CHAPTER 3

IMF Surveillance Following the Crisis

This chapter assesses how effectively IMF surveillance responded to the macroeconomic and financial sector challenges in the crisis aftermath, and then examines the IMF's efforts to revamp its framework for assessing risks and vulnerabilities. It concludes that:

- The IMF was effective in calling for global fiscal stimulus immediately following the Lehman collapse. But it prematurely endorsed fiscal consolidation in large advanced economies, and, in parallel, encouraged reliance on expansionary monetary policy to stimulate demand. This policy mix was less than fully effective in promoting recovery and contributed to capital flow volatility in emerging market countries.
- The IMF provided analyses of reform priorities in the financial sector and increased its focus on financial stability in economies with systemically important financial sectors by mandating FSSAs for them every five years. But five-year intervals are too long to ensure that the largest financial centers receive the requisite surveillance focus. Also, integrating macro with financial sector analysis remains a work in progress.
- The IMF dramatically expanded its framework for addressing risks and vulnerabilities, filling a number of gaps exposed by the crisis. Authorities who were interviewed for this evaluation appreciated the progress made but found it difficult to absorb the messages from these exercises, and they indicated that warnings on the euro area crisis and the volatility from quantitative easing and its tapering were not timely or delivered with clarity.

In 2012, the IMF adopted the Integrated Surveillance Decision (ISD), which clarifies the framework for surveillance, including the scope of risk and spillover analysis.[9] As the ISD only became effective in January 2013, it is too early for the IEO to evaluate its impact. The recent Triennial Surveillance Review (TSR) (IMF, 2014b) describes its initial implementation.

After the crisis the IMF undertook a series of institutional reforms in an effort to improve the quality and effectiveness of surveillance and to address its perceived weaknesses before the crisis. Among these reforms were efforts to encourage internal debates and greater teamwork across departments. There has been some progress in reducing the tendency for "silo behavior" and addressing difficulties staff had encountered in "connecting the dots" between related vulnerabilities identified in different contexts. IMF Management promoted a number of processes and products aimed at better integrating multilateral with bilateral surveillance and macroeconomic with financial sector analysis, in line with the ISD. It also launched a series of new exercises to identify risks and vulnerabilities and launched spillover reports for five large systemic economies.

A. Assessing IMF Macroeconomic Advice in the Crisis Aftermath

The IMF was a leading spokesman for coordinated fiscal stimulus following the collapse of Lehman Brothers. Its own work on the topic over the course of 2008 positioned it to be a leading proponent of a global fiscal stimulus. The IMF explained that stimuli enacted by many countries simultaneously would limit leakages from the national standpoint, thereby countering potential protectionist pressures. By November 2008, it had proposed that countries with fiscal space should contribute to a discretionary fiscal stimulus of 2 percent of global GDP, in addition to allowing automatic stabilizers to operate. Fiscal stimulus was advocated not only for the countries at the center of the financial crisis but also for a much larger segment of the global economy, including euro area economies and EMEs. Authorities and other observers report that the IMF's call for a large

[9] The ISD replaced the 2007 Surveillance Decision, which had proved difficult to implement and was perceived not to have provided an adequate framework to address post-crisis surveillance challenges.

Box 1. Advice to Initiate Fiscal Consolidation Stemmed from Concerns About Fiscal Solvency and Fiscal Crises

Examples from multilateral surveillance in 2010–11

"Hence, on balance, fiscal consolidation should take priority, all else given. Achieving fiscal sustainability will be a difficult and prolonged process, making it imperative for consolidation to begin as soon as there is clear evidence of self-sustaining recovery, whereas monetary policy being generally more nimble can respond more flexibly to evolving macroeconomic conditions. In particular, given a path for fiscal policies, monetary policy can be set to achieve a desired level of overall stimulus" (IMF, "Exiting from Crisis Intervention Policies," January 2010).

". . . recent turbulence in financial markets—reflecting a drop in confidence about fiscal sustainability, policy responses and future growth prospects—has cast a cloud over the outlook. Crucially, fiscal sustainability issues in advanced economies came to the fore during May, fuelled by initial concerns over fiscal positions and competitiveness in Greece and other vulnerable euro area economies" (IMF, *World Economic Outlook Update,* July 2010).

"The speed and severity with which financial pressures spread in the euro area should serve as a cautionary tale to Japan and the United States. . . . The credibility of Japan and the United States could suddenly weaken if sufficiently detailed and ambitious plans to reduce deficits and debts are not forthcoming" (IMF, *Fiscal Monitor,* September 2011).

Examples from bilateral surveillance in 2010

". . . given the risks posed by budgetary imbalances, the ground should be laid for fiscal consolidation, with a determined start made in 2011; meanwhile, monetary policy can maintain an accommodative stance to offset fiscal drag" (IMF, "United States: 2010 Article IV Consultation").

