IMF PERFORMANCE IN THE RUN-UP TO THE CURRENT FINANCIAL AND ECONOMIC CRISIS

ISSUES PAPER FOR AN EVALUATION BY THE INDEPENDENT EVALUATION OFFICE (IEO)

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The IEO is undertaking an evaluation of the effectiveness of IMF surveillance in the run-up to the current global crisis. This evaluation will assess whether the IMF could have done better in anticipating and warning about the crisis; it will identify impediments that might have hindered the IMF's effectiveness and it will draw lessons for the future. This Issues Paper defines the scope and the main questions to be addressed, and describes some of the material and methods that will be used in conducting the evaluation.

I. Introduction

1. In 2007, world financial markets entered a period of great turmoil. By 2008, the world was in the midst of the worst financial and economic crisis in more than half a century, with the global financial system threatened with collapse and sharp declines in activity across major economies.[1] There is already much debate and research about the causes and triggers of the crisis.[2] The crisis started in the U.S. financial sector and spread to other financial markets and then gradually to the real economy globally. There seems to be wide consensus that the crisis originated in U.S. financial institutions, which faced large but difficult-to-estimate losses when the housing and securities markets turned negative. This has been attributed to the widespread use of very high leverage by financial institutions in the U.S. and in some other countries to underwrite and invest in difficult-to-value structured financial instruments. Some have argued that such behavior, which might reflect a failure of governance in large complex financial institutions, was made possible by lax regulation and supervision in the U.S. and other major financial centers. Many analysts believe that relatively easy money and the moral hazard due to the "Greenspan Put"[3] created the environment for the housing and financial asset bubbles to develop, and that large current account imbalances contributed to propagating the crisis. This evaluation will discuss the critical vulnerabilities that were important in shaping or exacerbating the financial crisis as a basis for evaluating the IMF surveillance, but it will not expound on the relative roles of these factors in bringing about the crisis—this will be the subject of debate for many decades.[4]

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[1] In the last quarter of 2008, global output dropped at a rate of about 6.5 percent, while equity markets had lost about a third of their value.

[2] See, for example, "A Bird's-Eye View. The Financial Crisis of 2007–09: Causes and Remedies," Acharya, Philippon, Richardson and Roubini, in "Restoring Financial Stability: How to Repair a Failed System" (2009), Viral Acharya and Matthew Richardson, editors; "Initial Lessons of the Crisis," IMF (2009); and "Why Banks Failed the Stress Test," Haldane, BIS Review 18/2009.

[3] The "Greenspan Put" refers to the markets' belief that the Federal Reserve would lower interest rates and provide liquidity in reaction to large market disturbances. While the term was coined in the late 1990s, it is commonly applied to Federal Reserve actions since October 1987. It is commonly assumed that the perception of the "Greenspan Put" contributed to the emergence of speculative bubbles.

[4] More than 75 years later, academics are still debating the roles of monetary and fiscal policies in the run-up to and during the Great Depression.

2. Preventing crises, or providing an early warning to the membership so that country authorities can take measures to mitigate the impact of a crisis, is one of the main purposes of IMF surveillance.[5] Some have claimed that the IMF did not sound any alarms in the run-up to the current crisis, or that when raising concerns it did so in a muted or hedged manner.[6] Others, on the other hand, have claimed that the IMF issued warnings but that they were not heeded. The evaluation will explore this issue and try to understand what could be done to enable the IMF to be more effective in the future.

II. Scope of the Evaluation

3. The evaluation will examine the period up to the crisis, focusing primarily from 2004 into 2008.[7] It assess IMF performance in identifying the factors that brought about the crisis and the advice it provided to the membership on how to avoid or mitigate its consequences. The focus will be on financial and monetary issues, which are seen as having been at the root of the crisis. Many of the issues that brought about the crisis were raised in different ways by IMF officials and in IMF documents, albeit not always as risks or areas of concern. Many of these issues were also discussed in previous IEO evaluations, among them the urgency to better integrate financial sector considerations into macro surveillance; the need to look in Article IV consultations at the risks of spillovers from and to other countries; and the quality of advice on the financial sector, capital account, and exchange rate policy.

4. The evaluation will assess IMF performance in both bilateral and multilateral surveillance. It will examine public communications (e.g., reports, seminars, and IMF management speeches) and private and confidential interactions, to the extent that information is available. The evaluation will be centered around three pillars, each studying a different segment of IMF surveillance activities: bilateral surveillance in the systemically-important advanced economies where the crisis originated, bilateral surveillance of other advanced and emerging economies affected by the crisis, and multilateral surveillance.

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[5] According to the 2007 Surveillance Decision, the main objectives of IMF surveillance are "to help head off risks to international monetary and financial stability, alert the institution's 186 member countries to potential risks and vulnerabilities, and advise them of needed policy adjustments."

