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Introduction

Among the many surprising features of the global financial crisis of 2008–9 was the emergence of the International Monetary Fund (IMF) as a leading player in the response to what has become known as the "Great Recession." The news that the IMF was "back in business" was remarkable in view of the deterioration of the IMF's reputation after the crises of the late 1990s and the decline in its lending activities in the succeeding decade. The IMF had been widely blamed for indirectly contributing to the earlier crises by advocating the premature removal of controls on capital flows, and then imposing harsh and inappropriate measures on the countries that were forced to borrow from it. The number of new lending arrangements approved by the IMF had fallen from twenty-six in 2001 to twelve in 2007 (Figure A.2), and all but two of the latter went to the IMF's poorest members, which had little access to private sources of finance.

Moreover, the IMF, the intergovernmental organization assigned the task of promoting international economic and financial stability, initially had no direct role in dealing with the crisis. Finance ministers and central bank heads in the United States and Western Europe, where the financial institutions most affected by the crisis were located, sought to contain its impact by easing credit conditions and rescuing distressed financial institutions. The IMF was relegated to the sidelines as government officials in the advanced economies coordinated their responses to the crisis.

All this changed in the fall of 2008, however, after a series of financial failures in the United States. Global financial markets froze as lenders drew back in response to the uncertainty over which borrowers were still viable. The collapse of the financial system led to an economic contraction that spread outside the original group of crisis countries. World trade fell and capital flows slowed and in some cases reversed, as nervous banks, firms, and investors sought to reallocate their money to safer venues.

The financial crisis also triggered an upheaval in international economic governance. The Group of Seven/Eight (G7/8) was replaced by the Group of Twenty (G20) nations as the appropriate forum for international economic coordination, and the leaders of the broader set of countries met in Washington, D.C., to formulate a joint response to the crisis.[1] They announced their support of the IMF and agreed to boost its financial resources significantly so that the Fund could meet the demands for its assistance. In response, the IMF provided loans to a range of countries, including the Ukraine, Hungary, Iceland, and Pakistan (Chapter 10). In addition, the IMF restructured its lending programs, cutting back in many cases the policy conditions attached to its loans and increasing the amount of credit a country could obtain. The Fund also introduced a new credit line without conditions for countries with records of stable policies and strong macroeconomic performance. Moreover, the IMF pledged to work with national governments and other international organizations after the crisis receded to continue the economic recovery and improve the regulation of global financial markets. Consequently, many commentators hailed the rejuvenated IMF as a "phoenix" (Beattie 2010).

This book contends that the IMF's response to the Great Recession marked a significant break from its policies during previous global financial crises. These had taken place during an era when the IMF's membership was stratified by income and whether or not a country borrowed from the Fund.[2] In addition, the IMF had actively encouraged the deepening and widening of global finance. The IMF's previous responses to financial crises, therefore, reflected the dominance of its upper-income members as well as an ideological consensus in favor of financial globalization. Its lending programs had sought to restore countries in crisis to the global capital markets.

[1] The members of the G7 are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. The G7 became the Group of Eight (G8) when Russia joined in 1997. However, the G7 finance ministers continue to meet separately from the Group of Eight national leaders. The G20 includes the countries of the Group of Eight and Argentina, Australia, Brazil, China, India, Indonesia, Korea, Mexico, Saudi Arabia, South Africa, Turkey, and the European Union. See Chapter 3 on the formation of the G7 and Chapter 10 on the G20.

[2] The World Bank classifies countries by their gross national income (GNI) per capita. In 2011 low-income nations were those with a GNI of $1,005 or less; middle-income countries those with GNI per capita of $1,006 to $12,275; and upper-income countries those with GNI per capita of more than $12,276 or higher. The middle-income countries were divided into lower and upper middle-income nations at a GNI per capita of $3,975. These thresholds have risen over time, and countries have moved among categories. The three main groups correspond to what we call the advanced economies, the emerging markets, and the developing countries.

But the crisis upended those circumstances. The shock to the global economy originated in the upper-income countries, and the recovery of many of these nations has been relatively sluggish. The emerging economies, on the other hand, rebounded from the global economic contraction more quickly, in turn contributing to the recovery of the developing nations. Moreover, the crisis demonstrated that financial instability can be a systemic condition, confirming the need for prudent oversight and the regulation of financial markets and capital flows.