"With record-high budget deficits, credible *fiscal tightening* is essential to preserve confidence in debt sustainability and regain fiscal space to cope with future shocks. To offset this contractionary impulse and keep inflation close to target over the policy horizon, a highly *accommodative monetary stance* remains appropriate, supporting private demand and net exports. . . . The consolidation plan . . . greatly reduces the risk of a costly loss of confidence in fiscal sustainability and will help rebalance the economy" (IMF, "United Kingdom—2010 Article IV Consultation, Concluding Statement of the Mission," September 2010).

"Immediate action is needed to establish fiscal sustainability. . . . The aggregate fiscal stance of the euro area is correctly envisaged to be neutral in 2010, while consolidation will start everywhere at the latest in 2011" (IMF, "Euro Area Policies: 2010 Article IV Consultation).

"The authorities are well aware that a successful fiscal exit will not only establish the credibility of the new national fiscal framework, it will also help anchor fiscal policy in the euro area . . . a failure to consolidate the public finances in Germany would damage the national and European fiscal frameworks" (IMF, "Germany: 2010 Article IV Consultation").

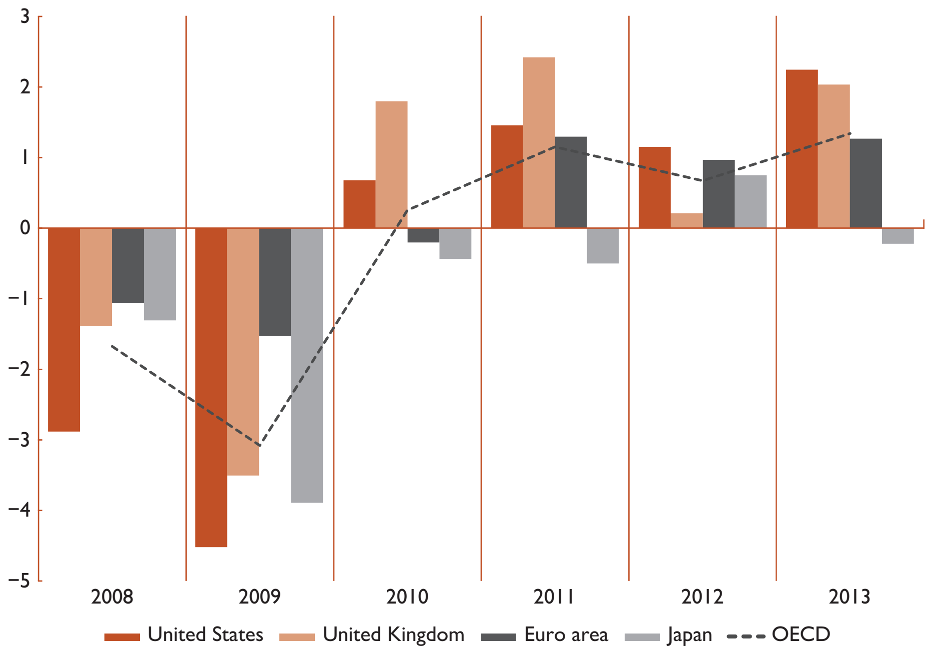
and concerted fiscal stimulus at the G20 and through other multilateral and bilateral surveillance channels was influential.[10] The fiscal expansion that followed is widely acknowledged as having contributed to shortening and dampening the recession.

In 2010–11, IMF advice to major advanced economies shifted to favor fiscal consolidation. This advice arose from concern that large fiscal deficits and rising public debt were threatening fiscal solvency and exacerbating the risk of fiscal crises. Moreover, IMF projections as of late 2009 indicated that economic growth in advanced economies would turn positive in 2010 and strengthen in the medium term. Thus in 2010 the IMF endorsed the additional fiscal consolidation that the United Kingdom initiated in mid-2010, and the proposed fiscal tightening that the U.S. authorities targeted for FY2011. Also in 2010, the IMF recommended that each euro area economy engage in fiscal consolidation by 2011 at the latest, inter alia to enhance investor confidence. In particular, the IMF called on Germany to initiate fiscal consolidation by 2011 to set an example for the other economies in the euro area. Box 1 provides illustrative quotations from multilateral and bilateral surveillance and other papers that were discussed at the Executive Board. Figure 1 shows that the fiscal policy thrust in advanced economies became contractionary from 2011 onwards.

In parallel, the IMF advocated the use of expansionary monetary policies including quantitative easing to counteract the fiscal drag resulting from fiscal consolidation

[10]The tone for the advice on fiscal stimulus was set by analysis such as the IMF Staff Position Note co-authored by the heads of the Research and Fiscal Affairs Departments (Spilimbergo and others, 2008). This argued the case for fiscal stimulus forcefully: "The optimal fiscal package should be timely, large, lasting, diversified, contingent, collective, and sustainable. . . ."

