



Independent Evaluation Office
of the International Monetary Fund

BACKGROUND PAPER



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IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–07

Summary of Views of the Advisory Group

December 9, 2010

IEO Background Paper
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Advisory Group members: Hamad Al-Sayari, Otmar Issing, Jin Liqun, Rachel Lomax, Tito Mboweni, Guillermo Ortiz, Yaga Venugopal Reddy, Eisuke Sakakibara, Edwin Truman, and William White

The views expressed in this Background Paper are those of the Advisory Group and do not necessarily represent those of the IEO, the IMF or IMF policy. Background Papers report analyses related to the work of the IEO and are published to elicit comments and to further debate.

Summary of Views

1. The Advisory Group met on October 5, 2010 in Paris and discussed preliminary findings, conclusions and recommendations of the IEO evaluation on the IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–07. Members considered the evaluation to be of high quality, forthright and balanced and broadly endorsed its analysis, conclusions and recommendations. They particularly emphasized some points and added others, including some important suggestions for making IMF surveillance more effective.

Findings and conclusions

2. Advisory Group members underscored the evaluation’s message that the Fund did not warn member countries about the risks and vulnerabilities that had led to the crisis—a core mandate of the Fund. In sharing their own experiences of discussions with Fund surveillance missions many members noted that these missions had focused on domestic issues and rarely devoted sufficient attention to the risks of spillovers and contagion from problems originating in advanced economies. In the discussion, members raised some issues regarding the causes of the crisis:

- Advisory Group members drew parallels with previous financial crises. The development of the crisis was seen as a complex story, particularly in the United States, but most members agreed that it was the culmination of a period of accumulating macroeconomic and financial imbalances. Failings of monetary policy—too low interest rates, too much liquidity—and the impact of excessive credit on the real economy, on lending standards and on asset prices, together with unchecked financial innovation that allowed for a large and rapid increase in financial leverage and risks, were among the underlying causes of the crisis. Advisory Group members agreed that signs of the crisis were initially manifested in the United States and in Europe in mid-2007, and that it then spread around the globe.
- Members suggested that there should be a thorough external review—outside the scope of this evaluation—of the sources of the crisis and the failure of the prevalent macro-economic analytical framework, which largely ignored the role of financial intermediation.

3. Advisory Group members broadly agreed with the major conclusions of the report, namely, that analytical weaknesses, organizational impediments, internal governance problems, and political constraints each played a role in the Fund’s failure to warn its members about risks and vulnerabilities that led to the crisis. They made special note of the following points:

(a) *With regard to analytical weaknesses:*

- The Fund had made insufficient progress in taking into account the interactions between the financial and real sectors and the role of credit in its analysis. The Advisory Group recognized that the intellectual framework and modeling for such analysis remains underdeveloped, but members thought this should not be seen as an excuse for a failure to recognize the importance of such interactions. Fund economists had become over-dependent on a narrow group of economic models. More generally, most members felt that Fund staff and national policy makers should avoid relying solely on formal models to identify and assess risks and vulnerabilities.
- For some time many outside the Fund, and some inside the Fund, had raised major concerns about financial stability; but these concerns were not sufficiently listened to. This was partly because of the confidence of the authorities in many advanced economies, and in particular in the United States, that financial institutions in their countries knew how to manage risks—a belief strengthened by the experience of successfully coping with several financial disturbances in recent decades.
- Part of the problem was the similar mindset of many mainstream economists working at the Fund, with similar background and training and who were not open to dissenting views. Both in and outside the Fund, there were other economists and policy makers with contrarian views. But their views were not encouraged or closely examined within the Fund.
- Members linked this problem to IMF governance, pointing out that the Fund, like other similar institutions, is by construction political, with associated challenges to its effectiveness.
- A related problem was the widespread belief that there could not be a serious crisis in a large advanced country, despite the Japanese experience, which should have been examined more fully. The presumption was that structural changes in the financial sector in advanced countries were benign. This colored and partly explained the differences in advice given to advanced and emerging market countries over the period.

(b) *With regard to organizational impediments and internal governance:*

- The lack of effective communication between economists and financial experts in the Fund, and the way the organization operates in silos—and the second class status of financial experts at the Fund in relation to macro-economists—like other issues reflect weaknesses in Fund management and governance. The rapid turnover of Management, Economic Counselors and other senior staff had also not been helpful.

- Members noted a general unwillingness of staff to challenge national authorities in advanced and large emerging market countries, and suggested that several of the IEO report's findings, such as the contradictory advice given in different countries facing similar problems, could be explained by this factor. Members also noted that the Fund appeared to be more willing to challenge authorities on fiscal policy than on monetary and financial issues. In particular, they saw a tendency of Fund staff to uncritically align its views with those of some monetary authorities and financial regulators in advanced countries.