While the Great Recession provided the IMF with an opportunity to demonstrate that it has learned the lessons of its past mistakes, there are fundamental economic and political transformations under way that will affect the ability of the IMF to counter future financial instability. The replacement of the dominance of the G7/8 by the G20 should lead to a more equitable governance structure within the IMF, although inertia has slowed the pace of reform. Moreover, the European debt crises pose new challenges to the IMF. The Fund is caught in the crossfire among Eurozone governments and their citizenries over how to deal with members in financial distress. Fiscal burdens will mount in other advanced economies with aging populations and rising health care and public pension costs. The emerging market governments, which face a different set of challenges as they seek to continue their rapid growth, will be suspicious of IMF programs if these appear to be less demanding than those extended during earlier crisis periods.

This book examines the evolution of the policies and programs of the IMF with respect to the global financial markets and crises in these markets.[3] We show how the IMF's activities during the period of 1973–2008 reflected the influence of its dominant members as well as the IMF's own commitment to capital market integration and evaluate the effectiveness of the IMF in its roles as crisis preventer and crisis manager. The challenges of the future are also addressed, as well as the steps the IMF must take to solidify its reputation.

The consequences of the changes in the IMF's own governance extend beyond the IMF itself. Similar relationships between the IMF and its members exist in other international agencies, where the need to accommodate the aspirations of the emerging market countries must be met. We draw

[3] Other research deals with related aspects of the IMF's work. Histories of the IMF include works by Boughton (2001b) and James (1996). Bird (2007) has provided an overview of the professional literature. Political analyses of the IMF's activities have been undertaken by Copelovitch (2010), Stone (2011), Vreeland (2007), and Woods (2006). Boughton and Lombardi (2009) offer an assessment of the IMF's dealings with its low-income members.

upon agency theory to explain how the advanced economies exercised a collective leadership to influence the IMF and other multilateral agencies, and how that control has been replaced by wider but perhaps less effective direction by the G20.

This account also illustrates the importance of viewing both economic and financial stability as international public goods. Financial stability was once seen as an outcome or accompaniment of economic stability. But the asset booms of the last decade, following the technology boom of the 1990s and the Japanese property bubble of the preceding decade, demonstrated that asset prices could veer for years from values justified by fundamental factors. The subsequent reversals have had serious consequences for economic activity that persist over many years and extend over national borders.

The remainder of this chapter presents a synopsis of the basic concepts that will guide our analysis. The next section provides an overview of the status of international economic and financial stability as international public goods (IPGs). It is followed by a description of the activities of intergovernmental organizations (IGOs) such as the IMF. The following section presents the theoretical perspectives of agency theory, which provides a valuable perspective on the Fund's relations with its member governments. The last section contains an outline of the main arguments of the book.

1.1 IPGs and Financial Stability

> Crises have been a constant of market capitalism – from the bursting of the British South Sea bubble and the French Mississippi in 1720, … to the depressions of the 1870s and 1930s in the industrial economies, to the debt crises of middle-income Latin American countries and low-income African countries in the 1980s, the collapse of output in the formerly socialist economies in the 1990s, and the East Asian financial crisis in 1997–1998. (Easterly, Islam, and Stiglitz 2001: 191)

The devastating impact and wide scope of the recent crisis provide ample evidence of the status of financial stability as an IPG. Public goods constitute a type of market failure, as characterized by the features of nonexcludability in their supply (once a good is provided, it is available to all) and nonrivalness in their consumption (a good can be used by more than one individual simultaneously) (Olson 1965, Cornes and Sandler 1996). Consumers have no incentive to purchase an item if they think that others may pay its cost and they can also enjoy it, a phenomenon known as "free riding." A government, however, can compel its citizens to contribute to the provision of a good that will benefit all.

Impure public goods are partially nonrival or nonexcludable. In the case of a club good, the good is excludable but partially nonrival, and a charge (such as a toll) can be imposed to ensure the efficient amount of the good is provided. A joint product has a combination of outputs that vary by their degree of nonexcludability and nonrivalness, such as a public good that is provided with a club good (Sandler 1977).