Figure 1. Fiscal Policy Thrust[1]
(In percent of potential GDP)



Source: Davies (2012), estimated using IMF, World Economic Outlook, April 2014 database.
[1] Calculated as the change in cyclically adjusted general government balance as percent of potential GDP. Positive numbers indicate fiscal tightening. OECD and euro area weighted by nominal GDP. OECD and euro area exclude Estonia.

and to sustain growth if needed. As economic growth in advanced economies consistently disappointed during 2011–13, the IMF recommended progressively easier monetary policies to stimulate demand. The dominant IMF view thus became that monetary policy should be the main driver for boosting aggregate demand given the assessment that the major advanced economies still needed further policy support. In 2012, the IMF began to reassess its views on fiscal policy and subsequently called for a more moderate pace of fiscal consolidation if feasible. This reflected both the weaker-than-anticipated recoveries in advanced economies and the results of its own analysis, such as reported in the October 2012 *WEO*, which implied that fiscal consolidation would be more damaging to growth than had earlier been assumed.[11]

Was IMF policy advice well founded?

The IMF's call for fiscal expansion and accommodative monetary policies in 2008–09, particularly for large advanced economies and others that had the fiscal space, was appropriate and timely. The support for ultra-expansionary monetary policies in advanced economies in 2010 and beyond was also appropriate, given those countries' contractionary fiscal policies—even if, as mentioned below, greater attention could have been paid to adverse spillovers. Moreover, as time progressed the IMF called for a more moderate pace of fiscal consolidation and showed greater understanding for the use of capital flow management measures taken by EMEs to counter the effects of spillovers. Other aspects of its advice were less appropriate, certainly with the benefit of hindsight.

IMF advocacy of fiscal consolidation proved to be premature for major advanced economies, as growth projections turned out to be optimistic. Moreover, the policy mix of fiscal consolidation coupled with monetary expansion that the IMF advocated for advanced economies since 2010 appears to be at odds with long-standing assessments of the relative effectiveness of these policies in the conditions prevailing after a financial crisis characterized by private debt overhang. In particular, efforts by the private sector to deleverage rendered credit demand less sensitive to expansionary monetary policy, irrespective of its ability to maintain low interest rates or raise asset prices. Meanwhile, a large body of analysis,

[11] The October 2012 *WEO* found that the IMF had significantly underestimated fiscal multipliers in the early years of the crisis.

including from the IMF itself, indicated that fiscal multipliers would be elevated following the crisis, pointing to the enhanced power relative to the pre-crisis environment of expansionary fiscal policy to stimulate demand.

Many analysts and policymakers have argued that expansionary monetary and fiscal policies working together would have been a more effective way to stimulate demand and reduce unemployment—which in turn could have reduced adverse spillovers.[12] Waiting longer to shift to fiscal consolidation might also have allowed for less aggressive monetary expansion, with less negative side effects.

The IMF advice was influenced by the assessment of risks associated with different policies as well as by the evolving euro area crisis. For example, the IMF's concern about fiscal crises extended to countries such as the United States and Japan, even as these countries' bond yields were falling to historic lows. In articulating its concerns, the IMF was influenced by the fiscal crises in the euro area periphery economies (see Box 1), although their experiences were of limited relevance given their inability to conduct independent monetary policy or borrow in their own currencies.[13] Moreover, the IMF's debt sustainability analysis did not acknowledge the likelihood that elevated fiscal multipliers in the conditions prevailing after the crisis would render fiscal policy a more powerful tool for reactivating the economy.[14] Nor did the IMF's recommendation to consolidate fiscal policy and use monetary policy to stimulate demand give enough weight to the prolonged deleveraging that typically occurs as private sector balance sheets are repaired following a financial crisis.[15]

[12]For example, Bernanke (2013) emphasized that monetary policy could not fully offset the fiscal contraction in the United States. Draghi (2014) noted that "since 2010 the euro area has suffered from fiscal policy being less available and effective, especially compared with other large advanced economies. . . . Thus, it would be helpful for the overall stance of policy if fiscal policy could play a greater role alongside monetary policy. . . ." Ball, DeLong, and Summers (2014) indicated that fiscal expansion would reduce the need for extraordinary monetary policies that potentially create instability. Turner (2013) noted the possibility that fiscal and monetary cooperation to reactivate the economy could be more effective than the policies utilized, while reducing adverse spillovers.

[13]Krugman's (2013) Mundell-Fleming lecture at the IMF elaborates on the misdiagnosis of fiscal crisis concerns following the financial and euro area crises.

[14]A number of economists have suggested that under the post-financial crisis conditions that prevailed, fiscal expansion would have been beneficial to fiscal sustainability (for example, DeLong and Summers, 2012).

