How to equip the IMF for the crises of our time

Lorenzo Bini Smaghi

After each major financial crisis, from Latin America in the 1980s to Asia in the late 1990s, the International Monetary Fund experienced several reforms aimed at strengthening its ability to deal with the new challenges. The most recent crisis in advanced economies, in particular Europe, does not yet seem to have triggered a comparable movement for reform. The main discussions so far have been focused on the need to increase the IMF's financial resources and to reduce the conditionality for more rapid access to IMF financing. While these are certainly important issues, they may not be sufficient to equip the IMF better to restore stability in the current financial environment. This is especially significant in the face of shocks at the core of the system.

Recent events have shown that crises in advanced economies may develop in very different ways from those of past crises in developing or emerging economies. This suggests that the options available to the IMF may need to be rethought and updated, from several perspectives.

First, the time horizon of standard IMF programmes appears to be too short. As a rule, IMF funding is provided for three years, on the assumption that in the meantime existing imbalances will be corrected and access to capital markets fully restored. While this may be the case for small open economies with flexible exchange rates, recent experience suggests that more time can be required to implement a sustainable adjustment, especially for countries that are members of a monetary union and have accumulated large external deficits.

Second, and related to the above, the practice of taking countries in IMF programmes away from the markets for a few years and funding them entirely with official financing may not be appropriate for developed economies. The experience in Greece and now in Portugal shows that using all available official financing at the start of the programme may help solve the short-term liquidity problems but tends to raise doubts in the markets about countries' ability to stand on their own feet at the end of their IMF programme – especially if the imbalances have not been sufficiently reduced. The fear that at that point no additional financing would be available raises the risk of debt restructuring and discourages private market participants through self-fulfilling expectations.

Third, recent experience has shown that the conditions in advanced economies' programmes should include details of the specific structural policies that will be necessary to ensure the sustainability of the macroeconomic adjustment. As the Irish experience has shown, a thorough restructuring of the banking system is often a precondition for restoring market access over time. Given that these policies are often politically difficult to achieve, and are more prone to reform fatigue if they are spread over time, they need to be frontloaded and subject to rigorous monitoring.

Crises in advanced economies may develop in very different ways from those of the past in developing economies

Fourth, debt restructuring in advanced economies has much more damaging effects than in developing countries. The impact on the countries themselves is greater, as a large part of the debt is held by residents and the contagion to the global financial system can be disruptive. On the other hand, advanced economies generally have substantial public and private wealth. Debt restructuring should thus be a last resort and avoided as far as possible, in particular by inserting in the conditions of the programme specific measures aimed at selling available assets and using the proceeds to reduce the debt.

Finally, the preferred creditor status of the IMF and other official creditors seems to have generated destabilising effects in financial markets, as the impact on private creditors of a possible debt restructuring tends to become larger the greater the size of the official financing. The special status of IMF finances has certainly been an important factor in ensuring that it receives sufficient resources from its shareholders. But in the current environment such a privileged status may weaken the catalytic role of IMF resources and delay the return of programme countries to market financing. It may also weaken the incentives for stricter surveillance.

These are only a few examples of the many issues that the recent European crisis has brought to the fore. They are not easy to solve. But it is in the interest of the IMF, and its major shareholders, that they are effectively addressed in order to restore stability and improve the resilience of the international financial system.

Deep thinking and strong leadership are urgently required. In the old days this was provided by the Group of Seven leading economies. But since this forum decided to dissolve, and the G20 is not yet an adequate successor, the world seems dangerously without guidance. Not the best position to be in the midst of a financial crisis.

