

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

29. 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 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.

30. 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.

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...”

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

Examples from multilateral surveillance:

“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” (“Exiting from Crisis Intervention Policies,” IMF, 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” (July 2010 *WEO Update*).

“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” (Fall 2011 *Fiscal Monitor*).

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” (2010 U.S. Article IV).

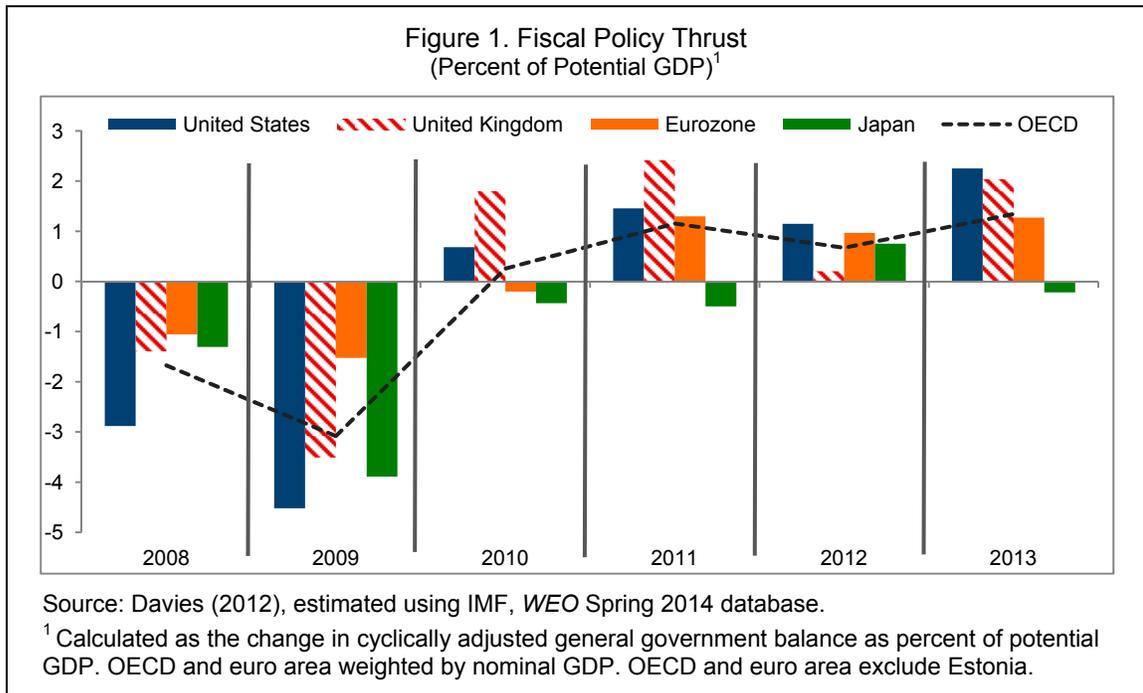
“With record-high budget deficits, credible *fiscal tightening* is essential to preserve confidence in debt sustainability and regain fiscal space to cope with future shocks. To offset this contractionary impulse and keep inflation close to target over the policy horizon, a highly *accommodative monetary 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” (2010 U.K. Article IV Concluding Statement).

“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” (2010 Euro Area Policies Article IV).

“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” (2010 Germany Article IV).

31. In parallel, the IMF advocated the use of expansionary monetary policies including QE to counteract the fiscal drag resulting from fiscal consolidation 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 Fall 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?

32. 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.

33. 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 longstanding 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

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

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, 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.

34. 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.

35. 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

36. The risks of ultra-expansionary monetary policy, including unconventional monetary policy (UMP), were not comprehensively discussed until 2013; and it was judged that UMP

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.

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 QE 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 QE on emerging markets, in terms of financial market and exchange rate volatility.

37. 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 (Spring 2013, *GFSR*), 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 UMP, 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

38. 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.

39. 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.

40. 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

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.

current account positions. This differentiation was particularly important in light of the constraints to pursuing countercyclical policies 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

41. 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.

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

42. 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.

43. 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; IMF, 2009a; IMF, 2009b; IMF, 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

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.