[15]The length of private deleveraging cycles tends to be proportional to the size of the private debt overhang that constrains spending in the crisis aftermath (Reinhart and Rogoff, 2008; Koo, 2008). Koo (2013) reports that it took until 2005 for Japan's private balance sheets to be repaired following its crisis in 1990.

The risks of ultra-expansionary monetary policy, including unconventional monetary policy, were not comprehensively discussed until 2013; and it was judged that unconventional monetary policy ought to remain in place because demand stimulus was still needed and the risks could be managed relatively easily. The attention to spillover risks from quantitative easing was not commensurate with the disruptions EMEs had witnessed since the crisis. The IMF's 2011 and 2012 spillover reports downplayed the adverse impact of quantitative easing on emerging markets, in terms of financial market and exchange rate volatility.

In 2013, the IMF did point to the growing tension between accommodative monetary policies and risks to financial stability from credit markets that were maturing more quickly than in typical cycles (*Global Financial Stability Report (GFSR),* April 2013), as well as to the risks that emerging markets might face from destabilizing capital flows (IMF, 2013a). The risks notwithstanding, these reports concluded that monetary policy should remain accommodative to meet advanced economy macroeconomic goals. By September 2013, IMF (2013b) highlighted to a greater extent the adverse spillovers to the rest of the world from the prospective exit from unconventional monetary policy, but by this time EMEs had already experienced substantial volatility in their foreign exchange markets from the prospect of tapering in the United States.

Insufficient tailoring of advice

A critique heard from authorities in several countries is that the IMF did not sufficiently tailor its macroeconomic advice to fit individual country circumstances. Most IMF reports and speeches indicating the need for stimulus added the proviso that this should be subject to available fiscal space. In practice, however, the IMF on occasion used the goal of a 2 percent of GDP global fiscal stimulus as a common benchmark for advanced as well as emerging economies (e.g., IMF, 2009d)—even though many EMEs faced financing and other constraints that made large fiscal expansions risky.[16] Country authorities have indicated that in the months following the Lehman collapse, the messages from IMF Management strongly favored fiscal expansion, sometimes in contrast to advice from bilateral surveillance.

[16]Indeed some, including some G20 members, faced circumstances (such as high fiscal and current account deficits, high inflation, and rising sovereign borrowing costs) that made any significant stimulus risky.

Article IV reports for large EMEs provided a more balanced discussion that acknowledged the risks of fiscal or credit expansion. They tended to support the stimulus programs that had already been undertaken following the Lehman collapse, while highlighting the risks of ongoing fiscal or credit expansions, and several of them appropriately urged an exit from such expansion. In some cases, these expansions, accompanied by looser credit standards, led to overheating. The expansion of public and private debt in some EMEs rendered them more vulnerable to capital flow volatility even as such volatility was rising.

Finally, greater differentiation could have been exercised in recommending fiscal stimulus during 2008–09 to euro area economies taking into account their different fiscal and current account positions. This differentiation was particularly important in light of the constraints to pursuing countercyclical polices imposed by the architecture of the currency union, which could not be changed at that time. Without such changes, however, the onus of contributing to the global stimulus should have been placed on the most creditworthy economies in the currency union.[17]

B. Financial Sector Surveillance Following the Crisis

In the crisis aftermath, the IMF was given a bigger role in financial sector surveillance. The IMF's main vehicle for multilateral financial surveillance, the *Global Financial Stability Report (GFSR),* reflected the IMF's evolving views on lessons from the crisis and recommended policies to boost financial resiliency. The *GFSR* has become "a basic reference point on financial sector issues," according to one prominent interviewed official. In addition, the IMF membership agreed to make the FSSA component of the FSAP mandatory for the 25 (subsequently 29) most systemically important financial centers. Finally, the G20 called on the IMF to collaborate with other international organizations, regulatory bodies, and standard-setting agencies to develop recommendations to strengthen supervisory, regulatory, and macro-prudential frameworks—inter alia by becoming a full member of the FSB. These three interrelated aspects of the IMF's financial sector surveillance are discussed below.

[17]IMF staff members indicated that the need for reforms to the currency union was conveyed in informal discussions with euro area authorities. More recently, IMF staff, Allard and others (2013), discussed issues relating to the architecture of the currency union.

Financial sector analysis in the *GFSR* and other IMF documents

Before the crisis, the IMF was largely of the mindset that minimal regulation and light-touch supervision would suffice to bring about financial stability, since financial markets were self-stabilizing. IMF documents showed a tendency to applaud financial innovations that increasingly relied on structured instruments, such as collateralized debt obligations used in mortgage-backed securities, which contributed to higher leverage in financial institutions.