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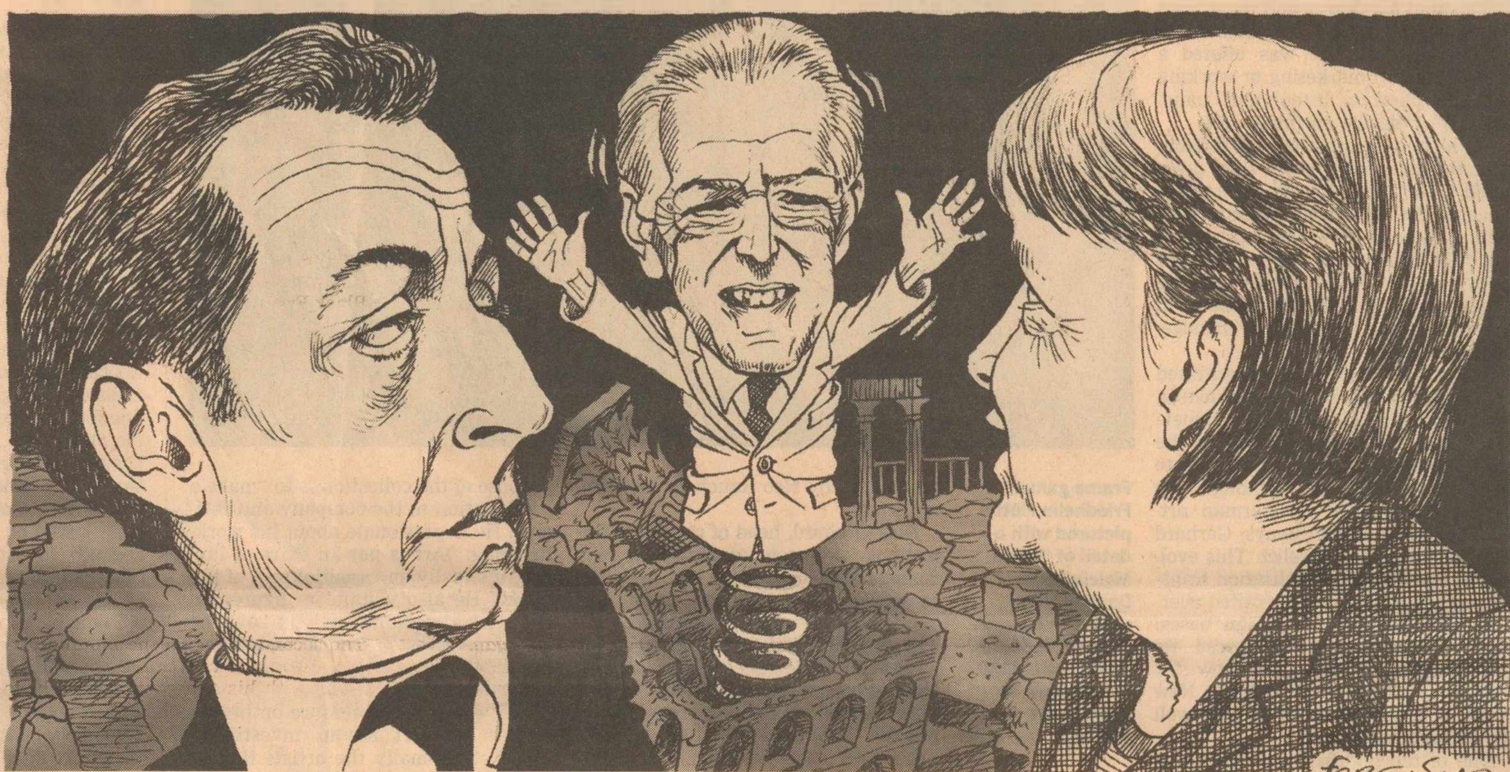
Europe rests on Monti's shoulders

Philip Stephens



Italy is back. Germany's Angela Merkel sits at the top of Europe's power list. France's Nicolas Sarkozy can lay claim to be the continent's most energetic leader. Mario Monti is its most interesting. After an absence lasting a couple of decades Italy has returned to the stage. Mr Monti's fate may turn out to be Europe's.

