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The Multilateral Response to the Global Crisis: Rationale, Modalities, and Feasibility

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Abstract[1]

The paper reviews the case for a strong multilateral response to the global crisis in emerging markets (EMs). It discusses modalities and feasibility of intervention and its associated risks, depending on country circumstances of fiscal space and liquidity needs. The specific role of Multilateral Development Banks (MDBs) in ensuring the development effectiveness of the fiscal response is also discussed. The paper concludes by highlighting the international financial architecture issues raised by the global crisis that cannot be addressed immediately but will need to be dealt with once the current crisis has been tamed.

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Keywords: Global Crisis, Latin America and Caribbean, Multilateral Development Banks, Policy Responses.

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1. Introduction

To respond successfully to the ongoing global economic crisis, emerging economies require significant multilateral assistance. Several countries in emerging Europe are already in "crisis resolution" mode, and assistance is now focused on containing the fallout, but for much of Latin America and the Caribbean (LAC) there is still time for "active prevention" to pay significant dividends. But the challenges remain large; the total public sector borrowing requirements of the seven largest economies of LAC are estimated at some US$640 billion for 2009-2010, while these countries' international gross reserves stood at about US$450 billion at end June 2008 (IDB, 2009a). Given strong trade linkages with the epicenter of the crisis (the United States and Europe), emerging Asia's position is arguably at least as fragile as that of LAC, but confidence is underpinned in Asia by Japan's and China's reserve position.

Moreover, as widely discussed after the Asian crisis, emerging economies are more constrained in terms of their monetary, fiscal and lender of last resort responses than their industrialized country counterparts.[2] It is almost a definition of being emerging that domestic government bonds are not seen as a riskless asset, especially in these circumstances. As the probability of a crisis at home rises, money tends to flow out of the economy to foreign assets as investors, particularly larger and more sophisticated ones, seek a perceived safe haven. This implies countercyclical monetary policy, especially through the direct use of the central bank balance sheet. Such a policy, however, as currently being undertaken in advanced economies, may well de-anchor inflation expectations.[3] It also implies a sharper trade-off between financial stability and monetary stability, as injections of liquidity to the financial system may simply fuel capital flight, causing exchange rate depreciation and monetary instability. This in turn implies that financing a countercyclical fiscal policy will become increasingly expensive and risky as domestic interest rates rise, maturities shorten and more debt is issued in foreign currency—assuming such markets even remain open. International reserves could be used instead, but only at the cost of exercising the insurance option they represent, and hence at the risk of higher probability of a sudden stop or a currency crisis run down the road. At the limit, sole reliance on domestic policy tools at the individual country level may well result in a worsening of the situation rather than ameliorating it.

[2] See G20 (1998) on crisis prevention.
[3] See Calvo (2006) on monetary policy in EMs.

Discussion continues as to the true source of the current crisis. However, whether it is considered microeconomic in nature and related to a sequence of regulatory failures in the world's financial system, or fundamentally a macroeconomic phenomenon related to global imbalances feeding a housing boom and financial bubbles, it is clear that this crisis did not start in emerging economies. Moreover, the crisis is global and may well be prolonged. If there is a sharp V-shape recovery, the pain will most certainly be less. However, in the midst of wide uncertainty among analysts, it looks increasingly plausible that the recovery may be slower: at least a "U" if not the extremely worrisome "L". To the extent that core financial markets are not performing well, emerging economies may find it increasingly difficult to roll over both public and private sector liabilities. While financing a fiscal deficit or investment is a flow issue, rolling over outstanding liabilities is a problem of stocks. The more prolonged the crisis in financial markets, the greater the concern that emerging economies will have to deal with their stocks of liabilities, and the greater the adjustment that will be required if that cannot be achieved. In somewhat similar vein to the Asian crisis, such a problem would be the counterpart of a quintessential Sudden Stop.[4]

Nonetheless, there remains the conviction that individual countries are able (and ought to be able) to weather the storm alone, and this conviction is held both among certain quarters of the international policy community and, above all, among emerging economy officials themselves. On the one hand, it is often argued that countries should have done more to prepare themselves for a rainy day, and on the other hand there is extreme reluctance to seek early assistance from the IMF on the part of national authorities in many countries. These views are both contradictory and shortsighted. It is difficult to argue that in good times individual countries should have accumulated reserves sufficient to self-insure against the possibility of a systemic event like the crisis that has materialized—and if they had done so, they surely would surely have been accused of pursuing mercantilist exchange rate policies. Moreover, self-insurance is a second-best option relative to insurance through international cooperation. Similarly, the reluctance to enter into a precautionary arrangement with the IMF under the current circumstances is akin to a troupe of trapeze artists deciding not to have a safety net for fear that the circus manager will assume they do not have the requisite skill.[5]

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[4] See Cavallo and Izquierdo (2009).

[5] Note that with no safety net in place the audience might also be in danger as other countries may be affected by a crisis in a neighbor that might have had a precautionary facility in place.