Staff views evolved with the crisis. A number of Board papers between early 2008 and early 2009 crystallized staff thinking on the causes of the crisis and on lessons for financial regulation and the global architecture needed for financial stability (IMF, 2008, 2009a, 2009b, and 2009c). As the crisis unfolded, the IMF began to warn that growing weaknesses in major financial institutions posed a serious risk to global financial stability, and to recognize the need for quick action to address these institutions' deteriorating solvency. The IMF estimated the cost of the banking crisis and highlighted the urgency of bank recapitalization, raising these issues before many country authorities had acknowledged the scope of the losses and the fragility of their financial sectors.

In diagnosing the causes of the crisis, the IMF emphasized market failures, insufficient regulatory and supervisory resources and powers, and deficiencies in the coordination of policies across countries. The IMF consequently recommended a reform agenda involving greater transparency and information disclosure to address market failures; expansion of the regulatory and supervisory perimeter together with empowerment of supervisory and regulatory agencies through strengthening their capacity, mandate, and authority; and greater international collaboration and coordination in the regulation and supervision of interconnected financial institutions.

Beyond these core strategies, the IMF provided detailed assessments of an extensive array of relevant regulatory and supervisory concerns. It advocated making financial institutions more transparent, less complex, and less leveraged—a turnaround from its pre-crisis views (IEO, 2011). Thus the IMF supported proposed reforms to enhance capital and liquidity buffers, strengthen oversight over shadow banking, limit systemic risks from the use of over-the-counter derivatives, and strengthen the means to resolve systemically important financial institutions. On several occasions, the IMF criticized the pace of implementation of the financial sector reform agenda and highlighted the nature of prevailing risks. Finally, the IMF engaged in research and policy work on macro-financial linkages and the potential for macro-prudential policies and tools to contribute to financial stability. Nevertheless, more effort is needed to operationalize these efforts by better integrating the analysis and messages of the *WEO* and the *GFSR* and in the bilateral context (see below).

The move in these directions was gradual, and in some areas further analysis and a possible rethinking of positions may be needed. During 2008–09, the IMF seemed timid in its analysis and critique of elements of Basel II. Its analysis, particularly during this period, underplayed the role of governance weaknesses in regulatory agencies, which in some countries had led to lax enforcement even when regulators had the authority to act. As important, the IMF's analysis did not give sufficient weight to how regulatory and supervisory deficiencies had shaped the incentives and actions of decision makers within financial institutions prior to the crisis. Its analysis and advice along these dimensions improved over time, but even in the later period it did not focus enough on the governance of supervisory and regulatory agencies. This is particularly important given the emphasis on granting these agencies greater authority.

Mandatory financial stability assessments

The FSAP program was launched after the East Asian crisis to assist member countries identify weaknesses in their financial sectors and to provide recommendations on how to address them.[18] The IMF is principally responsible for the assessment of financial stability issues, which is presented in the FSSA report that is discussed by the IMF Board alongside the country's regular Article IV consultation report. The Article IV report is expected to integrate the FSSA findings and recommendations into the macroeconomic framework.

In September 2010, the Board made FSSAs a mandatory part of the IMF's bilateral surveillance for the world's top 25 systemic financial centers every five years (see IMF, 2010).[19] By mid-2014, 24 of the original 25 jurisdictions had undergone financial stability assessments under the FSAP. A review of a sample of FSSAs that was conducted for this evaluation indicates that these assessments can be a useful tool for assessing risks to financial and macroeconomic stability. It found that the recommendations in the FSSAs were reflected in the corresponding Article IV reports, and that subsequent Article IV consultations followed up on the issues raised in the FSSAs.[20] The review found, however, that there is still room for improvement in how the staff integrates its financial sector and macroeconomic analysis.[21] This finding is consistent with a June 2014 report of an IMF staff working group, which noted that the range and analytical quality of financial sector issues covered in Article IVs varies widely, and that they are often treated as add-ons. Also, the recent FSAP review (IMF, 2014d) noted that the evaluation of financial sector oversight and supervisory effectiveness in FSAPs is often driven by identified gaps in formal compliance with established international standards rather than by the impact of these gaps on systemic risk.

More than any other instrument available to the IMF, FSSAs have the potential to detect emerging financial risks in time to act upon them. But recent experience with financial sector developments raises the question of whether with their current frequency, FSSAs are adequately placed to detect and warn about emerging vulnerabilities in time to act upon them. The IMF Board has discussed a staff proposal to conduct mandatory FSSAs every three years, but consensus could not be reached.[22] IMF staff notes that under the current resource envelope and allocation mechanism, some (non-systemic) countries may have to wait more than a decade between FSAPs (IMF, 2014d). To address such concerns, the June 2014 IMF staff working group report recommended strengthening the capacity of area departments to conduct financial sector surveillance.[23] Such mainstreaming of financial surveillance into the regular Article IV surveillance would increase country coverage and still provide sufficient depth for most countries. But this is a process that would take many years, and only experience will tell whether it will be effective.

