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Devil of a Crisis: A Call for Urgent Attention to Details

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- One lesson of the crisis could be said to be that there is great peril in neglecting the obvious e.g. that unfettered markets can fail big time; that incentive systems matter; and that the devil often lies in the details. This note is concerned with the last. It emphasizes the *urgency* of establishing mechanisms for tracking and tackling the devil and proposes some ways of doing so. The focus is mostly on the April 2009 G-20 communiqué and its follow-up pertaining to developing countries –especially low-income countries--and the International Financial Institutions (IFIs).

- The proposal for monitoring and assessing the details of measures being taken in response to the crisis and reforming the governance of IFIs, include notably those of the UN Commission on the reforms of the international monetary and financial system. Recognizing that the setting up of appropriate institutions and arrangements will take some time, the UN Commission is recommending that in the short-term, there should be an appropriate mechanism within the UN system for independent analysis on questions of global economic policy. Given the speed with which the crisis and the measures to deal with it are unfolding, there is no time to lose. And the question that arises whether this can be done in a short enough period of time, before hysteresis effects take over.

- Something needs to be put in place immediately. This could be an informal or semi-formal Committee or Task Force of the Shadow Gn (or one or more of the organizers of the Shadow Gn) established at or immediately following the meeting in Rome in May 2009. Such a committee could work closely even if informally (in the interest of speed) with some existing organs such as the UN Department of Economic and Social Affairs or civil society organizations.

- The urgency is highlighted by the fact that the London meeting of the G-20 and the subsequent Spring meetings of the IMF and the World bank have called for a number of exercises to be completed in the coming weeks and months in time for assorted upcoming international meetings such as those of the G-20 finance ministers and the International Monetary and Financial Committee (IMFC). Presumably some of these exercises have already commenced and they could form the basis of actions whose details may make all the difference. And those pertaining to the "systemically-not-so-important" countries – most low-income countries—are most at risk of inattention to the details which may contain many devils.

- An important outcome of the last G20 meeting was the considerable enhancement of the resources and the role of the IMF in assisting developing countries to manage the crisis. There have been a number of related welcome outcomes. These have included the a new issue of SDRs, renewed commitment to reform of the governance of Bretton Wood Institutions (BWIs) as well as of the reforms they require as conditionalities. The IMF has already made important changes to its modus operandi as evidenced by the introduction of the Flexible Credit Line (FCL) and its utilization by Mexico.

- The Fund has also recognized the need to reform its conditionalities (or in its phrase "modernizing conditionality"). Assorted Fund documents have explicitly or implicitly noted that Fund programs in the past carried too many conditions and had a pro-cyclical bias. However, there is, at this stage, much vagueness and generality about "modernizing conditionality", especially as it pertains to low-income countries.

- The details are going to be vital as illustrated by the following examples. The IMF notes that whilst, in principle low-income countries are eligible for the FCL, the credit line "targets members who have capital market access and are reasonably well-integrated into financial markets, with a capital account position dominated by private flows. Low-income countries typically do not meet such circumstances."[1].Hence for these countries the rough equivalent of the FCL may be said to be a modified Exogenous Shocks Facility (ESF). This will provide access to IMF resources to low-income countries that do not have a standard IMF program under the Poverty Reduction and Growth Facility (PRGF).(Access limits under the ESF and the PRGF have been doubled).

- The ESF is to have two components: a "rapid access" one of up to 25% of a country's quota with little or no conditionality and a "high access" component with access normally up to 75% of quota. For this latter component, resources are to be provided based on phased reviews of performance under programs of one-to two years duration. Moreover, for this high access "an economics program of the same standard as programs under the PRGF will be needed."[2] Thus basically the ESF boils down to the PRGF.

- So what is new aside from enhanced access limits? This will depend on the details of changes in IMF conditionality and the cross-conditionality of making other concessional lending a function of a Fund program. There is a welcome recognition by the IMF of the stigma associated with IMF lending and the need to

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[1] IMF, "Reforms of Lending and Conditionality Frameworks: Questions and Answers", April 09, 2009, p.4.

[2] IMF, "The Exogenous Shocks Facility: A Fact sheet-April 2009" p.1

remove it. The main elements seem to comprise greater sensitivity to country-specific circumstances, more reliance on pre-set qualification criteria (ex-ante conditionality) rather than ex-post conditionality and eliminating structural bench-marks from Fund programs.

- But as the IMF notes "structural reforms will continue to be integral to Fund-supported programs" though the "the implementation of structural policies in IMF-supported programs will from now on be monitored in the context of program reviews, rather than structural performance criteria"[3]. What exactly does that mean in terms of the content of such conditionality?

- Another set of issues revolve around the scope for counter-cyclical policies. A crucial element in IMF programs will be the debt sustainability analysis that will determine this scope. At the London G-20 meeting, low-income countries called for a review of the framework of such analysis on the grounds that it was biased towards excessively contractionary policies. Debt sustainability analysis is subject not only to sensitivity to various assumptions but also to how balance-sheet and related effects are accounted for. Thus for example, debt acquired to increase assets such as high-productivity infrastructure which will raise output and revenues has quite different implications from debt acquired to finance consumption or speculative activities. Working group 3 at the April G20 called for a review of the debt sustainability framework employed by the BWIs. But this is to be undertaken by them (presumably led by the IMF).

- Another proposal that emerged from one of the working groups at the G20 is to review the World Bank's Country Policy and Institutional Assessment (CPIA), the ratings under which are an important determinant of IDA allocations Who will review the details of these review and when? Again this is a role that the "Shadow Gn" committee or task force proposed above could perform.

- More broadly, the content of conditionality, especially that imposed on non-systemically important, low-income countries needs review and some of it with some urgency. Thus, for example, in a Frequently Asked Qs and As on IMF supported programs, the Fund's answer to the question on why IMF insists on low inflation in programs includes the following assertion ""in addition to the negative impact on the poor, a large body of empirical evidence has established that when (annual) inflation passes the 5 percent mark investment and economic activity also suffer"[4].

- This is a debatable assertion and raises concerns about the room that IMF programs will allow for getting the balance right between price-stability and other dimensions of macroeconomic stability and for countercyclical policies. More broadly it raises the question of the underlying model or "weltanschauung" that informs BWI conditionality. Whilst there is time to engage in this debate,

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[3] IMF, "IMF Implements Major Lending Policy Improvements" , March 24, 2009, p. 1
[4] IMF, "IMF-Supported Programs – Frequently Asked Questions", April 14, 2009. p.2

hysteresis effects lend an urgency to addressing some of these issues in the course of debate on the response to the crisis. A critical assessment may also serve to help political leaders and the management of the BWIs to bring about the changes they seek by overcoming the force of habit or long-standing "group think" that may get in the way of the staff of these institutions implementing the desired changes.