However, it is also the case that emerging economies are highly heterogeneous. We suggest below a broad working categorization. Based on this scheme, we suggest the types of multilateral support that should be made available. We argue below that there should be two overarching objectives for multilateral support. The first is to reduce the likelihood of a country suffering a Sudden Stop in capital flows and hence a deep crisis as a reaction to the stock adjustment problem. The second is to maximize the number of countries that might safely pursue some type of countercyclical fiscal policy as called for by the G20. The greater the number of countries that pursue such a policy, the more effective such policies become, as at the limit the "leakage" from a global package is zero. Moreover, we suggest a division of labor between the International Monetary Fund and Multilateral Development Banks in providing multilateral support.

The paper is organized as follows. In Section 2, we review the case for a strong multilateral response to the global crisis in emerging markets (EMs), and in Section 3 we discuss modalities of intervention and associated risks. The specific role of Multilateral Development Banks is discussed in Section 4. The question of the financial feasibility of such a multilateral response is dealt with in Section 5. The paper concludes with a discussion of the international financial architecture issues raised by the global crisis that cannot be addressed immediately but will need to be dealt with once the current crisis has been tamed.

2. Why Should Multilaterals Intervene?

The rationale for multilateral intervention in response to the global crisis in emerging markets is now fairly well understood. Nonetheless, opposition to a forceful and assertive response is still strong, both in certain quarters of the international policy community and in some individual countries. This is evidenced by the relatively late and limited financial resources with which potential creditor countries have come forth in supporting multilateral financial institutions, as well as the reluctance with which emerging countries have requested access to those resources. It is therefore worthwhile to review the case before discussing the modalities and risks of such intervention.

2.1 Limits of Traditional Policy Instruments

As private sector financial institutions hoard liquidity and investors seek the perceived safety of US government liabilities, there are severe financing constraints on emerging economies' policy responses to the crisis. The optimal response to the crisis in an emerging economy is similar in nature to the one of more advanced economies. However, while the United States faces its most severe financial crisis since the Great Depression, funding costs for the US Government have actually fallen. Other advanced countries enjoy a similar position, albeit to a lesser extent. But this is not the case in EMs. In general, EMs are facing higher interest rates on domestic government debt and higher spreads over risk-free rates than before the crisis, and both are significantly higher than in industrialized economies.

An interesting apparent exception is Chile. At least initially, after the collapse of Lehmann Brothers, when the crisis truly became global there appeared to be a flight to quality within Chile towards domestic Government bonds in local currency and in local currency indexed to inflation. Rates on domestic bonds actually fell. Of course Chile is an outlier in Latin America in several respects, most notably for its low level of public sector debt and the large magnitude of Central Bank and fiscal reserves constituted in foreign assets. Indeed it might be argued that this flight to domestic public sector assets is the antithesis of being an emerging economy, and it is tempting to suggest a new answer to the old question of the optimal level of reserves: namely, the level that leads to a response to crisis such as seen in Chile. As we argue above, however, it would be grossly inefficient for all countries to maintain such a level of reserves. Nonetheless, while not optimal for all, Chile's case does illustrate the potential power of unconditional access to a large stock of reserves under the current circumstances.

2.1.1 Fiscal Policy

In most cases it is not feasible to respond to the crisis with fiscal stimulus, let alone with quasi-fiscal credit support policies, without multilateral support. Even countries with sustainable fiscal policies might still face a relevant trade-off between expansionary policies and liquidity considerations. As we noted above, only a handful of emerging economies may be strong enough both from a fiscal sustainability and international liquidity perspective to pursue expansionary fiscal policies without risk. In fact, in some countries, fiscal adjustment as opposed to fiscal stimulus may be the "optimal" policy response to the crisis—particularly in the absence of a multilateral backstop because, under certain conditions, a fiscal contraction can be expansionary (Giavazzi and Pagano, 1989).

To fix ideas, consider the potential impact of two alternative fiscal policies in a country with no fiscal sustainability problems: one neutral towards the business cycle (i.e., no changes in either government expenditures or tax rates in response to recessionary pressures), and the other countercyclical (i.e., a rise in government expenditures and/or a reduction in tax rates). Since active fiscal policy will in principle imply a larger deterioration of the fiscal deficit, this deficit will add to the gross financing needs of the country, possibly affecting negatively the maturity and cost of this financing, i.e., shorter terms and higher rates. Therefore, a countercyclical fiscal policy implies deterioration in liquidity ratios relative to the neutral fiscal policy stance (IDB, 2009a), and even countries with sizable international reserves to back these policies would find it risky to use a sizable portion of their self-insurance policy.

Other countries in the region, may not even have the luxury of considering these tradeoffs, or can only do so at substantially higher downside risks. In fact, given the pro-cyclical fiscal policies pursued in many countries during the expansionary phase of the 2000s (on average LAC-7 countries increased public expenditures by 80 cents out of every additional dollar of revenue between 2003 and 2007, as discussed in IDB, 2008), pursuing a countercyclical policy during the downturn, which implies raising expenditures even further, may imply exponential debt dynamics, creating fiscal sustainability problems. In these cases countercyclical fiscal policies should simply not be an option (or may well be an option that becomes very costly ex post), unless there is a credible commitment to tighter fiscal discipline in the future.[6]

Of course, other forms of shoring up future fiscal discipline would also serve the same purpose of relaxing the fiscal sustainability constraint. For example, there is evidence in G7 countries that discretionary counter-cyclical policy is asymmetric and generates debt bias, while automatic stabilizers such as unemployment insurance do not (IMF, 2008). The reason is that automatic stabilizers are temporary but discretionary policy tends not be rolled over after the downturn. It is important to introduce automaticity in fiscal policy (contingent rules) so that discipline becomes more credible. More generally, addressing some of the long-term imbalances

[6] As we argue below, a key reform in this direction would be the establishment of an independent fiscal council in charge of estimating the structural fiscal balances actually run by governments and a budget rule setting prudent targets for these balances. A credible reform in this direction with a real bite in the future would allow countries and multilateral institutions to go further in any active policy in the present.

such as a deficit in social security would also help to shore up sustainability and open more space for fiscal action in the downturn.

