CHAPTER

I Introduction

1. This evaluation assesses the performance of IMF surveillance in the run-up to the global financial and economic crisis. It examines whether the IMF identified the mounting risks and vulnerabilities that led to the crisis and effectively warned the countries directly affected as well as the membership at large about possible spillovers and contagion. The evaluation analyzes the factors that might have hindered the IMF's effectiveness, and offers recommendations on how to strengthen its ability to discern risks and vulnerabilities and to warn the membership in the future.

A. Evolution of the Crisis[1]

2. By mid-2007, world financial markets were in turmoil, and by 2008, the world was engulfed in the worst financial and economic crisis since the 1930s, with the global financial system threatening to collapse and sharp declines in activity across major economies. The story of the crisis is a complex one. Most analysts agree that the crisis stemmed from a combination of unconstrained financial innovation, too much global liquidity, and an extended period of accumulating macroeconomic and financial imbalances that supported an unsustainable increase in financial leverage and risks. The crisis initially manifested itself in the United States and some European financial sectors, with financial institutions facing large but uncertain losses after housing price declines accelerated and mortgage-backed securities markets collapsed. Many argue that the widespread use of very high leverage by financial institutions to underwrite and invest in difficult-to-value structured financial instruments was made possible by lax regulation and supervision in the United States and other major financial centers. Others stress that easy monetary policy and the moral hazard due to the "Greenspan Put"[2] created the environment for the housing and financial asset bubbles to develop, and that large capital inflows in deficit countries inflated these asset bubbles further. This evaluation discusses the effectiveness of IMF surveillance in identifying and conveying to the membership the critical vulnerabilities that were important in shaping or exacerbating the financial crisis; but it does not expound on the relative roles of these factors in bringing about the crisis.

3. The crisis unfolded in several waves (Figure 1). U.S. housing prices reached their peak in 2006. By mid-2007, increasing defaults in the U.S. subprime market led to the failure of some hedge funds and mortgage companies in the United States and Europe, spikes in credit spreads, and liquidity problems in interbank markets. By early 2008, many of the advanced economies were entering an economic downturn. Between March and September 2008, Bear Stearns, Fannie Mae, and Freddie Mac were rescued from deep financial troubles with U.S. government support. In September of that year, the Lehman Brothers collapse led to a reassessment of risk, triggering a liquidity crisis and a sudden stop in capital flows around the world. This, together with the sharp drop in global economic activity, spread the crisis to emerging markets. Domestic vulnerabilities also played a major role in the contagion. Some of the most adversely affected emerging and advanced economies had pursued policies that made them particularly vulnerable—they had experienced rapid increases in consumer debt, high leverage ratios in many finanical institutions, and housing and equity market booms.

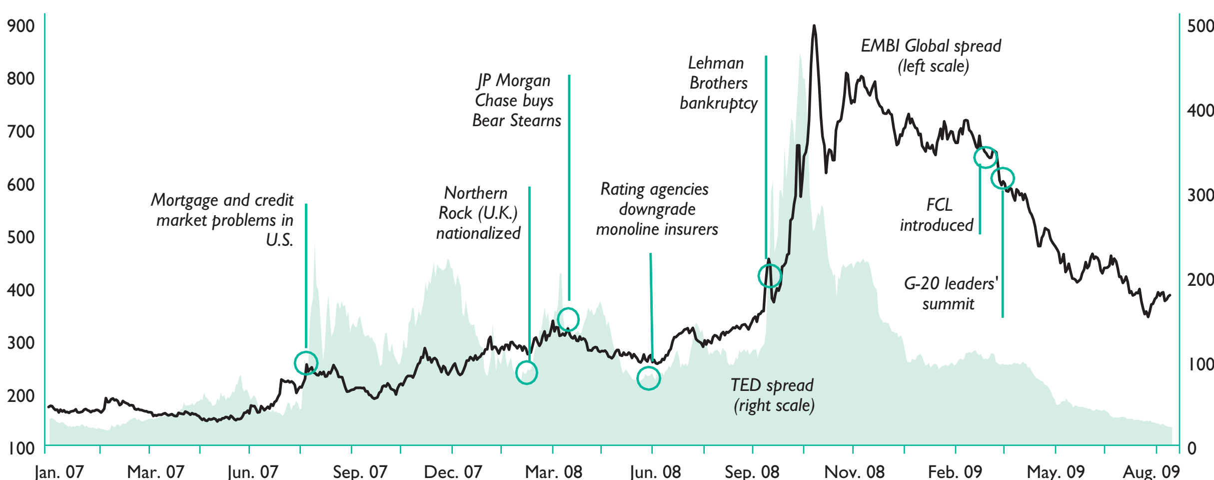
B. IMF Surveillance Objectives

4. This evaluation examines how well the IMF met the objectives of surveillance in the run-up to the crisis. Surveillance is one of the IMF's core activities. It consists of monitoring the global economy and that of member countries to help head off risks to international monetary and financial stability, alert member countries to potential risks and vulnerabilities, and advise them of needed policy adjustments. The two main modalities of surveillance are multilateral and

[1] Annex 1 presents a timeline of relevant events from 2004 to 2008. Annex 2 summarizes the IMF's own analysis of the factors that contributed to the crisis.

[2] The "Greenspan Put" refers to the markets' belief that the Federal Reserve would lower interest rates and provide liquidity in reaction to large market disturbances.

Figure 1. Timeline of Crisis in Advanced and Emerging Markets
(Basis points)



Source: Reproduced from IMF (2009d).

bilateral. Multilateral surveillance focuses on ensuring the stability of the global system and is mainly conducted via two twice-yearly "flagship" publications—the *World Economic Outlook* (*WEO*) and the *Global Financial Stability Report* (*GFSR*)—and through confidential discussions of World Economic and Market Developments (WEMD).[3] Bilateral surveillance centers on Article IV consultations, that is, IMF Executive Board (the Board) discussions of a staff report that is prepared following a staff visit to the corresponding member country to assess its policies and compliance with the IMF Articles of Agreement.[4]

5. The implementation of surveillance and expectations regarding the IMF's role have evolved in response to changes in the global economic environment. The series of crises in the 1990s led to the recognition of the importance of a healthy financial sector in supporting macroeconomic stability and thus to some major changes in the practice of surveillance. In 1999, the IMF and the World Bank introduced the Financial Sector Assessment Program (FSAP) to help promote sound financial systems in member countries. IMF area departments were tasked to examine macro-financial linkages as part of Article IV consultations. In 2001, the IMF's International Capital Markets Department (ICM) was established to focus on systemic capital market developments and risks. In 2006, the Monetary and Capital Markets Department (MCM) was created (by merging ICM and the Monetary and Financial Systems Department), with the aim of better integrating the work on financial institutions and capital markets. In June 2007, the Board adopted a Decision on Bilateral Surveillance to clarify the purpose of bilateral surveillance, using the concept of a country's external economic stability as the organizing principle.

C. Outline of Report

6. The report is organized as follows: Chapter 2 discusses the evaluation framework, including its scope, questions, and methods. Chapter 3 considers the IMF's messages to member countries in the run-up to the crisis. Chapter 4 explores possible reasons for the IMF's performance, and Chapter 5 concludes with recommendations to strengthen the IMF's surveillance in the years ahead.

[3] The WEMD discussions refer to periodic, strictly confidential discussions at the IMF's Executive Board on the key risks to the global economic and financial outlook.

[4] See, in particular, www.imf.org/external/pubs/ft/aa/aa04.htm for the obligations of IMF members under Article IV of the IMF's Articles of Agreement.