[18] The FSAP was established as a voluntary program conducted in partnership with the World Bank. The World Bank is responsible for the diagnosis of developmental institutional issues, which is conducted mainly for emerging markets and low-income countries (LICs). The assessments are conducted by large teams of international experts and take a significant amount of time.

[19] In 2013, Denmark, Finland, Norway, and Poland were added to the list of countries for which FSSAs are mandatory.

[20] Seven FSSAs were reviewed: for Brazil, China, France, India, Italy, Switzerland, and the United States.

[21] Another challenge that requires continuous attention is to enhance candor in FSSAs for systemic financial centers; this is complicated by concerns about the possible systemic consequences of negative findings.

[22] IEO (2011) recommended that the five-year interval for mandatory FSSAs be reconsidered once sufficient information became available on how rapidly the assessments become outdated. The IEO emphasized the need to prioritize the country coverage and periodicity of FSSAs according to risks and systemic importance.

[23] The working group proposed that the principal responsibility for financial surveillance and macro-financial work at the country level rest with area departments, which would therefore need to build a critical mass of macro-financial economists by training, hiring, and transferring relevant staff from other departments.

The critical concern from a global perspective is for the IMF to be able to detect emerging vulnerabilities and risks to financial stability in the systemic financial centers. The experience over the past few years indicates that these vulnerabilities and risks can emerge in a period much shorter than five years. This view is shared by IMF staff who have indicated that FSSAs conducted every five years are too infrequent to provide continuous surveillance of financial developments and macro-financial linkages. Mainstreaming of financial stability surveillance to area departments—in particular, to undertake assessments with the requisite depth needed in economies with systemic financial centers—is not a feasible objective in the short term. Nonetheless, it would not be prudent to delay strengthening surveillance in these countries. A simple perusal of the list of 29 countries raises the question of whether the program of mandatory FSSAs is appropriately targeted. From a global stability perspective, a strong case can therefore be made to increase the frequency of FSSAs for the few countries with truly systemic financial sectors.

The IMF has one of the largest combinations of talented macroeconomists and financial economists of any institution. In addition, the Monetary and Capital Markets Department (MCM) has assembled a large group of financial sector experts who have specialized experience in financial supervision and regulation. The IMF thus appears uniquely placed to combine these skill sets to produce more integrated macro-financial analyses. Since 2009, the IMF has significantly increased its efforts in this direction. Focusing these efforts initially on countries with systemically important financial centers appears appropriate and, if successful, could be expanded to other countries. It would also further enhance the quality of *GFSRs.*

Interacting with the Financial Stability Board

Chapter 2 discussed issues of coordination between the IMF and the FSB. It pointed out that staff from both organizations were satisfied with the interaction, but that it was important for the IMF to clarify responsibilities and accountabilities to ensure its independence. Also, concerns have been voiced that the two organizations were working in parallel rather than in an integrated manner. To mitigate both these concerns, the IMF should continue to build up its own capacity to assess risks and vulnerabilities in the financial sector as part of its work on FSSAs, Article IV consultations, and *GFSRs*. This would allow the IMF to develop methodologies that it could bring to bear in cooperating with the FSB, and would also allow for independent views on financial sector issues.

C. Revamping the Approach to Assessing Risks and Vulnerabilities

Following the crisis, the IMF greatly expanded its framework to detect and warn about risks and vulnerabilities. The reforms included the establishment of an interdepartmental Risk Working Group to coordinate the IMF's work on risks; the introduction of the EWE to identify tail risks and "connect the dots" between different risks and vulnerabilities; vulnerability exercises for advanced countries and for LICs to complement the vulnerability exercise for emerging markets that was in place before the crisis; spillover reports to assess the impact of outward spillovers from systemic countries; the *Fiscal Monitor*—a third IMF flagship report that assesses fiscal sustainability issues; a Pilot External Sector Report, which extends and deepens the earlier Consultative Group on Exchange Rates exercise; and a Tail Risk Group, composed of economists not involved in the regular risk exercises, that looks for tail risks from a fresh perspective.