2.1.2 Monetary Policy

Most emerging market countries are today better positioned than in the past to allow the exchange rate to absorb the initial impact of the global crisis. For instance, the "fear-of-floating" coefficient in the monetary policy rule of many emerging markets has decreased significantly in most countries (Ortiz, Ottonello and Sturzenegger, 2009). This is partly related to smaller foreign exchange exposures, but also to the monetary policy credibility acquired through the implementation of flexible inflation targeting regimes for more than a decade. Indeed, in the same sample of countries, the speed with which central banks react to shocks (which is inversely related to measures of commitment to a given monetary policy stance) decreased significantly in most of the countries that recently adopted an inflation targeting regime.

The greater policy flexibility at the onset of the crisis is important. Past experience suggests that initial conditions are crucial in terms of the policy flexibility necessary to minimize the likelihood of, or mitigate the impact of, sudden stops on economic activity (Cavallo and Izquierdo, 2009). Both theory (e.g., Benigno et al., 2009; and Braggion, Christiano, and Roldos, 2005) and new evidence (Ortiz, Ottonello and Sturzenegger, 2009) show that the ability to pursue expansionary monetary policies in periods of financial turmoil can reduce the size of output contractions. A flexible exchange rate response would have several additional benefits in addition to leaving more room for other uses of scarce international reserves. First, it would prevent the loss of market share in the context in which downward pressure on the nominal exchange rate is global. Second, it may help contain the deflationary impact of commodity price decline in those cases in which deflation pressure were to emerge (Catão and Chang, 2009).

Nevertheless, exchange rate flexibility is not a silver bullet. Unlike in previous episodes of country-specific Sudden Stops, this is a global event. Not all countries can depreciate, and the global nature of the present shock means that devaluations may not have significant expansionary effects even in the absence of adverse balance sheet effects. For most EMs, even if a flexible exchange rate response could be effected the economy would need an additional policy instrument to help contain the output gap opened up by the external shock.

Indeed, the nature of the shock imposes an important constraint. First, the global nature of the Sudden Stop faced by emerging capital markets and the concern regarding financial systems across the globe limits the use of the financial system as a vehicle for countercyclical monetary policy. Banks in many emerging countries are currently holding large amounts of liquidity and are unlikely to respond to a reduction in interest rates to expand credit as in normal times. Similarly, a reduction in liquidity or reserve requirements is also likely to be met by even higher levels of liquidity rather than increases in credit.[7] Moreover, to the extent to which the shock faced by emerging markets has a permanent component (i.e., deleveraging is not temporary), a monetary policy response that aims at preserving the pre-shock equilibrium would not be desirable either. In some countries, however, lowering benchmark interest rates might support valuations of riskier assets and also lower the total cost of borrowing for households and firms, and hence ultimately contain the likelihood of generalized insolvency. Through this channel, monetary policy can contribute effectively toward containing the negative spillovers from the real sector to the financial sector of the economy (Mishkin, 2009). However, this potential benefit must be weighed against the potential risk of the effect of lower interest rates on capital flows.

A second limit is imposed by the risk of losing credibility by attempting to use directly the central bank balance sheet in domestic currency to respond to the shock. A powerful additional instrument through which central banks in advanced economies are responding to the crisis is the direct use of their balance sheet to substitute for markets and intermediaries that are impaired, so-called quantitative easing. This means lending directly in domestic currency, and in a potentially unlimited manner, to the private sector, as opposed to loosening the funding conditions of the core domestic financial system through price signals to implement a more accommodative monetary stance. A key challenge to implementing such a policy is how to prevent inflation expectations from running out of control; and the risk of de-anchoring inflation expectations is much higher in emerging markets because of weaker policy institutions and their past histories of monetary instability. In emerging markets, therefore, aggressive quantitative easing in domestic currency would inevitably set off inflationary expectations, thus squandering

[7] Monetary policy lags may be shorter in emerging markets than in advanced economies, hence making it more effective (Catão, Pagán and Laxton, 2008). The shorter duration of financial contracts, possibly underpinning this stylized fact, however, makes these economies more vulnerable to sudden increases in risk premia, thus suggesting that financial frictions may result in tougher constraints in these economies.

their recently hard-won inflation-fighting credibility, and thereby fuelling a flight to safer currencies. In emerging markets, quantitative easing (or more conventionally called, lending of last resort) must therefore be conducted in hard currency, using either own or borrowed reserves (Calvo, 2009).[8]

Most inflation-targeting central banks outside emerging Europe have lowered their reference rate in line with inflation, which is declining globally. Unlike in the more advanced economies, as inflation subsides, there may be room for emerging central banks to seek additional interest rate reductions within inflation-targeting frameworks. Indeed, recent analyses of optimal policy in the presence of financial frictions suggest that a tightening of domestic financial market conditions should be met by responding more than normally to the output gap (e.g., Cúrdia and Woodford, 2008). Naturally, a central bank must weigh the case for such a reduction against the potential for capital flight and exchange rate instability when this is a constraint on the monetary policy framework.

