Staff Response to the Independent Evaluation Office Report on IMF Performance in the Run-Up to the Financial and Economic Crisis

Executive Board Meeting
January 26, 2011

This report nicely complements IMF analysis about the failure of Fund surveillance to adequately anticipate and warn about the global crisis. While it could have been more specific in certain areas and staff have concerns about some methodology, inferences, and factual errors, none of this detracts from the correctness of the report's recommendations.

General Points

1. On the bottom line, two points should be acknowledged up front.

- First, the IEO correctly identifies the Fund's failure to call attention to the buildup of vulnerabilities and risks in the global financial system. This is in line with recent IMF work, such as the 2009 paper on the *Initial Lessons of the Crisis*, the 2008 *Triennial Surveillance Review*, and the recent review of the *Fund's Mandate*. These papers came to similar conclusions and proposed reforms.
- Second, it is true that much remains to be done to implement remedies, many of which are well in train but whose effectiveness remains to be seen. The IEO report briefly highlights a few of these, such as the inclusion of advanced economies in the Vulnerability Exercises (VEs), the launching of the Early Warning Exercise (EWE), more research on macro-financial linkages, the introduction of spillover reports for systemic economies, and the move to mandatory stability assessment modules under FSAPs for systemically important financial centers. The larger challenge will be to ensure that this new work consistently finds its way, as it lately has done, into frank discussion of vulnerabilities and responses—at least in private when it is not possible to do so in public.

2. On the core issue of *why* the Fund failed to predict the crisis, the report examines institutional factors, some of which ring true and others that warrant more reflection. On one side, despite progress, it is clear that we need to enhance our capacity to better "connect the dots" between financial and macroeconomic surveillance and between multilateral and bilateral surveillance. On the other side, the report ultimately ascribes the failure to warn about the crisis to "groupthink," which is as much a description as an explanation. The report could have looked more at the extent to which staff considered contrarian views (arguably, they did) and how they judged these positions against the much larger evidence marshaled by the mainstream (clearly, they judged incorrectly). This also speaks to the IEO recommendation to increase financial expertise and staff diversity—which undoubtedly is correct, and indeed a goal of the institution, but does not follow from the pre-crisis experience: the vast majority of financial experts, from a diversity of countries and backgrounds, also failed to see the crisis coming. (Ironically, the prescient individuals cited by the report are from remarkably *undiverse* backgrounds—i.e., macroeconomists with PhDs from U.S.-U.K. universities.) That said, the recommendation to access thoughtful and diverse opinion is a very important one, and one that we return to below.

3. Staff also have concerns about some other aspects of the report, including the dismissal of the role of data gaps. Lack of information about off-balance-sheet exposures, risks housed in the shadow banking sector, interconnections (national and international), and bank-specific balance sheet data severely hampered real-time analysis. Such data could have said a lot about core issues—such as whether securitization was dispersing risk or concentrating it. Indeed, this subsequently led to significant multilateral initiatives on filling data gaps and exploring financial networks. Moreover, the resistance of supervisors to share relevant data on globally important institutions should have been emphasized as an important finding. Finally, the report is not without misrepresentations. For example, a closer reading of the text around the selective quotes

on the United Kingdom and the United States makes it clear that staff did cite many of the vulnerabilities seen over the crisis, but incorrectly judged their systemic importance. Similarly, the claim that the IMF had been recommending faster capital account liberalization in India is at odds with the documented record and even with the IEO's own 2005 report on *The IMF's Approach to Capital Account Liberalization*.

Recommendations

4. Staff strongly agrees with the thrust of the IEO's five recommendations. While there has been a comprehensive program of reform since 2008, it is clear that further improvements could be made. Staff welcomes this opportunity for the Board to discuss where best to focus these efforts, while being mindful of the current budgetary environment. Many of these could be taken up in the forthcoming *Triennial Surveillance Review* (TSR).

Recommendation #1: "Create an environment that encourages candor and diverse and dissenting views."

5. Staff agree that more can be done to seek alternative or dissenting views. In particular, the Board may wish to consider the case for *direct* interactions with eminent outside analysts, especially to present contrarian views, in both bilateral and multilateral surveillance. It should be noted, nonetheless, that much is already in train on enhancing outreach efforts by Fund Management and staff. These include the establishment of regional advisory groups, dedicated units within departments that focus on outreach and liaison, and heightened outreach to external stakeholders such as in the context of bilateral and multilateral surveillance (e.g., related to the WEO, GFSR, EWE, and the VEs) and reviews of and reforms to IMF policies and facilities.