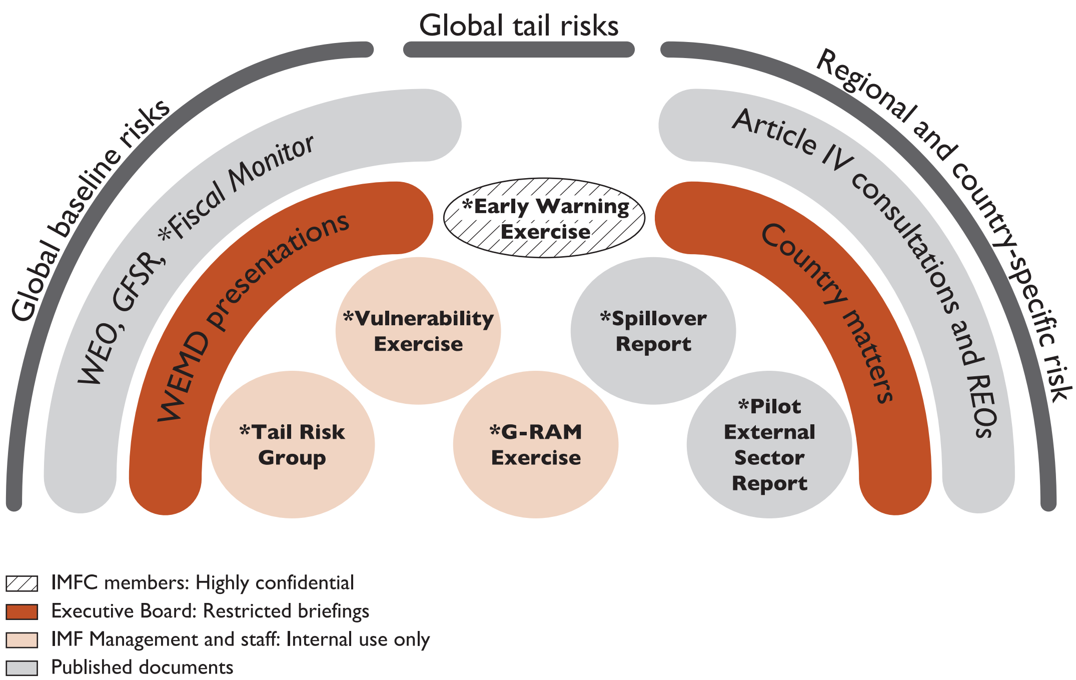
IMF risk management framework

As illustrated in Figure 2, the current system for addressing risks and vulnerabilities has three basic layers:

- Published outputs—the multilateral flagships, *Regional Economic Outlooks*, G20 papers, and the Article IV consultations, which cover baseline risks.
- Confidential outputs—the EWE, whose findings are presented to senior policymakers at the IMFC; and the World Economic and Market Developments and Country Matters briefings presented to the Executive Board, which are intended to cover the full gamut of baseline and tail risks.
- Analytical inputs to this work, which include the vulnerability exercises, the Global Risk Assessment Matrix, and the conclusions of the Tail Risk Group (which are restricted to Management and staff), and the spillover reports and the Pilot External Sector Report (which are published).[24]

[24]The objectives of the spillover and Pilot External Sector Reports in particular go well beyond providing inputs to risk assessment.

Figure 2. IMF Exercises to Address Risks and Vulnerabilities



Note: Exercises marked with an asterisk have been introduced, or substantially reformed, since 2008.

Although the risk assessment framework now fills gaps exposed by the crisis, it has become very complex, involving nine different exercises managed in five separate departments.[25] The volume of analysis is very difficult to absorb, both for policymakers and for IMF staff. Substantial efforts and transaction costs are incurred to ensure consistency, which is not always achieved (Box 2). Moreover, staff do not appear to look back to assess whether risks did or did not materialize, and draw relevant lessons. Finally, the approach and methodologies used by the IMF are considered opaque by many country authorities, diminishing their policy traction.

A number of interviewed authorities expressed appreciation of the IMF's efforts to revamp its risk assessment capabilities, but considered that the discussion of the two systemic problems that manifested in the post-Lehman period—the crisis in the euro area and the destabilizing capital flows that followed the announcement of prospective tapering of quantitative easing in May 2013—was not conducted in a timely manner. Moreover, some officials considered that the IMF was still too hesitant to highlight risks with sufficient urgency if this entailed criticizing the policies of influential members.

Authorities from across the membership believe that for this important work to be helpful, staff would need to produce a short integrated summary of the IMF's views on the global outlook, risks, and vulnerabilities, and the measures needed to address them, as background for each IMFC meeting. This summary should be concise and written with high-level officials as its target audience. In parallel, to address concerns about opacity, the IMF should periodically produce a note describing the main risk-related exercises and their methodologies. This methodological note could be more technical and would aim at officials involved in similar activities in ministries and central banks. It would help improve the transparency and credibility of the IMF's work and would provide opportunities for internal and external feedback on the system as it evolves.

Options for simplification and strengthening

Various options have been put forward by external contributors to the 2014 TSR and in Robinson (2014) to

[25] While some of the new products do not focus solely on risks, the External Advisory Group to the 2014 TSR indicated: "The Fund is trying to do too much. By trying to spot every risk 'under the sun,' it is in danger of missing the big risks" (IMF, 2014c).