2.2 Benefits of Multilateral Intervention

Having reviewed the limits to individual countries' ability to respond to the global crisis, we now move on to discuss the possible global benefits of a multilaterally supported response. Countercyclical multilateral lending is needed to sustain access to external finance after excessive market retrenchment. In so doing, multilateral intervention bridges short-term financing needs and covers liquidity risks while the temporary market disruption lasts. This kind of intervention contains the damage to fundamentals that a full-blown liquidity crisis would provoke and relaxes the constraints on national policies facing the downturn. For example, multilateral intervention may back up international reserves, freeing them for policy uses or directly financing countercyclical fiscal policy.

Apart from partially offsetting the external shock suffered by each country and empowering domestic policies, multilateral intervention addresses systemic dimensions that are crucial in a global crisis. First, providing abundant multilateral financing to respond to the crisis is desirable from both the individual country viewpoint and, especially, the global perspective. As long as the international trade regime remains open, there are positive externalities from sustaining aggregate demand. Moreover, the growth payoff from fiscal stimulus rises with the

[8] Calvo (2009) points out that a global financial regulator should be established alongside a global lender of last resort to be effective, in analogy with the institutional arrangement prevailing at the national level.

number of countries adopting it as, at the limit, there is no loss of effectiveness due to international spillover from a global package. While the total demand from emerging countries may be small, emerging countries tend to have larger marginal propensities to consume out of income and hence fiscal stimulus packages may be more effective. Emerging countries also have higher propensities to import, and hence leakages may be higher, but if many countries pursue such packages this problem is reduced. In fact, such leakages imply that in particular the advanced countries will be helped. It is therefore better to err on the side of too much financing rather than too much adjustment under the current circumstances. Interestingly, unlike the traditional case for unilateral free trade, protectionist fiscal packages, at the limit the failure to enact fiscal stimulus policies on account of import leakages, may be in the interest of individual countries. This reinforces the need for multilateral institutions to guard against protectionism even in the best-run economies.

Second, even if positive spillovers from financial stimulus were negligible, the threat of large negative spillovers as a result of the global economic crisis is credible and imminent, as the Great Depression experience teaches and as recent country initiatives highlight. Pressures to raise trade protectionism and competitive devaluations in a deflated world economy are rising and may lead to a global trade war that spirals out of control (World Bank, 2009). Protectionism rises as a countercyclical domestic policy response to the crisis as an attempt to increase domestic demand and production. In a global recession, such a policy response is globally disastrous but may be individually beneficial. Multilaterals can fight this on two fronts. First, they can offer financing to support individual economies as well as the global trade system. Second, they can make financing in situations of outright crisis conditional on avoiding such disruptive policy responses. There is a strong argument for action through multilateral institutions able to internalize international spillovers.

Multilaterals have an opportunity to oppose protectionism in fiscal policy in this global recession and at the same time encourage, and finance, stimulus packages that would be otherwise discarded or scaled back by national authorities because boosted demand “leaks out” of the domestic economy. This is also an opportunity for multilaterals to coordinate global stimulus action. From the point of view of an individual country, a stimulus package that restricts spending to products with high domestic value added (in other words, impedes spending on imports) has a higher GDP-multiplier and can be presumed to be more beneficial in terms of

GDP reactivation (despite its inefficiency, like that of any other trade barrier). This would be appropriate for a national recession but not in the case of a global recession like the present one, because the reactivation of depressed GDP in the rest of the world is equally valuable from a global perspective.

Multilaterals should also be mindful of the potential for policy reform backsliding due to instability and defend against that possibility. The international community should be mindful of rewarding the good policies implemented in the past by now helping to avoid unwarranted external adjustments at a time of global recession that may erode the economic or political basis for supporting reforms. Nonetheless, in many countries macroeconomic policies have been insufficiently countercyclical during the boom years to create the necessary space to respond quickly and effectively to the global economic downturn. Similarly, multilateral conditionality in these cases can help assure that policy interventions that may be beneficial in the short term do not become important obstacles to the resumption of income and productivity growth in the medium to long term, as illustrated by IDB (2009b).

3. How Should Multilaterals Intervene?

In the current phase of the downturn, there is a premium on fast and decisive action. A consensus has emerged that a lack of confidence and heightened uncertainty about systemic risk is leading to a collapse of global economic activity and international trade. It is therefore paramount to move aggressively and quickly to short-circuit the negative feedback loop from tighter global financial conditions to a deeper world recession. Moreover, acting sooner rather than later is desirable also in light of the fact that traditional lending countries in the multilateral lending institutions are facing daunting challenges in managing their own fiscal responses to the crisis, as well as in light of the political backlash against financial sector support programs. The situation has already reached a point at which the domestic fiscal needs of advanced economies may soon start to crowd out possibilities for supporting emerging countries.