Market failures take place on an international as well as a national basis. If the benefits of a public good transcend national borders, it is an international public good (Kaul, Grunberg, and Stern 1999b, Kaul *et al.* 2003, Sandler 1997, Sandler 2004). Climate change, for example, cannot be addressed adequately on a national or regional basis. Similarly, the rapid spread of communicable diseases demonstrates the need for international coordination to offset threats to public health. But the same problems exist with IPGs as with domestic public goods. Market incentives to provide the goods do not exist or are distorted, and private producers will not supply them. The problem is compounded on the international level, since the rewards to providing an international public good are diffused among many nations, and there may be little incentive for a single country to supply it.

Axelrod and Keohane (1986), however, pointed out that the long-term horizons – the "shadow of the future" – of economic relationships could contribute to the willingness of nations to engage in collective actions. Another situation that can promote the provision of IPGs is the emergence of a hegemonic nation that receives most of the benefits of the good. The hegemonic nation may decide to provide the good unilaterally and allow smaller countries to share the benefits. Great Britain played a hegemonic role in the nineteenth century, and the United States held a similar position after World War II.[4]

An additional characteristic of a public good is the determination of its supply, or its aggregation technology (Cornes and Sandler 1984). The available amount of most public goods is based on the summation of the contributions of the individual units. In the case of a "weakest-link" technology, however, the smallest contribution determines the availability of the public good. The prevention of disease, for example, is dependent on the efforts of the state with the least-effective controls, which can motivate other nations to contribute to the provision of the good in that state (Sandler 2004). A related technology is the "weaker link," where the smallest contribution has the largest impact on the overall level of the public good, followed by next

[4] Eichengreen (1989), however, questions the extent of hegemonic domination by the United States.

smallest, and so on. Other possible technologies include the "best shot," where the amount provided of the public good depends on the efforts of the most-qualified or largest contributor. Cures for diseases are typically discovered within countries with the financial resources to support drug development and testing. With "better shot" public goods, the largest contributor provides the largest contribution, followed by the second largest, and so forth.

Financial stability (or the lack of instability) has historically been viewed as a public good. While there are many descriptions of what constitutes financial stability (Houben, Kakes, and Schinasi 2004), many analysts would agree with Crockett's (1997) claim that stability includes the ability of key financial institutions to meet their obligations, and movements in the prices of financial assets that reflect changes in fundamental factors. When financial stability prevails, Crockett (1997: 14) points out, "it creates a more favorable environment for savers and investors to make intertemporal contracts, enhances the efficiency of financial intermediation, and helps improve allocation of real resources." The absence of financial stability results in instability, defined by Allen and Wood (2006: 159) as "episodes in which a large number of parties, whether they are households, companies, or (individual) governments, experience financial crises which are not warranted by their previous behavior, and where these crises collectively have seriously adverse macro-economic effects."

The international aspects of financial stability have received more attention in recent years due to the rise in cross-border capital flows and the occurrence of crises with global consequences (Griffith-Jones 2003, Wyplosz 1999). The integration of financial markets contributes to the rapid spread of shocks across frontiers, thus making their prevention an international task. The occurrence of crises in several countries simultaneously or in rapid succession may be due to a common external shock, or trade or financial links among the crisis countries (Claessens and Forbes 2001).

Financial crises can take different forms (Reinhart and Rogoff 2009). A currency crisis occurs when there is a wave of selling of a currency that is fixed in value by a central bank. If the central bank's efforts to preserve the pegged value are unsuccessful, it is forced to devalue the currency. The depreciation raises the cost of imports and servicing foreign debt and may induce a contraction in output in the short run as well as higher inflation rates. A successful defense of a currency peg can be costly if the central bank is forced to raise interest rates or spend its foreign currency reserves to preserve the pegged rate (Eichengreen, Rose, and Wyplosz 1995).

A bank crisis occurs when the financial intermediary is not able to meet its obligations to its depositors. In the case of a liquidity crisis, a solvent bank lacks sufficient liquid assets to cover its liabilities. If the bank's assets decline in value, however, resulting in negative net worth, then the bank is insolvent. Bank crises are usually resolved by government intervention, which has a fiscal cost. The total fiscal cost of bank crises in the developing economies during the twenty-five-year period before the latest global crisis had been estimated to exceed $1 trillion (Honohan and Laeven 2005).

