IMF needs to be more than just Santa Claus
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The global financial crisis has shifted the International Monetary Fund from being an expert but largely irrelevant commentator on the sidelines of global economics to being a central player. But its role is still confused.

Most prominently, it has dealt itself into the action through big assistance programs for Romania, Poland, Hungary, Ukraine, Iceland, Latvia, and now Greece. Gone are the penny-pinching handouts of the 1997-98 Asian crisis, where programs amounted to about 2 per cent of a recipient's gross domestic product. Now close to 10 per cent is the norm, and the assistance given to Hungary larger still.

There is nothing necessarily wrong with that: big problems require bold responses. But in at least one case, the analytics seem seriously flawed. In its eagerness to play a leading role in the Greek rescue, the IMF has failed to provide the analytical backbone that its central core mission requires.

It is the IMF's role to point out the inconvenient truth that Greece is not a case of temporary illiquidity, but rather insolvency. Greece lacks the political will to put a swift end to years of living beyond its means. Moreover, its membership of the euro zone limits its options: it cannot devalue to boost export demand.

The need is not for more temporary funding, but for the restructuring of an unsustainable government debt burden. The bailout just delays the inevitable default/restructuring, while letting private sector creditors off the hook and transferring the inevitable losses to the European governments which arranged the bailout.

It can be argued that this is a politically driven solution. Maybe, but the IMF's job is to insert sensible hard-nosed economics into this sort of exercise. If that is not possible, it should stay out of the game.

This is not the only example of the IMF's eagerness to deal itself into the action by lowering its lending standards. Having imposed politically crippling conditionality on Indonesia in 1997, the IMF has swung to the other extreme and is ready to lend with no conditionality at all, through its Flexible Credit Line. With little fanfare, Mexico has received an allocation as big as the rescue operation in its 1994 crisis.

Such is the residual political stigma in Asia attached to any borrowing from the IMF that neither Korea nor Indonesia chose to use the facility, even when under great pressure in 2008. Instead, Korea drew on a $US30 billion ($35 billion) swap facility from the US Federal Reserve. Now the IMF, determined not to be bypassed as the source of assistance in times of trouble, is negotiating with Korea to create an even more flexible facility which mimics the characteristics of the Fed swap.

This amazing about turn – from tight-fisted Scrooge in 1997-98 to Father Christmas today – reflects deeper issues. Its governance structure largely reflects global power distribution at the end of World War II. The Netherlands and Belgium, together, have more voting power than China. It's hardly surprising that an organisation grossly overweight on European voting power made the politically expedient decision to delay addressing Greece's intrinsic problem. Managing director Dominique Strauss-Kahn is widely believed to have presidential aspirations back in France and is seen as using his position as an active and generous source of funding as part of the campaign.

Two elements in the IMF's make-up need substantial rebalancing. First, the governance needs drastic restructuring so it is less at the whim of current political pressures and

personalities, and more able to reflect hard-nosed economics and the current balance of geopolitical power.

Second, the IMF has to restore its role as an overriding, analytical umpire. It has by far the strongest team of global policy analysts anywhere, but they must be allowed to do more than comment from the sidelines. Their analysis must be the central guiding framework of the IMF's lending programs, and the analytical foundation of G20 economic discussions.

What would this mean in practice? Greece's concerns have infected the whole euro zone. Financial markets fret about the fiscal position of just about every European country. Even countries with sustainable fiscal positions are being urged to tighten fiscal policy, despite weak economic activity, for fear that the "bond market vigilantes" will cut off government funding. This threat of a "double dip" hangs like a black cloud over global recovery prospects.

The best way to deal with the situation may be to isolate the clearly insolvent countries. The IMF is an obvious candidate to organise the necessary sovereign debt rescheduling, with Greece the first candidate. An orderly restructuring, perhaps along the lines of the 1980s Latin American Brady bonds, would leave creditors with losses, but moral hazard considerations require nothing less. This would re-establish the precedent that sovereign debt can default. In future, lenders will have to make a risk assessment, thus asserting discipline over sovereign borrowers, just as they do for private debt.

After Greece, can a sensible defensive perimeter be drawn around other countries which are on the market's hit list? Portugal starts with much less government debt. Spain, too, has smaller government debt and, more importantly, a government which seems ready to address the key problems.

With the insolvent cases clearly isolated and dealt with and the IMF's resources standing ready to shore up the defences of the rest of Europe, European countries could get along with fiscal policies appropriate to their needs, without the bond vigilantes breathing down their neck.

The IMF's core duty is to speak out unambiguously in circumstances where politics is overriding hard-edged economic analysis. If it fails to do this, the specific problems in an individual small country can infect the global economy.