The *Firefighters* of the IMF

BY HECTOR R. TORRES

Sitting idle while the neighborhood burns.

One of the International Monetary Fund's main purposes is to "give confidence to members by making [its] general resources temporarily available to them." However, its members are increasingly facing capital volatility, and there is a sharp decline in the use of Fund resources. Ironically, this is happening at a moment when the Fund should want to be lending: it is awash in liquidity and has almost no sources of income other than repayment of its loans.

If the IMF had to live up to private-sector standards, it would create a new instrument that would meet members' potential demand for short-term liquidity. Alas, there is no urge to do this. Until a year ago, the IMF used to congratulate itself for running out of clients. An idle fireman looked desirable. But the situation is different now. There is a fire out there, but no one is calling the fire brigade. Only Georgia, [and now Hungary and the Ukraine] not surprisingly, [are] asking for help.

Potential borrowers have been accumulating massive reserves and pooling them regionally to protect themselves against shocks and speculative capital, but not at the Fund's urging. On the contrary, accumulating reserves beyond a certain threshold carries a high opportunity cost and suggests the need to let the currency appreciate. The implication is that potential borrowers are not absorbing as many imports as they could and not relying, as they should, on the multilateral pooling of reserves that the Fund is meant to use to "give confidence" to its members.

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So what's wrong with the fireman? The traditional model of trading financial support for conditionality does not bode well with emerging economies that, despite having strong macroeconomic fundamentals, still need help to cope with external shocks. "Giving confidence" to this sort of customer requires the capacity to provide quick, automatic, meaningful, and front-loaded financial support; otherwise, accumulating reserves and pooling them in regional agreements will still look like a more reliable option. But the IMF is in no position to provide such support.

Its financial support is limited to a percentage of members' quotas, which do not reflect their potential borrowing needs. Unfortunately, a recently approved reform, despite being marketed as a strategic improvement, has only benefited a few, and far too little. According to the "new quota formula," members that issue international reserve currencies still appear to be those with more "potential need to borrow" from the IMF. This is laughable.

So this brings us to the need to increase "normal" access limits. In 2003–04, arguably the last period in which the Fund had to provide meaningful assistance to members, approximately 80 percent of the volume of financial support was provided on an "exceptional" basis, defined as more than 300 percent of quotas. Needless to say, "exceptional" access comes at exceptional financial and political costs. No wonder, then, that members rely more on their capacity to accumulate reserves than on the Fund's ability to provide opportune, affordable, and reliable financial support.

The Fund has no instrument to provide short-term liquidity to emerging markets facing capital volatility. In today's crisis, we have seen some agile and creative reactions from central bankers in advanced economies. They stepped beyond their mandates to provide quick financial support to investment banks, mostly by supplying private banks with liquid instruments in exchange for longer-term and less liquid assets. Why couldn't the Fund do the same thing for central banks from developing countries and emerging economies?

If the IMF is to provide short-term liquidity to members in need, a crucial question that must be resolved is whether such financial assistance should be available only to those with strong macroeconomic fundamentals. Overly strict qualification criteria are likely to deter members that may need this kind of support most from applying for it; but overly loose criteria may stigmatize potential users.

The Fund could solve this dilemma by applying an insurance-like approach. All members would, in principle, be eligible, but premium rates would be differentiated and established on the basis of quantitative criteria.

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The scale of premium rates would need to be transparent but the actual cost of access for individual members would remain strictly confidential (as in any insurance contract).

Admittedly, this would require departing from the Fund's traditional lending in exchange for conditionality. It could also require some adjustments to the Fund's Charter, but so what? The recently approved reforms already require changes to the IMF's "Articles of Agreement."

Some argue that furnishing members with rapid and front-loaded liquidity insurance would encourage irresponsible policies or reckless borrowing. Admittedly, it could help members cope better with volatility and, therefore, be more open to inflows of short-term capital, but this need not result in bad policies. Given the Northern Rock and Bear Stearns bailouts, overplaying the "moral hazard" argument here sounds hypocritical.

If the IMF fireman remains idle, it is not because of a lack of fires, but because neighbors, rather than relying on the fire brigade, are protecting themselves. This undermines the IMF's relevance and is at the root of the early repayments that have left the Fund with almost no income.

The IMF must change this. "Normal access" should be raised to levels that are concomitant with members' potential need to borrow, and a new liquidity line to provide reliable and meaningful front-loaded financial support should be created. This would make emerging markets and developing country members regard reserve accumulation as expensive and extravagant, thereby helping to liberate those resources to help the world economy overcome today's crisis. ◆