A first important role of multilateral intervention is to provide a backstop for liquidity or lender of last resort; see Calvo (2009) for a recent note on the issue. A traditional counterargument is that this may provoke moral hazard. Several papers, however, argue that this is not necessarily the case. Morris and Shin (2003) and Corsetti, Guimarães and Roubini (2006) suggest that, in the presence of appropriate fiscal policy, a lender of last resort providing sufficient liquidity can prevent a bad "run-equilibrium" and therefore increase rather than reduce the incentives for that "appropriate" fiscal policy.[9] Arozemena and Powell (2003) develop a repeated game, and show that assuming a lender of last resort can punish countries by removing its backstop, an equilibrium is supported with no moral hazard but with liquidity protection that prevents "runs" from occurring.[10] An interesting feature of all these theoretical models is that the lender of last resort does not actually have to disburse. The access to the backstop allows countries to roll over debt in private markets, eradicating the necessity for actual disbursements.

A second counterargument is that risky debt appears for a reason, hence multilateral involvement must attempt to replace the discipline of shortening maturities for something else (Jeanne, 2008). In the context of the current crisis, the higher probability of a run (that is discipline) does not reflect a country's poor behavior so much as the global context, hence it shows the limits of discipline when the shock is systemic. In a similar vein, D'Amato, Grubisic and Powell (1997) and Levy-Yeyati, Peria and Schmukler (2009) both suggest market discipline has a limit in banking when shocks are systemic.

A second role for multilaterals is to help provide global fiscal stimulus while at the same time preventing an increased risk of liquidity problems or preventing the liquidity difficulties experienced over the past several months from turning into solvency issues, which would be much harder to resolve.

At the same time, the fundamentals of the current global slowdown may themselves raise solvency questions. The possible permanence of some of the changes observed, such as a drop in unsustainably high world growth and the anticipated deleveraging in global financial markets, has structural, non-cyclical implications that call for adjustment to a lower-growth, medium-term equilibrium. The provision of financing without regard for needed adjustment would increase required adjustment down the road and backfire.

International financial institutions then have multiple roles in the current circumstances, and the particular role to be played will depend on the situation in a specific country. These roles include (a) backstopping liquidity; (b) providing long-term finance, particularly for financing

[9] In these models a "global game," with particular assumptions regarding what lenders know about fundamentals and what lenders know about other lenders, supports a unique equilibrium.

[10] The one period version of this game is one where the trade-off for the lender of last resort is to provide liquidity protection but at the cost of moral hazard. The interesting feature is that the only equilibrium is in mixed strategies representing the tension between (say) the IMF wishing to provide support and a country's being tempted to pursue riskier strategies in the presence of unconditional support. A "minimum punishment strategy" supports a unique equilibrium in the repeated game.

countercyclical fiscal policies and/or protecting particular fiscal expenditures (thereby altering the composition of fiscal expenditure); and (c) facilitating fiscal adjustment. In what follows we suggest a categorization of countries to describe the potential roles of multilaterals in each. The two over-arching objectives of support are first to reduce the likelihood of a crisis and second to attempt to maximize the number of countries that might contribute to the global efforts towards fiscal stimulus. A third objective we consider important is ensuring that fiscal and expenditure policies are appropriately designed.

A) A country with no liquidity problems (high reserves and/or assured normal access to credit)

In a case of financial self-sufficiency, the country may implement appropriate domestic policies without multilateral support. In practice, the absence of liquidity problems in this crisis is in all likelihood accompanied by a fiscal situation with enough space to consider countercyclical fiscal and quasi-fiscal policies, as opposed to the need for fiscal retrenchment or adjustment to maintain fiscal sustainability. In such cases multilaterals should insist on non-protectionist stimulus packages but not actually intervene in order to preserve resources for the other cases listed below.

B) A country with fiscal space but potential liquidity problems

Some countries may be considered to have fiscal space to enact a countercyclical fiscal policy from a solvency perspective but face a high cost of borrowing and have liquidity concerns (potentially insufficient reserves and a debt structure that does not eliminate liquidity risks). In these cases multilaterals may play at least two important roles. First, they may provide long-term financing (or guarantees such that countries can finance long-term) to improve countries' debt maturity structure and reduce liquidity risks. This is particularly important to finance any fiscal stimulus in such a way that the country's liquidity position does not deteriorate. Second, multilaterals may provide a back stop to reserves essentially augmenting access to international liquidity. In relation to the Guidotti-Greenspan rule, all else equal, this would serve to reduce the denominator (the amount of liabilities coming due in one year) and increase the numerator (the stock of international reserves) respectively, while enabling the country to produce a strong countercyclical response (Fernandez-Arias and Montiel, 2009). Multilateral development banks

(MDBs) currently provide longer-term financing, and so their comparative advantage is in relation to the first role. The second role is a natural one for the IMF to play, and for a country with fiscal space it is likely that there would be access to the new Flexible Credit Line (FCL) or a high access precautionary program.[11] In this case, multilateral intervention would have no strings attached to the fiscal policy package being financed other than ensuring that the package is not protectionist and is aligned with the multilateral effort being coordinated.