The simultaneous occurrence of a currency crisis with a bank crisis has been named a "twin crisis" (Kaminsky and Reinhart 1999). Most bank crises in emerging markets and developing countries are accompanied by currency crises, although not all currency crises are tied to bank crises. A "sudden stop," which is the reversal of capital flows from inflows to outflows, can also occur during a bank crisis. Another form of crisis is a sovereign debt crisis, which occurs when a government or government-sponsored agency is unable to make payments on its debt and either asks its borrowers for relief or defaults on its obligations. Emerging markets that borrow in the international capital markets often issue debt denominated in a foreign currency, and their default can lead to a currency crisis.

Bordo *et al.* (2001: 72) studied the frequency of currency, banking, and twin crises in a sample of countries during the period of 1880 through 1997 and concluded: "Since 1973 crisis frequency has been double that of the Bretton Woods and classical gold standard periods and matched only by the crisis-ridden 1920s and 1930s. History thus confirms that there is something different and disturbing about our age." These authors also noted that there has been a rise in the frequency of twin crises, which are more disruptive than banking or currency crises alone. Kindleberger and Aliber (2005: 278) confirmed that the dominant pattern of recent financial crises "was one of banking and foreign exchange crises occurring at the same time."

These crises impose costs on economies in terms of lost output. Bordo *et al.* (2001) found that financial crises over the preceding one hundred years were followed by economic downturns lasting on average two to three years and costing 5–10 percent of GDP. Similarly, Hutchison and Noy (2005) examined the output costs of currency and banking crises in a group of countries over the period of 1975–97 and reported that currency crises reduced output by 5–8 percent over a two- to four-year period, while banking crises lowered GDP by 8–10 percent.[5] In addition, Baldacci, de

5 Boyd, Kwak, and Smith (2005) and Hoggarth, Reis, and Saporta (2002) offer analyses of the costs of banking system instability.

Mello, and Inchauste (2002) reported that financial crises are associated with an increase in poverty. The negative repercussions of financial crises extend past the time of their occurrence, imposing intergenerational effects. Cerra and Saxena (2008) reported that currency, banking, and twin crises have persistent negative effects on output. They also contribute to macroeconomic volatility, which has a negative impact on long-term growth. Hnatkovska and Loayza (2005) found that this inverse relationship of growth and volatility has become larger in recent decades and was exacerbated in the poorer countries. Another channel of transmission from crises to lower growth results from the fall in investment expenditures following bank crises (Joyce and Nabar 2009).

Financial stability has often been treated as synonymous with economic stability. However, they are related but different phenomena, and since the Great Recession the linkages between them have become the subject of scrutiny and analysis. Economic stability has traditionally referred to consistent rates of growth in output and low and stable inflation rates. It had traditionally been assumed that financial and price stability were linked, but the record of the last two decades has demonstrated that low inflation rates are not a sufficient condition for stability in asset prices (Borio and Lowe 2003).

1.2 IGOs and the IMF

The provision of IPGs can be promoted by IGOs. The IGOs are associations of national governments with permanent secretariats that perform the work of the organization (Archer 2001). IGOs exist because they provide (or assist national governments to provide) IPGs and are a relatively recent phenomenon in international governance. The first was the International Telegraphic Bureau, founded in 1865, which still functions as the International Telecommunication Union. There are currently approximately 240 such associations (Union of International Associations 2008).

IGOs can be viewed as elements of regimes, which are a form of IPGs. Keohane and Nye (2001: 17) described regimes as "sets of governing arrangements," and Krasner (1983: 2) defined them as "sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge in a given area of international relations." Kaul, Grunberg, and Stern (1999a) view regimes as intermediate public goods that contribute to the provision of final IPGs. In the international sphere there are regimes governing shipping, health standards, air traffic, communications, and many other areas.