6. We also agree that broadening financial sector expertise of IMF staff is important. Efforts need to continue in hiring financial sector experts and managing their career progression once in the Fund. In particular, consideration should again be given to developing a non-management promotion ("guru") opportunities for these experts, while being mindful of budgetary considerations.

7. The recommendation that "Summings Up of Board discussions better reflect areas of significant disagreement and minority views" warrants further discussion. This is more an issue for the Board than for staff, but clearly any change in this area would involve a re-think about the nature and purpose of Summings Up, which by design emphasize consensus building. The recommendation would benefit, though, from empirical backing, as the examples of Summings Up provided in the background paper (Switzerland and the United States) suggest that pervasive concerns about the outlook *were* acknowledged by the Board.

8. A separate risk assessment unit may not be useful, given overlap with other initiatives. As described in the report, the unit would report "directly to Management, with the purpose of developing risk scenarios for systemically important countries and analyzing tail risks for the global economy." With the advent of an Early Warning Exercise that includes advanced economies, this recommendation has effectively been implemented. Still, enhanced outreach to disseminate risk assessments under the EWE could be considered. In addition, the IEO should have made more concrete the vague proposal for staff "to challenge their own preconceptions … and frankly disclose the limitations of data and technical tools …."

Recommendation #2: "Strengthen incentives to speak truth to power."

9. This is a valid if exceedingly difficult issue for any international agency, and the IEO findings are relevant for both the staff and the Board. At a minimum, we must be ready to speak truth to power in private when financial stability is at stake and where there is a concern about triggering an adverse market reaction. This arguably has been done over the past two years since the onset of the crisis, and will need to be carried forward consistently. The upcoming *Triennial Surveillance Review* will examine the promotion of effective surveillance, including how best to present views that challenge those of the authorities. We agree on the need to conduct such regular self-assessments with input from both authorities and outsiders, as has increasingly been the case in recent years (the Fund's Mandate, medium-term strategy, conditionality). Internally, the review process has been strengthened to challenge initial staff positions with broader perspectives (see below).

Recommendation #3: "Better integrate financial sector issues into macroeconomic assessments."

10. The emphasis on the importance of the recent changes to the Fund's work on financial sector issues is welcome. In addition to the reforms of the FSAP, the Fund has taken other measures since the crisis such as additional hiring and better integration of financial sector experts, enhanced analysis of financial sector risks and surrounding policy issues in both multilateral and bilateral surveillance, the new macro-financial unit in the Research department, and significantly more resources to research and surveillance on financial markets and large and complex financial institutions.

11. The report makes some useful recommendations on further changes to the FSAP. In particular, staff would welcome a discussion of the possibility of conducting mandatory financial stability assessments every three years, an approach that did not command sufficiently broad support when last taken up by the Board.

12. The case for MCM sign-off on surveillance papers could have been better justified. An additional layer of sign-off responsibility runs counter to the progress achieved in recent years to streamline the review process and may actually increase the pressure to conform. Moreover, the next crisis may not be a financial one, so it could be equally argued that other departments, such as FAD, should sign off on surveillance papers. At any rate, the real issue is MCM engagement on financial sector issues in Article IV consultations for systemic cases, which has been increasing markedly and without recourse to added bureaucratic processes.

Recommendation #4: "Overcome silo behavior and mentality."

13. Despite recent progress, more can be done to foster cross-departmental collaboration. The new internal review process—with shorter, more focused policy notes (instead of briefing papers)—allows Fund departments to bring diverse multilateral and cross-country perspectives into country papers at an earlier stage. Many other initiatives also have been introduced since the crisis, including upcoming spillover reports written by cross-departmental teams, regional studies divisions in area departments, the vulnerability exercise for advanced countries and the early warning exercise, and weekly cross-departmental surveillance meetings led by the economic and financial counselors. Staff would have appreciated more specific suggestions from the IEO on furthering collaboration.

Recommendation #5: "Deliver a clear, consistent message to the membership on global outlook and risks."

14. The integration of the WEO and GFSR is being strengthened. Recent efforts include joint forewords and a new statement by the Managing Director that seeks to integrate themes. The case for full merger of the two documents is not clear cut, and some fresh analysis to justify the IEO's proposal for it would have been more useful than repeating the call for integration.

15. The recommendation to be ready to err more often in the direction of emphasizing risks and vulnerabilities in systemic cases needs to be thought through more carefully. The recommendation flows from the IEOs finding that cognitive biases affected the IMF's ability to predict the crisis. The question, however, is how to balance the potential to miss crises (Type I errors) against warnings about crises that never occur (Type II errors). The problem with the IEO's approach is that it could stoke bureaucratic impulses to pro-forma recitation of risks, thus increasing false alarms and reducing the traction of Fund surveillance.