(c) *With regard to political constraints:*

- Members accepted that there is no evidence of direct pressure from the U.S. authorities to change the message of the U.S. Article IV consultation. They noted, however, that pressure was exerted by major countries in relation to the messages in the Fund's multilateral surveillance, in its bilateral surveillance of other countries, and in some cases in bilateral surveillance of their own economies. This could have contributed to staff self censorship, which the Advisory Group accepted had happened. Such pressure could also have affected Management's priorities over the period and could have distracted attention from the vulnerabilities that led to the crisis; though Fund Management and staff should have been able to multi-task.
- Members emphasized in particular the unfortunate convergence of views at the time between the Fund and the United States and other advanced countries' authorities. It appeared to be a case of complete intellectual capture. They were concerned about the unwillingness of staff to challenge authorities' views on the soundness of financial institutions. Members noted the IEO report's assessment that there were incentives that discouraged staff from "speaking truth to power."

Recommendations

4. Advisory Group members saw a well functioning and effective Fund as a central pillar for better multilateral cooperation which is critical to greater global economic and financial stability. To this end, they placed particular emphasis on the need to strengthen the Fund's management and governance, and endorsed the main recommendations of the IEO report, namely the need to:

- *Create an environment which encourages candor and considers diverse/dissenting views;*
- *Modify incentives to "speak truth to power;"*
- *Better integrate macroeconomic and financial sector issues;*
- *Overcome the silo mentality and insular culture of the Fund;*

- *Deliver a clear, consistent message to the membership on the global outlook and risks.*
5. The Advisory Group also made a number of additional observations and emphasized some of the IEO recommendations:
- Members agreed that there should be some form of process, parallel to regular surveillance work, with the explicit task of scanning for “out of the box” risks to the global economy and to individual members. This process would be aimed at identifying things that could go wrong and challenging the institutional orthodoxy. Two alternatives were suggested to achieve this: establishing a dedicated separate risk assessment unit reporting to Management, or setting up ad hoc groups, possibly staffed from both inside and outside the Fund, to assess alternative downside scenarios.
 - There should also be a more systematic attempt to seek out external views and present them within the Fund.
 - The Fund needs to be much more open than it has been to alternative analytical frameworks. It would help to widen the pool of economists by recruiting from a greater diversity of backgrounds, including more staff with hands-on policy experience.
 - A change in staff incentives is needed to encourage greater candor and clarity, a greater willingness to challenge national authorities, and more candor about the limitations of their analysis. At a minimum, Management should aim to ensure that lack of candor and clarity and giving priority to “getting along” with national authorities are not seen as key to enhanced career prospects.
 - Like central banks, the Fund should see its job to worry and not hold back from noting risks and downside scenarios in bilateral as well as multilateral surveillance. The Advisory Group thought that 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. Member country authorities would have to discuss and agree on such an approach.
 - Staff should be ready to challenge national authorities on all aspects of economic and financial policy while being equally ready to learn from their experience. The Fund would need to find ways to do so, without creating adverse market reactions, but this was seen as a problem mostly for smaller countries.
 - In multilateral surveillance it would help to find a way to integrate the *WEO* and *GFSR* into a single report, which would both help improve coherence and provide a more efficient way to get the Fund’s messages to member countries. However, the

Advisory Group recognized the organizational difficulties involved and the risk of reducing the diversity of views. Some suggested it could be useful for the combined report—or the *WEO* and *GFSR* separately—to note also alternative, contrarian, views.

- Board review of surveillance documents was seen as having had little added value or impact, in spite of some insightful interventions in several discussions. This was seen as an issue that needed to be addressed. The Advisory Group considered the need for a more effectively structured process of peer review by the Board. In order to promote more openness and candor, as well as less political interference, members discussed the possibility of issuing staff reports without the need for Board endorsement.
- Bilateral surveillance of systemically important countries, including that of the United States should be resourced by the Fund in a way commensurate with their importance for the rest of the world. The Advisory Group agreed that the IEO report correctly asks whether the Fund warned the rest of the membership about the potential problems building up in the United States and Europe. More generally, the Fund needs to address the question of whether and to what extent its recommendations to major economies take into account their impact on other countries and on the global economy.
- Members expressed frustration that many of the recommendations in the IEO report, as well as their own, had been repeatedly made before, but that insufficient action had been taken. This, like other problems revealed by the IEO report, reflects weaknesses in Fund management and governance. The Advisory Group called on member country authorities and Management to ensure that these weaknesses are addressed and that the necessary reforms are implemented in an effective manner.

6. To conclude, the Advisory Group stressed the need to address the recommendations at the highest possible level. Country authorities and Fund Management should undertake to change the Fund “culture” towards greater candor in its assessments and greater openness to alternative views. In particular, country authorities should encourage and welcome Fund missions’ candid and objective assessments of their policies and prospects.