C) A country with no fiscal space and potential liquidity problems

Unfortunately, many emerging countries simply do not have the fiscal space to effect a counter-cyclical fiscal policy, and indeed they should be deterred from doing so. In fact, several countries may need to adjust fiscal policy to reduce deficits given the negative impact of the global crisis on the prices of key exports and the resulting decline in fiscal revenues. In these cases multilaterals may again provide a backstop to reserves and longer-term financing, but this should be offered on the basis of the typical "no-new-debt rule." In other words, multilateral financing should replace rather than add to market debt. In the case of countries where adjustment is required, multilateral financing may help with the fulfillment of public sector borrowing requirements in order to avoid the costs of abrupt adjustment, but within a framework designed to reduce fragility and regain fiscal sustainability. This implies agreed-upon budget envelopes that permit gradual adjustment to a new medium-term budget equilibrium. Indeed, support should be non-precautionary, with ex post conditionality under this modality.

Again providing a back stop to reserves is a natural role for the IMF. Countries in this category would not qualify for the FCL, but most would be advised to seek a traditional Stand By facility. The IMF is also the agency charged with assessing the fiscal situation and advising on the macroeconomic adjustment effort that may be required. MDBs again have a comparative advantage in supplying long-term development financing and should work with countries to ensure that resources are employed as efficiently and effectively as possible. For example, they focus on the development effectiveness of public investment and development policy as well as structural reforms fostering growth and fiscal discipline. Furthermore, expenditures that protect vulnerable groups should be maintained as far as is feasible.

[11] Note however that as long as the country is free to use international reserves for budget support, both roles are formally equivalent from a financial viewpoint. Under those conditions, the role of the MDBs in this equation is to ensure whatever fiscal space there is, is used appropriately in sound operations. In order for the opinions of these institutions to be heard it is surely the case that they should have resources committed.

D) A country with more serious sustainability problems

A smaller set of emerging countries have more serious issues in relation to the sustainability of policies given debt levels. The current crisis is putting countries in this category in an extremely difficult position. At some point the question may become whether to adjust fiercely or combine a smaller adjustment with a debt restructuring. This places multilaterals in a difficult position. Should they lend to countries that may face a debt restructuring, or should they hold off—which would most likely force the restructuring to occur? The lack of a framework in the current international financial architecture for countries to restructure debts akin to corporate debt restructurings (such as Chapter 11 in the United States) tends to make multilaterals very reluctant to cease financing. However, at some point the restructuring may become inevitable, and in general it is optimal to restructure early rather than delay. Moreover, if core financial markets are closed in any event, restructuring may not imply severe short-term costs. In any event, it is clear that multilateral intervention in a country with solvency problems needs to provide for both an agreed framework for fiscal adjustment and potential debt restructuring.

In summary, in a phase of impending downturn, heavy ex-post conditionality is not warranted except for insolvency cases in which there are few incentives to use additional liquidity productively. In these cases, traditional ex post conditionality is still justified to ensure the effectiveness of the financial support to countries. Other than that, financing should be made available on the basis of ex-ante conditionality under the liberal concepts of “good performer” and “sustainable framework.” The gain from advancing the reform agenda through conditionality (extracting a conditionality concession in exchange of support) pales in comparison with the risk of impeding the success of swift crisis support through delay or lack of cooperation.

Implicit ex ante conditionality is appropriate. To reward past good policies, multilaterals should lend more and more freely than in the past, provided that such support should be accompanied by appropriate monitoring to ensure that policies remain on track and support is productive (Jeanne, Ostry, and Zettelmeyer, 2008). Countries with sizable debts that are able to commit to policies of fiscal discipline in the future and save in the subsequent boom phase of the cycle should receive higher levels of financing on account of their enhanced fiscal sustainability. In that case, additional financing could be attached to conditions that preserve and enhance medium term sustainability.

One exception, however, is the condition that all types of multilateral financial support must go exclusively to countries that refrain from protectionist measures. This blanket condition is justified because, in the context of a global crisis, protectionism to safeguard local demand may be in each country's individual interest, but at the expense of the collective good. So the effort would be geared toward preventing the adoption of measures disruptive of the international prosperity.

Indeed, the recent change in the IMF's lending toolkit goes precisely in this direction. And perhaps even too much in this direction, as in practice it will be difficult to differentiate conditionality across member countries, while some cases would still benefit from the commitment device provided by traditional ex post conditionality.

4. What is the Specific Role of Multilateral Development Banks?

By virtue of their countercyclical lending at medium and long-term maturities, MDBs play a supporting role to the IMF's pivotal role of backstopping liquidity. In fact, in small countries, MDBs can also aim at covering balance of payments and general budget support, including funding domestic financial intermediation, at a systemic level. Besides this supporting role, however, MDBs have specific roles concerning the development effectiveness of multilateral financing.

A strategic objective of MDBs is helping to design appropriate expenditure composition policies and, when warranted, expenditure-increasing policies in order to protect social programs and enhance medium-term productivity growth.[12] For example, a specific objective of MDBs is to protect the tremendous social progress of the past several years by providing targeted financial support for the most effective social protection programs. Such an effort is crucial in helping to make prudent economic policies politically sustainable until the world economy becomes more stable and resumes growing. MDB activity in these areas can also help to avoid perverse incentives, particularly in the labor market, that may increase informality, with negative implications for medium-term growth. Another priority area is infrastructure investment, as protecting large national investment programs may provide additional automatic stabilization to the economy during the downturn and can also set the stage for a smooth recovery once demand

[12] See García (2009) for a more technical discussion of the modalities of fiscal stimulus in LAC.

resumes growing globally. These objectives apply not only to the national government but also to subnational governments.