The other day the White House said that Italy's prime minister would soon meet Barack Obama. To describe its announcement as effusive would be an understatement. Mr Monti and the president would discuss "the comprehensive steps the Italian government is taking to restore market confidence and reinvigorate growth through structural reform, as well as the prospect of an expansion of Europe's financial firewall". Translate and you get: "Mr Obama is behind Mr Monti all the way – including when he puts pressure on Ms Merkel."

There was a time when Italy had something to say in Europe. The Italians championed the great integrationist leap of the 1980s. The Milan summit in 1985 gave the push for the single market. Five years later a meeting in Rome set the timetable for the euro. This provided the occasion, incidentally, for the toppling of Margaret Thatcher: her "No, No, No" to the single currency stirred a Tory rebellion. Strange as it seems, British Conservatives were once mostly pro-Europeans.

The era of Silvio Berlusconi put an end to Italian influence. Though always assured of a warm welcome from Vladimir Putin, Mr Berlusconi was shunned by his European Union peers – seen by turns as a cause of irritation and embarrassment. Mr Monti, a serious-minded academic with a serious plan, is different in every dimension. Mr Berlusconi made crude jokes about Ms Merkel's appearance. Mr Monti talks to her about economics.

There is a second Italian at the top table. Mario Draghi – the other Mario – has made his own headlines during his short presidency of the European Central Bank. As far as economic orthodoxy goes, Mr Draghi styles himself an honorary German. Yet a big refinancing operation launched under his direction – quantitative easing by another name – has propped up the banking system and calmed financial markets.

The ECB scheme is not a permanent fix, but it has given the politicians space to negotiate Ms Merkel's precious fiscal compact. For all the ever-present shadow of Greece, there are signs that the euro crisis is passing from an acute to a chronic phase.

Mr Monti matters because it is in Italy that the euro's long-term prospects will be decided. If Greece does fall by the wayside, Ireland, Portugal and Spain will be in the line of fire. Italy, though, is the pivotal player. If the eurozone's third-largest economy cannot chart a credible economic course, the euro does not have a future as a pan-European project.

Mr Monti has a couple of cards to play. His austerity measures are already proving unpopular but Italy's elected politicians are scarcely in good shape. Mr Berlusconi snipes from the sidelines but his centre-right coalition would be crushed in a snap election. So Mr Monti thinks he has another year – until scheduled elections in spring 2013 – to get his strategy up and running.

The second card is that he can speak truth to German power. His record as a liberal reformer in the EU Commission is indisputable. His demeanour defies every stereotype of the feckless southern European. Oh, and Mr Obama is right behind him when he tells Ms Merkel that indefinite austerity would turn a fiscal into a suicide pact.

I suspect Mr Sarkozy rather resents Mr Monti's intrusion. The French president is not one to share the limelight. Until now Paris has sustained the pretence that leadership belongs to the Franco-German partnership. In truth, the chemistry between the president and chancellor is anything but good.

As it happens, Mr Sarkozy has more interest in Mr Monti's success than most. Whenever I meet the French elites, as at the latest Franco-British Colloque, I am struck by their insistence that survival of the euro is existential. What they mean, I think, is that the break-up of the single currency would see France tipped into Europe's second economic tier – and rob it of any remaining claim to global influence.

There is no guarantee that Mr Monti will succeed. Big spending cuts and tax increases are one thing. The real test will come in liberalising the economy. Here he confronts a honeycomb of closed shops, restrictive practices and rent-seeking cartels. This week Italian cities have been thrown into chaos by taxi drivers and truck operators. Lawyers, pharmacists and petrol-station operators are also up in arms at plans to strip away their privileges. This will not be easy.

The choices are unavoidable. The debate about the future of the eurozone is hopelessly polarised. On one side stand those who say the enterprise can be saved only if Catholic southern Europe absorbs the Protestant north's culture of thrift and hard work. On the other side are those who say that all would be well if only the Germans were ready to spend and borrow more and underwrite the debts of their southern neighbours. Both sets of arguments are hopelessly naive.