Box 2. Varying Messages in IMF Discussion of Unconventional Monetary Policy and Tapering

In early 2013, the Early Warning Group began to focus on the potential for volatility in the event of a prospective U.S. exit from unconventional monetary policy.[1] Its work touched off internal debate between those who believed that U.S. monetary tightening in response to higher U.S. demand growth was likely to have positive spillovers and those who saw a risk of a disorderly reaction in financial markets, accompanied by interest rate overshooting. In the event, the *WEO, GFSR*, Global Policy Agenda (GPA), and EWE presented the following messages at the Spring 2013 IMFC meeting:

- The *WEO* noted that while the Federal Reserve might have to raise interest rates earlier than planned, prompting capital outflows from EMEs, in this event any commensurate increase in emerging market risk spreads was likely to be limited and temporary, and the overall impact would be positive.
- The *GFSR* observed that the potential for capital flows to persist or accelerate, partly driven by low interest rates and higher risk appetite in advanced countries, would increase financial stability risks; and that emerging markets could prove vulnerable to an eventual rise in global interest rates amid rising uncertainty.
- The GPA noted that concerns were rising about the spillovers from loose and unconventional monetary policy and that many EMEs were concerned about the possible blow to output and the financial system if large inflows of capital were rapidly reversed.
- The EWE noted that while a U.S. recovery was good for the global economy, countries should be prepared for volatility resulting from a U.S. monetary policy exit. It considered the implications of a scenario of a sharper than expected rise in U.S. long-term interest rates for emerging markets, and how that might interact with emerging market vulnerabilities, and made specific recommendations on policy measures to reduce risks.

[1] This risk was also flagged by the Tail Risk Group in February 2013, although only as 1 of 19 potential tail risks.

Source: Robinson (2014).

simplify the risk management framework.[26] In parallel, given the rapid expansion of departmentally-based exercises, more effort is needed to ensure the IMF can develop a consistent and integrated assessment of global risks. Such integration would benefit from incorporating perspectives from outside the IMF.[27]

The EWE is among the most important of the innovations introduced after the crisis, and was generally praised by those authorities who attended EWE presentations alongside the IMFC meetings. That said, there is room to improve its impact in a number of areas. Most senior policymakers interviewed were unaware of the main messages from the EWE, due to the restricted attendance and limited debriefing by the participants, and they were not able to find many concrete examples of follow-up in their organizations. In practice, the IMF and the FSB have worked in parallel on their presentations. This runs counter to the goal of ensuring that the interaction between macro-financial and regulatory issues is appropriately covered.

The EWE thus needs to be revamped to make it more useful and user-friendly: it should foster greater debate and input by authorities, and outreach on its results should aim at authorities in at least a significant majority of member countries. One way to address these objectives would be for IMF Management to brief the Board after each EWE session on the main messages from the discussions, and on necessary follow-up by the IMF and by members themselves.[28] This would enable Executive Directors to share these key messages from the EWE with a wider group of senior policymakers. In addition,

[26] The 2014 TSR recognizes the need to further improve the IMF's risk and vulnerability framework. However, it emphasizes the need to intensify the ongoing effort by bridging remaining gaps including by adding additional reports and quantification. This report, on the other hand, gives greater emphasis to: streamlining, consolidation and simplification of the Fund's risk management framework; enhancing communication of EWE findings to policymakers; and improving the transparency of the Fund's work.

[27] IEO (2011) had recommended the establishment of a small risk unit, reporting directly to Management and staffed in part by external analysts, that would serve to identify emerging risks and to protect the IMF from the tendencies of insularity and groupthink that affect large bureaucracies. The existing RWG has a different role, which is to coordinate views across departments.

[28] The Executive Board is already being briefed on the preliminary findings of the EWE prior to the IMFC presentation. The brief following the EWE session would focus on the discussions and on follow-up actions.

the IMF in collaboration with the FSB should explore ways to better integrate their analyses, even if they continue to have two separate presentations.

The effectiveness of any risk assessment system depends critically on staff's willingness to raise alternative and contrarian views and on effective cooperation across units to be able to "connect the dots." Senior IMF staff interviewed for this evaluation believed that the IMF had become more open to discussing risks and that interdepartmental meetings and task forces had helped break silos, encouraged team work, and provided fora for vigorous debate. Nevertheless, the IMF has continued to encounter difficulties in integrating messages from the flagship reports and risk assessments prepared by its different departments.[29] Moreover, the 2013 Staff Survey suggests that A-level staff members (who constitute most of the IMF's staff) still feel constrained in speaking their minds.[30] These factors suggest that further progress in these areas is still needed.

[29]Box 2 illustrates the difficulties of integrating the work of different departments with a case study on how publications from different departments assessed the risks associated with the prospective tapering of quantitative easing.

[30]In this regard, the Fund's survey results compared unfavorably with those of comparator organizations.