CHAPTER

5 Toward More Effective IMF Surveillance

66. In considering recommendations, the aim is not to predict a crisis, as crises and their triggers are inherently unpredictable. It is rather to strengthen the IMF's working environment and analytical capacity to better allow it to discern risks and vulnerabilities and alert the membership in time to prevent or mitigate the impact of a future crisis. The Fund needs to cultivate a culture that is proactive in crisis prevention, rather than primarily reactive in crisis response and management. It needs to take measures to prevent or mitigate future crises, as much as to address the weaknesses that were uncovered by past crises.[33] To this end, it should continuously scan for risks and emphasize vulnerabilities, rather than playing the role of uncritical enthusiast of authorities and the economy.

67. The IMF has already taken steps to address some of the weaknesses that were evident in the run-up to the crisis. Among these are the inclusion of advanced economies in the Vulnerability Exercises, the launching of the Early Warning Exercise, increased research on macro-financial linkages, the preparation of reports that analyze spillovers and contagion from systemic economies, and the recent decision to make financial stability assessments under the FSAP a mandatory part of surveillance for the 25 most systemic financial sectors. These are welcome developments. However, the IMF expressed the need for similar steps after previous crises, but some of them were not implemented at that time and the results of others have not been as positive as had been hoped. Thus, it is critical to establish a process of monitoring reforms and evaluating their impact, as the basis for designing new and corrective initiatives. This is as true for the following IEO recommendations as it is for the ongoing reforms and recommendations from previous studies (Annex 6). The implementation of these initiatives will need close attention by Management and Board oversight, as well as the support of authorities in member countries.

[33] Most of the following recommendations focus on changes to deal with risks and vulnerabilities in the financial sector. The IMF should also scan for risks and vulnerabilities in other areas that could be at the center of a future crisis. For example, a future crisis could have fiscal and/or debt sustainability origins. If so, a possible response could be developing a comprehensive diagnosis program focused on public finances, perhaps along the lines of the FSAP.

68. A common theme across this report's recommendations is the need to address weaknesses in IMF governance, a recurrent theme in IEO evaluations. In this context, it is critical to clarify the roles and responsibilities of the Board, Management, and senior staff in providing incentives for staff to deliver candid assessments, in overcoming the obstacles of silos and "fiefdoms," and in confronting political constraints. The IMF needs to establish better mechanisms for monitoring implementation and a clear accountability framework.

69. Five general recommendations are each followed by more specific suggestions on how they could be implemented. These suggestions should be seen as a starting point for further reflection; they are not necessarily the only way to follow through, and alternative approaches could have significantly different resource implications.

Create an environment that encourages candor and diverse/dissenting views

- Actively seek alternative or dissenting views by involving eminent outside analysts on a regular basis in Board and/or Management discussions.
- Create a risk assessment unit that reports directly to Management, with the purpose of developing risk scenarios for the systemically important countries and analyzing tail risks for the global economy. This unit should organize periodic Board seminars on the risk scenarios and provide an assessment on whether its analysis was appropriately incorporated into multilateral and bilateral surveillance.
- Change the insular culture of the IMF through broadening the professional diversity of the staff, in particular by hiring more financial sector experts, analysts with financial markets experience, and economists with policy-making backgrounds.
- Ensure that Summings Up of Board discussions better reflect areas of significant disagreement and minority views.

- Encourage the staff to be more candid about the "known unknowns," to be more ready to challenge their own preconceptions, and to frankly disclose the limitations of data and technical tools underlying its analysis.

Strengthen incentives to "speak truth to power"

- Management should encourage staff to ask probing questions and challenge Management's views and those of country authorities. Well-founded analysis should be supported by Management and the Board even when the diagnosis might not be shared by country authorities.
- In order to promote more effective bilateral surveillance, consideration must be given to the possibility of issuing staff reports without the need for Board endorsement. This could be followed by a peer review process structured to give surveillance greater traction.
- Clarify the roles and responsibilities of Board members and Management in ensuring that staff is not unduly constrained by political considerations when conducting surveillance.
- Conduct regular IMF-wide self-assessments to look at the health and functioning of the organization. As is common practice in private corporations and in some other international organizations, this assessment should be managed by an independent external consultant and its results delivered to the Board. In addition to considering factors like staff morale, communication, teamwork, and diversity, the assessment should gauge staff perceptions on their ability to challenge IMF-held views in internal discussions and authorities' policies in conducting surveillance.

