundamentals, and were largely innocent bystanders of the crisis.

We have also extended our help to advanced countries. Consider Iceland, a rich western European country undone by leverage. The assets and liabilities of its banking system grew alarmingly large relative to its economy, outstripping the authorities' ability to act as a lender of last resort. Investors starting retreating, and its banking sector collapsed. The IMF stepped in and provided necessary financial support.

And what about the low-income countries ? Already hit by the food and fuel price shocks, these countries are now suffering from a collapse in trade and remittances. Let us not forget the stakes—this crisis could have catastrophic implications. According to the World Bank, almost 50 million people could be pushed further into poverty this year—earning less than $2 a day—if financing needs are not met. As many as 3 million additional children may die between now and 2015 if the crisis persists. We could witness social unrest, political instability, and even war.

The world community cannot simply stand by and let this happen. The G-20 has asked the IMF to provide an additional $6 billion in concessional resources to low-income countries over the next 2 – 3 years, and we are committed to achieving this goal.

This crisis is by no means over, and I expect we will be called upon to help more countries before the year is out. Our latest forecasts have just been released, and they show further deterioration. We now project the global economy to shrink by 1.3 percent in 2009. I can see two forces at work. On the one hand, the major collapse in confidence and demand that began late last year continues to push the economy down. But on the other hand, the corrective policies that governments are implementing are lifting the economy up. Where does this leave us? Well, we expect a recovery in 2010—a modest recovery, yet still a recovery. So I see some light at the end of the tunnel, but this depends on the right policies stopping and reversing the descent. I will come back to this later on.

As this crisis has evolved, the IMF is trying to do its job. To do so though, we need to beef up our firefighting arsenal. To this end, the G-20 pledged to triple the IMF's lending capacity to an unprecedented $750 billion, and—in addition—to double its capacity for concessional lending to low-income countries. We are committed to achieving this target.

At the same time, the world community has placed its trust in the IMF and we intend to live up to that trust. With the world engulfed in the worst crisis in generations, it cannot simply be "business as usual". We are adapting—we have introduced a package of reforms that transforms the way we do business, drawing lessons from the present crisis and also from past experience. As a key first step, we have doubled all loan access limits—including for low-income countries—to give confidence to countries that we can meet their needs.

It is also better to prevent fires than put them out. Indeed, the absence of an insurance facility has been a major gap in the global financial architecture. Many countries opted instead to self-insure by building large buffers of foreign reserves. Thus, as a second step, we have introduced a flexible credit line that grants rapid upfront financing in large amounts—with no ex post conditions—for countries with a proven track record of good performance. Mexico, Poland, and Colombia have already sought to access this new facility, and I expect more countries to follow. And third, more generally, we are committed to providing larger amounts and more upfront financing across a wide range of our facilities.

I want to add that conditionality remains important. We know that adjustment does not come without pain. Putting out a fire is a messy business, but it's still better than letting the house burn down. That said, conditionality must become more focused and streamlined—this should encourage countries to approach the IMF early on, before things get really bad.

I want to point out here that the IMF remains committed to protecting the poorest and most vulnerable. Many recent programs call for sizable increases in social spending in the midst of serious and needed efforts to cut deficits. For example, social spending is set to rise by 1½ percent of GDP in Latvia, ¾ percent of GDP in Ukraine, and ½ percent of GDP in Pakistan. In Hungary, low-income pensioners were specifically protected from benefit reductions. In low-income countries too, many programs have explicit targets for health and education spending. These safeguards are critical.

One final point on firefighting: The G-20 also supported the allocation to members of $250 billion in "Special Drawing Rights"—the IMF-issued reserve asset that borrowing nations can draw upon if needed. This expansion of global liquidity would be a significant symbol of the commitment of the international community to multilateralism.

Effectiveness as a policy advisor

Let me now turn to another of the major functions a multilateral institution must have—its role as a policy advisor. As the crisis evolved, the IMF was among the first to pinpoint the policy responses that have now become part of conventional wisdom. I would like to highlight two key areas where the IMF got it right—the case for fiscal stimulus, and the need to restructure the banking system.

Let me begin with fiscal stimulus. As you all know by now, we have been recommending, as early as January 2008, a discretionary loosening for countries that can afford it. At the beginning, this was a novelty coming from an institution associated with belt-tightening. But we made this recommendation because the decline in demand was exceptionally large, was expected to be long-lasting, and because we recognized the clear limits of monetary policy in this environment. We also argued early on that collective action was essential, and that countries had to move together.

We recommended 2 percent of GDP and I am pleased to note that countries have delivered in 2009. I have been particularly impressed by the unprecedented degree of international coordination, contrary to what is often said. Countries are still delivering stimulus for 2010, less than in 2009, but still sizeable. The jury is still out on whether this will be enough, or whether more may be needed, since we are not out of the woods just yet.

We also noted very early on that a speedy recovery depended on cleansing banks' balance sheets of toxic assets. This remains true today. The primary objective must be to get the stalled machinery of the financial sector moving again. Without this, efforts to boost demand will be fruitless. We can say this with confidence because we have experience with banking crises—122 banking crises, to be precise. There are different ways to do it depending on country circumstances, but it must be done. Policymakers must resist the temptation to sweep the problem under the carpet. And here, the message is mixed—while moving in the right direction, the response has tended to be slow and piecemeal. The new U.S. plan is a major step forward, but its success hinges on the willingness of banks to sell their toxic assets.