The challenge facing Europe – one crystallised by the euro crisis – is to adapt to a world in which it can no longer dictate the terms of exchange. Policymakers and economists can argue all they like about the merits and demerits of devaluation or fine-tuning the balance between fiscal rectitude and support for demand. The big question is whether Europe can compete in a world over which the west no longer holds sway. That's why what Mr Monti is doing in Italy really does matter.

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The A list

Experiment at the Fed with imperfect tools
New approach could create confusion and even greater hesitancy, says Mohamed El-Erian
www.ft.com/thealist

Diogenes was right to value more than happiness

Samuel Brittan

The Greek philosopher Diogenes is said to have lived in a tub. But far from being dismissed as a crank, he was the only thinker whom Alexander the Great went to see – the others had to come to him. Was Diogenes a happy man? You can answer how you like. You can say that he was happy living in a tub. Or you can say that he thought that other things were more important than happiness.

Or to take an example nearer home: are you happier than your great-great-grandparents who had no television, electricity or computer, probably no running water and who had to travel by horse? Unless you are unusually Spartan, you would be very unhappy if transported back to these times. But would your ancestors have been happy if they could be transported forward? They might not gain from gadgets they did not know, and they might well be put off by the noise and incessant activity of the 21st century, let alone by the confusion of values among the population.

The moral of these examples is that ordinary language terms lose their meaning if stretched to extreme situations. We can all understand the question: "Is your son happy at school?" Or the statement that some of your friends "will never be happy", even though others adapt well to a range of circumstances.

The stretching of the term "happiness" beyond the area in which it is normally used is what is wrong with the happiness agenda so eagerly embraced by UK prime minister David Cameron and French president Nicolas Sarkozy. In opposition, Mr Cameron suggested we focus not just on GDP, gross domestic product, but on GWB, general well being. More recently he ordered the Office of National Statistics to investigate the possibility of a national happiness index. This is an instance of the way in which he (or his advisers) is irresistibly drawn to fashionable left-of-centre gimmicks but eschews genuinely radical measures such as stopping official support for arms sales or instituting a land value tax.

The one place where gross national happiness is the official guide to policy is the Himalayan state of Bhutan, where it has led, among other things, to compulsory national dress and the oppression of the Nepalese minority.

Of course, the promotion of happiness has a respectable intellectual ancestry. The US Declaration of Independence speaks of the inalienable right to life, liberty and the pursuit of happiness. John Stuart Mill, the English philosopher, defined utilitarianism as holding that actions are right if they tend to promote happiness and wrong if they tend to produce the reverse of happiness. (Mill also said, somewhat incongruously, that it was better to be Socrates unhappy than a pig happy. I have always had a sneaking sympathy for the pig).

Mill said it was better to be Socrates unhappy than a pig happy. I have always had a sneaking sympathy for the pig

For a long time, political economists accepted that they could not measure happiness; so they interpreted it as the opportunity to satisfy desires, which was crudely approximated by real income per head with various adjustments. But recently some have tried to measure happiness directly, mainly using questionnaires asking, for instance: "Taking all things together, would you say that you are very happy, pretty happy or not too happy?"

The general pattern that emerged was that within a country rich people were, on average, happier than poor people; but once a certain threshold was reached, increases in national wealth did not produce an increase in reported well-being. A technical difficulty about these questionnaire studies was that happiness, as defined, has a maximum whereas GDP has not. Two conclusions were still drawn:

1. In the developed world, it was comparative rather than actual income that mattered and levelling-down measures would promote the general welfare.

2. As take-home pay ceased to matter after a certain point, increases in GDP should be predominantly devoted to collective services provided by government.

A broadside has been issued via a pamphlet from the free-market Institute of Economic Affairs that takes issue with the whole happiness industry. The authors claim the most recent research shows there is, after all, a modest link between happiness and absolute income, but none at all with "equality". They also say that people's preferences should be revealed by their own actions rather than imposed by government on the basis of subjective survey results. But if you believe this last assertion, you do not need the first one.