MDBs should also focus on development-oriented structural reforms through policy-based loans. These include policy and institutional reform aimed at fostering productivity and growth in the private sector as well as the reform of the State to better fulfill its development role, including fiscal discipline. For example, MDBs can help ensure that "transitory" measures, such as quasi-fiscal credit policies, are credibly transitory. More generally, MDBs would focus on the reform of fiscal institutions to ensure fiscal discipline and soundness in support of development objectives. While the IMF is the agency in charge of monitoring the budget envelope in the short run, MDBs should focus on reforms that would generate better frameworks for fiscal policy.

Finally, MDBs may also be effective partners of bilateral donors who want to help achieve critical mass coordinating around an overall plan to address cyclical financial needs or other sector-specific objectives, including serving as a financial conduit on their behalf without any balance sheet burden.

5. Is it Feasible to Gear Up Multilateral Lending Substantially?

Preventing or supporting external adjustment in the developing world with targeted multilaterally financed programs may remain feasible, even at the current level of capitalization, provided the temporary exceptional financing promised at the recent G20 meeting materializes in full. For instance, lending to finance fiscal stimulus and backstopping liquidity to the tune of, say 2-3 percentage points of GDP pale in comparison with the gap that would be produced if a financial collapse were to occur in the near future, with historical average stabilization packages of 5-10 points of GDP. Nonetheless, financing is endogenous to the severity of the crisis. So it is useful to think about other ways to expand demand and contain supply of resources for multilateral intervention regardless of the envelop size at any point in time.

To expand the supply of multilateral financing, multilateral financial institutions should therefore use their balance sheets creatively to the extent possible. In a process of global deleveraging and global credit deterioration, they could use their preferred creditor status, combined with their ability to affect the international regulatory standards at the global level, to leverage their balance sheet above normal criteria on a temporary basis. The alternative is that countries do that individually, lending directly to potentially insolvent households and firms, and hence increasing the probability of bigger country busts in the future.

Second, the existing system of bilateral insurance agreements between systematically important EMs and all of the G3 central banks should be strengthened. Brazil and Mexico in LAC, for instance, should seek to establish arrangements with the European Central Bank and the Bank of Japan similar to those established with the Federal Reserve Board. Similarly, there is scope for strengthening sub-regional arrangements such as the Fondo Latinoamericano de Reservas (FLAR) and the Corporacón Andina de Fomento (CAF) as a complement rather than a substitute to multilateral assistance. Nonetheless, as shown by the experience of Asian countries, barring individual countries' accumulating cushions of global dimensions, regional arrangements cannot effectively insulate against global shocks.

Third, and more generally, there are two distinct sources of foreign liquidity that should be recycled to global capital markets through institutional arrangements. The first is the traditional recycling of hard currency from countries underrepresented in the multilateral system but with large stocks of foreign reserves. The second is recycling of G3 funds attracted by the flight to quality. Both types of recycling, as with petrodollars in the 1970s, could simply be channeled through the IMF, as Japan, the United States, the Euro zone and a few other countries are doing. However, there are also alternative proposals on the table, such as setting floors on emerging market assets prices similar to those being implemented for toxic assets in the United States. Both recycling mechanisms can provide arrangements serving the objectives of both borrowers and lenders in a global crisis.

As discussed above, a way to contain demand of multilateral financing is to use the crisis as an opportunity to engage in institutional reform by establishing a credible commitment to strengthen future fiscal balances along the lines of a structural fiscal framework. The key would be to establish an independent and reputable agency to produce and disclose the structural position of the fiscal accounts in such a way that national debate on fiscal aggregates revolves around these structural estimations. The benefits are clear. First, it is efficient because it allows the stabilization of tax rates and public spending. Second, it would enlarge the sustainability space and allow a larger scope for a countercyclical response in the current downturn, be it a stimulus package or a shallower adjustment. Third, and related, such an approach would attract more financing from the market. Not only are the benefits clear, but the time is also right from a political economy viewpoint. The implementation of a structural fiscal framework in this downturn would not come accompanied by an adjustment to the current fiscal balance, as would happen in boom times, but rather with a friendly expansion.

Several other actions may help contain the cost of multilateral intervention. First, it is important to persuade individual countries to go to multilaterals sooner rather than later. Specifically, there is a need for peer pressure: leading emerging economies in the G20 should be encouraged to go to the IMF early, while the large bilateral donors should make it a condition for support, especially now that the arsenal of lending facilities of the IMF has been modified in the right direction. MDBs could be an intermediary to facilitate this process rather than being used as an alternative to avoid going to the IMF. Moreover, the so-called stigma problem is misleading in the current circumstances. As the recent examples of Mexico and Poland illustrate, the world economy is in a state in which markets would likely cheer similar initiatives and would take a benign view of countries that try to move proactively.

It is also important to prioritize countries and activities, recognizing systemic relevance and matching country size with appropriate source of support. There are applicable operational notions of country vulnerability, but the current circumstances require a notion of “systemic relevance.” In other words, there is a need to distinguish systemically important countries or systematically important activities in certain countries. Moreover, we need to differentiate large from small countries to treat them differently because magnitudes are too great in systematically important countries.