Better integrate financial sector issues into macroeconomic assessments

- The recent Board decision to make the financial stability assessment component of the FSAP a mandatory part of the IMF's bilateral surveillance for the world's top 25 financial centers every five years is welcome. It is necessary, however, to ensure that the coverage, periodicity, and participation in the mandatory financial stability assessments reflect new developments in the rapidly changing financial markets and institutions. In particular, the coverage of institutional, regulatory, and supervisory issues is critical to ensuring the robustness of these assessments. The Board should also revisit the possibility of conducting mandatory financial stability assessments every three years, once the IMF has collected sufficient information about how quickly assessments become outdated relative to the corresponding financial systems.
- Continue to strengthen the FSAP and address the problems, noted in Annex 5, which limited its effectiveness in the run-up to the crisis.[34] In particular:

  —Develop analytical tools to better integrate the analysis and results of FSAPs into bilateral surveillance;

  —Continue to enhance the analytical rigor of assessments by strengthening the methodology for assessing liquidity risk, spillovers, and contagion;

  —For stress tests and the FSAP analysis, consider more severe shocks, taking into account domestic, global, and regional developments and risks (drawing on the Early Warning Exercise, the *WEO,* and *GFSR*);

  —Enhance candor and clarity in the FSSAs, including an explicit discussion of data and methodological qualifications regarding stress test results; and

  —Give greater attention to the role of nonbank institutions and markets, and financial conglomerates in the assessment of financial stability.
- The IMF should strengthen its ability to regularly monitor, assess, and warn about stability in global and systemic financial markets and institutions. To this end, it should continue to strengthen its collaboration with the Financial Stability Board, particularly on developing the systems necessary to more effectively monitor financial stability. But the IMF should also build up its own capacity to independently assess risks and vulnerabilities in financial sectors as part of bilateral surveillance.
- Management should report to the Executive Board on a biannual basis on the results of its efforts to strengthen macro-financial integration in bilateral and multilateral surveillance. Higher priority should be given to research on macro-financial linkages.
- Strengthen financial sector expertise in the IMF by updating the staff's knowledge through training and by hiring experienced market participants in both the Monetary and Capital Markets Department (MCM) and area departments.
- Missions to G-20 economies and other financial centers should include experienced financial

[34] This recommendation builds on "Financial Sector Assessment Program After Ten Years: Background Material" (IMF, 2009b).

experts. Moreover, MCM should be given a more prominent role in the surveillance of these economies, for example, by having sign-off responsibility akin to SPR.

Overcome silo behavior and mentality

- Management should clarify the rules and responsibilities for the internal review process, in particular for "connecting the dots." It should hold the corresponding units and senior staff responsible for integrating multilateral and bilateral surveillance, taking account of alternative views, bringing cross-country experience to bear, and having policy consistency across countries/regions on cross-cutting issues.
- Establish interdepartmental collaboration at an earlier stage of the Article IV process and of the development of themes and ideas for multilateral surveillance documents. Ensure that substantive differences in departments' views are addressed as they arise.

Deliver a clear, consistent message to the membership on the global outlook and risks

- Ensure that the assessment of the global economy is consistent and comprehensive, taking a stance on a central scenario with clear specifications of risks and vulnerabilities around this scenario. This assessment should be transmitted to the membership in a clear fashion. One way to do this is by better integrating the analysis and assessments of the *WEO* and the *GFSR*. Alternatively, the IMF could issue a self-standing global surveillance report—a short, candidly-written document on the macroeconomic outlook, risks to global financial stability, and potential spillovers.
- On issues of systemic importance, the Fund should be ready to err more often in the direction of emphasizing risks and vulnerabilities, rather than focusing on possible benign scenarios. This change in approach would need to be discussed and agreed by the membership at large.