The best case against the happiness industry was provided by Aldous Huxley in his 1932 novel *Brave New World*, in which people were made to swallow "soma" pills to keep them happy. In fact, there are no such pills that work the whole time without undesirable side effects, and which would also allow the work of the world to continue. If there were, I might have to reconsider my attitude.

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WORLD NEWS

Greek rescue deal set for review

Talks due to be held on debt relief

Bondholders look at concessions

By Quentin Peel in Berlin and Kerin Hope in Athens

Eurozone policymakers are preparing to review the size and terms of the €130bn rescue package for Greece agreed last year, depending on the outcome of the talks with private creditors over Greek debt relief which reopened in Athens yesterday.

Lucas Papademos, Greek premier, and Evangelos Venizelos, finance minister, were due to hold talks last night on an updated debt restructuring proposal by representatives of holders of some €200bn of Greek bonds, amid rising optimism that a deal could be reached ahead of Monday's European Union summit.

According to people with knowledge of the proposal, the co-heads of the bondholders' committee negotiating with Greece, Charles Dallara and Jean Lemierre, could make concessions on interest rates for new bonds that would mean higher losses for private investors, but which could be recouped if the country returns to strong growth.

A lower interest rate on long-term bonds would allow Greece to reduce its ratio of debt to gross domestic product from 160 to 120 by 2020, making its debt viable, according to the International Monetary Fund. But it would also impose net present value losses above the 70 per cent previous ceiling set by private investors.

One Athens banker said: "An agreement that bondholders could accept appears close, provided the extra official funding comes through."

In Brussels, Olli Rehn, the European commissioner responsible for economic and monetary affairs, said that there was likely to be a need for some increase in official sector funding, "on the basis of the revised debt sustainability analysis".

In Berlin, Angela Merkel, the German chancellor, said the Greek talks were "on quite a good path", but warned that Greece would have to spell out "its additional obligations" before any deal could be done.

Officials in Berlin say that European leaders will need a full report by the "troika" officials representing the IMF, the European Commission and the European Central Bank before finalising the rescue. They doubted the report would be ready for Monday's summit.

> Merkel warned Greece would have to spell out its 'additional obligations'

Greece's government still has to sign up to austerity measures under a new medium-term fiscal programme before funds from a €130bn second bail-out are disbursed. Talks were set to continue with the visiting officials today, amid disagreements over more wage and pension cuts and measures to make the labour market flexible.

"We are preparing a package which will pave the way for a sustainable solution for Greece," Mr Rehn told Reuters news agency.

He declined to say how big the funding shortfall would be, although he insisted that increased taxpayer support for Greece would be "not anything dramatic".

Both the IMF and European policymakers have agreed that Greek government debt must be reduced to 120 per cent of gross domestic product by 2020 in order to be sustainable

In Germany – the principal financial guarantor of the eurozone rescue fund which will provide most of the support for Athens – resistance to any rise in public funding for the bailout remains strong. The Netherlands and Finland are also sceptical.

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Spaniards grow edgy for reform Rajoy promised

By Victor Mallet in Madrid

After years of decrying as incompetent the former Socialist government of José Luis Rodríguez Zapatero, Spain's business leaders and fund managers are having twinges of doubt about the Popular party administration they elected in November to replace it.

Mariano Rajoy, the PP prime minister, had raised expectations he would enact radical economic reform to save Spain from the eurozone sovereign debt crisis and the ignominy of a bailout such as those of Greece, ing goal in the face of imminent recession. Mr Montoro has hinted the target could be renegotiated as it is based on optimistic assumptions of economic growth, now turning negative, while Mr de Guindos has spoken of an "inescapable commitment" to austerity.

The second reform pro[illegible]ised by Mr Rajoy concern[illegible] the labour market and the country's inflexible collective bargaining system. Employers doubt changes will be as profound as those they say will be needed to reduce unemployment from the current level of 5.4m.