

## **The Role of the IMF**

Remarks by Mr Lorenzo Bini Smaghi,  
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I will base my discussion on the following question: how do the two papers help us in addressing the key policy issues concerning the role of the Fund 60 years after the Bretton Woods agreements?

These two papers fit quite nicely with the two key issues relating to the main tasks of the Fund: crisis prevention and crisis resolution.

I will use the paper by Eichengreen, Kletzer and Mody (*“Monitoring International Borrowers: The IMF’s Role in Bank and Bond Markets”*) as the basis for my remarks on crisis prevention, and the one by Chami, Sharma and Shim (*“A model of the IMF as a Coinsurance Arrangement”*) to address the issue of crisis resolution.

I draw from the first paper (EKM) the following considerations:

- In a world of imperfect information, the role of the Fund in surveillance is essential.
- Surveillance by the Fund is most valued by market participants when countries have a programme (i.e. they borrow), including precautionary.
- However, this is true only when the country has a sustainable level of debt.

Let me give the authors a note of caution on their findings. When this type of analysis is conducted, one should check for three main problems:

- Endogeneity
- Missing variables
- Alternative explanations.

For example, the paper tests the following causal relationship: an IMF programme means more information; more information means a lower risk premium, and a lower risk premium means more bond issuance.

There can be an alternative explanation: an IMF programme may be interpreted as the expectation of a bail-out, which means a lower risk premium, but also more bond issuance. The two hypotheses imply a similar relationship between the existence of an IMF programme and bond issuance.

The fact that the link between IMF programme and risk premium does not work at a high level of the debt should provide reassurance against this alternative hypothesis.

Another note of caution. Bank credit and bond issuance are not perfectly substitutable. They depend on a series of factors, related only on the creditors’ choice.

Third note of caution. Bank loans are not necessarily easier to restructure than bonds, as the paper seems to suggest. This was the case in the Asian crisis. However, the Turkish case (2002) has shown that it is increasingly difficult to coordinate bank roll-over, especially if the central banks do not play a leading role. The Argentine and Uruguay cases have shown that bondholders have over time found solutions to the coordination problem. (Politically it might become even more important in the future. Financial institutions do not vote, while bondholders do).

What are the main policy lessons that I draw from the EKM paper?

First, IMF programmes are a very important element in surveillance. This means two things:

- a. Surveillance needs to be strengthened independently of programmes.
- b. There should be a way for all countries to have access to the kind of surveillance and monitoring that is foreseen for countries that have an IMF programme.

The G7 is currently working on a strategic review of the Bretton Woods institutions. One idea is to have IMF programmes that do not necessarily entail borrowing from the IMF, the so-called “non-borrowing programmes”. Non-borrowing programmes would be based on strong policy commitments by countries. The Fund’s task would be to provide high frequency monitoring and sending clear signals on the extent to which the country is achieving the objectives. It would be stronger than staff-monitored programmes because it would involve the Board. The reports would also be published.

Such programmes could also help as “exit strategies” from programmes. They could also support the transition to accessing capital markets and could complement precautionary programmes, with less risk to the exposure of the Fund.

Second conclusion, IMF surveillance for high debt countries should be strengthened (at present it does not add much to available information) and be made more accountable and more transparent, i.e. more independent.

The IEO has shown that one of the main problems in surveillance and, in particular, Debt Sustainability Analysis, has come from the over-optimistic assumptions made by the IMF staff. This is not surprising. If you ask the same people who have designed a programme to assess it (in particular in terms of DSA, stress test, sensitivity analysis), they will select hypotheses which are consistent with the programme. There is a conflict of interest.

Surveillance (including DSA) is not sufficiently independent of programme design.

In any financial institution, the decision to lend is separate from risk management. The Analysis produced by risk management is provided independently to the Board.

In the IMF, the management has access to both assessments, but DSA is produced by country desk. The case of Argentina since 2001 is one where the information has not been provided transparently to the decision-making body, which is the Board. The risk profile of the IMF portfolio has to be decided by the Board.

In the Strategic Review, the G7 are examining ways to strengthen surveillance, ensuring greater accountability.

Two ideas can be put forward:

- a. better integration between multilateral, bilateral and regional surveillance;
- b. better separation between surveillance and programme design.

Concerning the second point, greater independence could be achieved by making PDR responsible for DSA. This would ensure independence of programme design.

Let me turn now to crisis resolution. Here I will use the paper by Chami, Sharma and Shim.

The main note of caution with this paper, as recognized in the paper itself, is in footnote 20 (page 25): time inconsistency of the optimal policy by the country.

The paper does not include reference to private sector financing and its relationship with IMF financing. This is particularly relevant in addressing recent crises.

Another issue that the paper does not address, but which is very relevant to the current international debate is the status of the IMF as a preferred creditor. The ongoing discussions about Argentina underline the importance of this issue. How can an assumption on IMF repayment be made without some specific target concerning the primary surplus and independently of the hypothesis on haircut? How can the IMF defend disengagement while the private sector is taking a substantial hit?

The other issue that is not addressed in the paper is the possibility of defaulting with the IMF. The whole LIA policy is ignored.

Two counter-arguments have been put forward in the past: resources and micromanagement.

With respect to resources, some savings can be made in other areas, especially if bilateral and regional surveillance are more closely integrated. Concerning micromanagement by the Board, it is often forgotten that the principles of good Corporate Governance (e.g. those by the DECD) give responsibility to the Board to ensure that organizations are effective and avoid conflicts of interest.

As the paper recognizes, the key to ensuring the credibility of IMF policies is clear access limits. New procedures and criteria have been adopted recently. This has been a major innovation in IMF policy. We now have to implement it! This is the major challenge for the IMF. Recent research by the Banco de España shows that the main shortcomings in recent reforms has been implementation. One recent example is the concept of “*negotiations in good faith*” which has been questioned in the resolution of the Argentine crisis. Further clarification could be useful, in particular in the context of the Code of Conduct. This is an area where further progress would be very welcome.