Under either modality of fiscal support discussed above, reserves or budget support, there are risks that intervention remains inadequate if it is limited to fiscal concerns. As there are competing demands on limited stocks of foreign reserves or lines of credit in hard currency, the issue arises of how to prioritize them. Obviously, official reserves are needed to lean against the wind and smooth changes in the equilibrium real exchange rate. They must also be used to roll over public sector debt coming due in foreign currency (and possibly domestic currency, when monetizing the debt poses significant inflationary risks). Foreign currency liquidity may be needed to provide credit to the private sector previously provided by private foreign and domestic residents, or to facilitate the rollover of private sector liabilities in case the shock were to be very protracted. In past episodes of Sudden Stops, for instance, it has proven to be crucial to support trade credits (such as in the case of Brazil in 2002).[13] In the current environment, protecting domestic credit growth to small and medium enterprises likely to be rationed out of the market may be equally important. Finally, additional potential claims on reserves include the provision of foreign currency liquidity to the banking sector if it is under stress from the deposit side of the balance sheet (as in Uruguay in 2002) or from the pulling back of foreign lines of credit.

In practice, with scarce hard currency resources, support must be prioritized. In fact, in addition to fiscal stimulus and backstopping liquidity, there is a need to preserve the flow of private credit. As part of this attempt, multilaterals may be backing active financial policies of directed lending, either through public or private banks. A multilaterally financed initiative is more likely to be successful, as country-led initiatives risk running out of money before the crisis is over. Given that countries are directing lending into economies with increasing insolvency, there is a risk that once they were to run out of own resources, they would face a much worse situation.

To be sure, it is important to avoid the institutional arrangement that emerged for the international trade regime whereby progress (or lack thereof) with multilateral liberalization has been crowded out by a proliferation of bilateral trade agreements. Also, tied bilateral financial aid in this context may serve as a cloak for protectionism on the part of the donor. Multilateral institutions ought to remain central and guarantee a level playing field by requiring bilateral arrangements to abide by common principles.

6. Looking Ahead

Full reform and recapitalization of the multilateral financial institutions cannot be put in place in time to avert the spreading of the current crisis, but it should be an objective for the post crisis era. The current situation does not provide time to change the international financial architecture, but we should not lose sight of the shortcomings of the system for post-crisis reform.

The secular increase in international financial integration requires a recapitalization of the system regardless of the need to intervene in response to the current crisis. The current crisis, however, has vividly exposed the risks associated with the notion that an increased role of

[13] Protecting trade credits was vital during Sudden Stops as their disappearance constraints further the availability of foreign currency in the domestic market.

private capital markets justifies moving toward elimination of public sector intervention in the form of multilateral surveillance and lending. The global nature of the current crisis that is affecting all countries in all regions at the same time, albeit in slightly different manners across countries, strengthens this case and calls for an urgent response.[14]

The governance structure of the multilateral system is also inadequate. The international monetary system is one in which countries that have embraced globalization and are now in large and persistent international creditor positions hold such small stakes in the system that they o have no incentive to participate fully, or assurance that will be able to do so—including by means such as putting significant resources at the system's disposal. Vice versa, countries that are progressively less integrated into the world economy continue to be overrepresented in the system by virtue of arcane and outdated representation formulas. The G20 represents an interesting development in this regard and is a natural forum for discussions between creditor and borrower nations.

There is also an urgent need to revisit multilateral policies on crisis prevention and crisis resolution. First, it is important to foster the emergence of country insurance products for crisis prevention. The most effective way of securing countercyclical financing to countries in need is not through ex-post multilateral lending, but instead through ex-ante establishment of contingent contracts that deliver countercyclical private financing. Contingent contracts transferring resources to countries in the event of low export prices or generalized credit rationing in international financial markets, to mention two examples of relevant exogenous shocks, would amount to automatic financial stabilizers. Multilateral financial institutions have a role to play in helping to develop these instruments, which would entail a contingent increase in their balance sheet exposure in exchange for a reduction in the capital needed to provide countercyclical financing. If the private sector is successfully engaged in participating in these country insurance schemes, the multilateral capital required to address countercyclical needs would be minimized.[15] Of course, countercyclical lending is premised on the assumption of procyclical repayments.

[14] Recent theoretical analysis of multilateral and commercial lending confirms the social optimality of the former, given the pro-cyclicality of the latter (Boz, 2009).
[15] The argument has been made that contingent private loans would have the effect of private creditors lowering their country credit ceilings anticipating future overindebtedness, without changing the fundamental problem. Derivatives that do not create debt but simply transfer resources ex-post, such as insurance or swaps, may be more attractive in this regard.

This implies adequate terms of lending to match the required cyclical flows and clarity about the countercyclical purpose of these facilities.

Second, discussions on institutional arrangements for crisis resolution should resume in earnest. Unfortunately there remains a gaping hole in the international financial architecture in relation to debt restructuring, and the international community's heralded "solution" of Collective Action Clauses still appears inadequate to deal with these cases. This implies that countries forced by the current crisis to restructure debt obligations will likely see "punishment" far out of proportion to their "crime" and far more suffering than if a comprehensive resolution technique such as an efficient bankruptcy resolution procedure had been put in place. There is still much work to be done here, as unfortunately may become evident if the world economy does not improve relatively soon and debt restructuring become necessary in critical cases.

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