Let's not forget what is at stake. The just-published *Global Financial Stability Report* shows that systemic risks are still very high. Without policy action to address balance sheet weakness, the recovery will be delayed, and adverse feedback loops could get worse. We should not forget this international dimension, which is why we need coordination among the affected economies. I would caution especially against the temptation of financial protectionism—the repatriation of capital by advanced country banks. There can be no purely domestic solutions in today's world.

Legitimacy as a provider of early warnings

I've talked a lot about a multilateral institution's evolving role during the crisis, but what about predicting the crisis itself? Where was the IMF? We have been accused of sleeping at the wheel. I take some of this criticism. It is fair to say that the multilateral institutions charged with surveillance, including the IMF, made some mistakes.

We certainly gave warnings, but these warnings were not loud or clear enough. We were simply too optimistic about the economic situation in advanced economies, lulled by the experience of strong growth and low and stable inflation. And we failed to pay enough attention to factors like excess leverage, systemic risk, credit booms, and asset prices. At the same time, when we did give warnings, these warnings were often ignored by policymakers. We were not vocal enough. People don't like listening to warnings from Cassandras when times are good.

Moreover, effective surveillance depends on successful outreach as much as sound analysis. Collective action also proved elusive—while we forged ahead with multilateral surveillance, fully recognizing the growing linkages across countries, this exercise had only a modest impact.

I think we proved our worth once the crisis broke. Exactly a year ago, our Spring *World Economic Outlook* forecasts were widely derided for being too pessimistic. And yet, such pessimism was warranted. We were right. The same thing happened with our estimate of credit losses from the *Global Financial Stability Report.* In each case, we were ahead of the curve.

Looking ahead, we intend to do better in the area of early warnings. These new early warnings must be strong, candid, credible, and even-handed. They must not shy away from "naming and shaming" where appropriate. Early warnings that are ignored by policymakers have limited value.

With this in mind, our strategy will be to focus our surveillance on systemic risks from all quarters, better integrating the macroeconomic and financial sector work, and better monitoring policy spillovers and cross-country linkages. We are developing, in collaboration with the newly strengthened Financial Stability Board, an early warning exercise covering both advanced and emerging market countries, and here we will canvass a wide range of outside views and follow up where warranted.

Let me give one example of how this approach might be useful. From the start of the crisis, we have been monitoring risks in emerging Europe. We highlighted some policy challenges—fixed exchange rate countries will need a comprehensive adjustment strategy, home and host country regulators will need to coordinate on bank recapitalization, and policymakers will need to prepare for possible private debt restructuring. The idea is to impress upon policymakers the need for a timely, coordinated, and comprehensive solution.

Legitimacy as a global institution

Before I conclude this afternoon, let me address the topic of legitimacy, the legitimacy of multilateral institutions as global institutions. In a sense, this is the tie that binds everything together. If we do not have legitimacy, countries will not approach us to meet their financing needs until it is too late. If we do not have legitimacy, the mere existence of the flexible credit line will not prevent self-insurance. If we do not have legitimacy, nobody will listen to our policy advice, or take our early warnings seriously.

This is why we need to reform our governance structure to give more influence to emerging markets and low-income countries. In short, our voice must be respected in every corner of the world. We must be seen as evenhanded and independent, not beholden to the interests of any country or group of countries. This has not always been the case.

The reform process began in 2008, with the decision to increase the quotas of 54 member countries—granting the emerging markets a greater stake in the institution—as well as to increase the voice of low-income countries, including by creating an additional alternate executive director position for the two African chairs at our Executive Board. These reforms are in the process of being ratified by members and I hope they will come into force very soon. We need to forge forward with quota reform, speeding up the rebalancing process begun over a year ago. In this context, I welcome the G-20 support for completing the next phase by early 2011.

Of course, legitimacy is a broader consideration than quota and voice reform. We need to do a better job in reaching out to civil society, to the people on the ground—people, I must say, who have often criticized us in the past. We also need to foster a diverse staff, for that too goes hand-in-hand with legitimacy.

Conclusion

Let me briefly conclude. I have argued that a robust multilateralism is essential to the resolution of the current crisis, and indeed, to the prevention of future crises. In an increasingly globalized world, the web of connections between countries and activities will continue to grow. We have seen the walls between the financial sector and the global economy breaking down. We have seen that a financial sector problem in one country can spill swiftly across borders, gain momentum, and return to the home country with even greater ferocity.

We need stronger global coordination in macroeconomic and financial sector policymaking. If countries come together to tackle their joint problems in a cooperative manner, everybody wins. As this crisis unfolded, we saw the benefits of cooperation with the global fiscal stimulus, and with coordinated liquidity provision by central banks. We also saw the costs of non-cooperation with temptations to protect domestic banking systems at the expense of neighbors, ring-fence assets, and favor domestic lending.

I hope that cooperation and multilateralism will win out. I am pleased to note that countries are increasing inclined to adopt a coordinated response to policy challenges. I note especially the achievements of the G-20. I also note some of the recent agreements brokered by the IMF with banks to keep supporting subsidiaries in eastern Europe.

I have argued that the IMF is perfectly poised to play a critical role in the international financial architecture. It is adapting to circumstances, shedding what did not work, improving what did. *Time magazine* has dubbed it "IMF 2.0". I like that. But of course, we can always do better. We have made some progress, but we still have a journey ahead of us. Let's look forward to "IMF 3.0"! Remember, at the end of the day, it's not about the IMF, it's about the global economy and the welfare of the nearly seven billion people who share this planet.

Thank you.