Keohane and Murphy (2004: 914) have described IGOs as the external manifestations of these regimes: "We can think of the regime as an overall set of rules and practices, and the IGO as the purposive bureaucratic organization that monitors and reacts to activity." An IGO is well suited to provide IPGs (Abbott and Snidal 1998, Martin 1992, 1999, Russett and Sullivan 1971). The organization can provide information and resolve problems of cooperation among its members, thus lowering the transaction costs to collective action. In addition, an IGO can undertake activities for its members that may be difficult for individual governments to perform.

International organizations differ from each other in a number of aspects (Koremenos, Lipson, and Snidal 2001, Sandler and Cauley 1977). For example, IGOs can operate on a regional or a global basis. The optimal size of the IGO is based on the principle of subsidiarity, which states that the size of an organization should be based on the size of the geographical area it serves. IGOs also vary in the number of their activities. If there are economies of scope, then one organization can provide more than one public good more efficiently than separate institutions.

Another important aspect of an IGO's operations is its governance. In some cases, such as the General Assembly of the United Nations, all member nations have an equal vote. In other settings, such as the IMF, votes are weighted in some manner. There may also be rules on voting procedures, such as the need for a supermajority in some circumstances. All these features affect the ability of the IGO to formulate and implement common policies, and to respond to new crises and challenges. Fratianni and Pattison (1982), for example, pointed out that consensus is less likely to be obtained when the number of members of an IGO increases.

The IMF has been the primary IGO to be assigned the responsibility of promoting international financial stability. Kindleberger and Aliber (2005: 293) noted that the IMF was established in response to the financial instability of the 1920s and the 1930s. While the first Article of Agreement of the IMF, which lists its goals, does not specifically mention financial stability (Chapter 2), it does refer to "exchange stability" and "orderly exchange arrangements." The revised Article IV, which was adopted in 1973, refers to "financial and economic stability" as an objective (Chapter 3). The G7 governments expanded the IMF's responsibilities in this area after the capital account crises of the 1990s.

Stanley Fischer (Fischer 2000), a highly respected economist and former first deputy managing director of the Fund, in a description of the nature of the public good provided by the IMF, claimed:

> It is worth going back briefly from time to time to first principles and asking why one needs an institution like the IMF. The basic fundamental reason is that the international financial system left to itself does not work properly, and it is possible to make it work better for the sake of the people who live in that system....

Our goals are to prevent crisis, to create stability and to promote economic growth. Those have been our goals for over 55 years now.

The IMF fulfills its IPG mandate by providing joint products with different degrees of publicness, such as multilateral surveillance and crisis lending (Joyce and Sandler 2008). In the post–Bretton Woods era, the IMF has sought to identify those weaker-link economies that pose a threat to international financial stability in order to strengthen their macroeconomic policies and financial regulatory structures (United Nations Industrial Development Organization 2008). When a crisis in a country does occur, the IMF acts with other multilateral agencies and governments to provide financial credit and other forms of assistance as the domestic government implements policies to address the crisis.

While there was agreement on the IMF's key position in this area during the era of the Bretton Woods system, new organizations, called collectively the international financial institutions (IFIs), have been established also to deal with the maintenance of international financial stability. Many of these are based in Basel; they include the Bank for International Settlements, which actually predates the IMF, and the Basel Committee for Banking Supervision. The Financial Stability Forum was established in 1998 to coordinate activities intended to promote stability across national boundaries. In 2009, this body was expanded to an organization with a larger membership, the Financial Stability Board, and the relationship of the new organization with the IMF is one of the outstanding issues in the postcrisis era (Chapter 11).

1.3 Principals and Agents

Agency theory provides a framework for analyzing the relationships of governments and IGOs (Copelovitch 2010, Hawkins, Lake, Nielson, and Tierney 2006). In a principal-agent relationship, the agent is a person, firm, or organization that performs a task for others, the principals. The delegation of authority to the agent can be constrained by rules of conduct, or the agent may have discretion in performing its job.

If there is a divergence between the interests of the principal(s) and those of the agent, then there is a possibility that the agent may act to further its own interests. This type of situation, known as "slippage," arises because of asymmetric information. Problems with asymmetric information occur whenever one party to a transaction has relevant information that the other does not. To minimize the occurrence of slippage, the principal(s) must monitor the actions of the agent and provide incentives to obtain the desired results.