[6] For example, as late as April 2007, the opening sentence of the *Global Financial Stability Report (GFSR)*, the IMF flagship on financial issues, noted that "Favorable global economic prospects, particularly strong momentum in the Euro area and in emerging markets led by China and India, continue to serve as a strong foundation for global financial stability. However, some market developments warrant attention, as underlying financial risks and conditions have shifted since the September 2006 *GFSR*."

[7] Other periods, both prior and following these dates will be reviewed when relevant to understanding developments in the run-up to the crisis either globally or in a particular country.

5. The period under review was one of prosperity for most emerging markets and developing countries, fueled by rapid global growth and easy availability of private financing. During this period there was a significant reduction in the demand for IMF resources.[8] As a consequence, many members urged for a shrinking of the institution.[9] This led to the 2007–08 downsizing exercise, which some have argued distracted IMF management and staff at a critical time. The evaluation will examine the impact that the downsizing exercise and earlier internal reorganizations of financial sector work may have had on the IMF's performance.

6. The study will also explore how different parts of the IMF—e.g., departments, management, the Board—performed in identifying vulnerabilities and conveying their concerns to the membership. It will also examine whether lessons from previous financial crises were absorbed and incorporated into Fund policy and practice.

A. Evaluation Questions and Methods

7. The evaluation will examine the IMF's analysis, diagnosis, and recommendations on financial, monetary, fiscal, and structural issues in the run-up to the crisis. It will review the views and messages conveyed by staff, management and the Board to country authorities and country groupings (e.g., G-20 and G-24). The focus of this evaluation is on learning, which has implications for the questions raised and the methods utilized. For example, the analysis will seek to identify what processes and data would have helped the IMF forecast the crisis and mitigate its consequences, in addition to asking whether it could have done a better job given what was known; the tools at its disposal; and what others saw and said.[10] The following questions illustrate the issues that will be addressed in the context of the three pillars proposed for the study (each focused on a different modality of surveillance and different country circumstances):

Global prospects assessments and messages

- What was the IMF assessment of the global economy and financial markets in the period preceding the crisis? Did the crisis simulations that IMF management and staff had performed bear any relevance to the actual crisis? Was the IMF analysis hindered by ideological bias, political considerations, "group think," or organizational issues?

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[8] Lending from the IMF's General Resources Account (GRA) dropped from an average of almost SDR 20 billion in 2000–03 to less than SDR 3 billion in 2004–07.

[9] "An Agenda for Reform of the Fund," Boorman (2008), presents a different view, predicting that there would be future crises when the IMF would again be needed as a "lender of last resort" and arguing that the IMF should not be downsized until its role and strategic direction had been decided.

[10] An accountability evaluation is best based on the information set available when the crisis exploded. On the other hand, 20/20 hindsight can be a helpful framework to draw lessons and suggest system changes.

- How did the IMF assessment compare with the assessment and messages of other organizations, public and private, that prepare assessments at the national or global level?

- How clear were staff, management and the Board in conveying difficult messages? If the IMF was too timid, was it out of concern of being out of sync with the consensus views of other forecasters, or were there pressures from policy makers to tone down warnings? Did the IMF's corporate culture make it challenging to convey difficult messages?

- The IMF repeatedly warned of potential risks from global imbalances, a concern also raised by the G-7 and others. Global imbalances have diminished through a rapid rebalancing of savings and investment in the U.S., the U.K., and other countries brought about by the ongoing deleveraging of their economies. These adjustments have played a key role in propagating the crisis around the world. Did the IMF anticipate or consider such an outcome? Would the IMF's warnings have carried more weight had the risks from global imbalances been linked to unsustainable asset booms and the possible global propagation of a financial crisis in the U. S.?

Financial sector: analysis and advice

- Were there analytical weaknesses that prevented the staff from identifying systemic problems in the financial sector? Did IMF analysis address these issues and the "tail risks" that materialized during the crisis? If so, was this analysis incorporated into the bilateral and multilateral surveillance of the IMF? Was the staff blinded by "group think" or reassurances from policy makers in major countries? Did the IMF focus excessively on some risks (e.g., a disorderly unwinding of global imbalances) to the exclusion of others?

- In particular, was the IMF too sanguine about the ability of securitization to disperse risk, and as a result, not sufficiently concerned about the capacity of banks to absorb major asset price shocks? Did the IMF point to the risks associated with the rapid growth in use of complex and not clearly regulated instruments such as collateralized debt obligations, structured investment vehicles, and credit default swaps? Did the IMF alert authorities about how off-balance sheet conduits were increasing leverage, or how mortgage-backed securities were subject to growing risk given an environment of inflated housing prices? Was the IMF sufficiently concerned about liquidity or counterparty risk given the extensive utilization by many banks of short-term funding and credit derivatives?

- Did the IMF examine whether the regulatory and supervisory framework governing the growing use of these instruments was adequate?

- Was the IMF well equipped to understand financial sector risk in systemically-relevant economies? This raises the more general question of whether an Article IV consultation is an adequate tool for in-depth financial sector surveillance in the absence of a recent FSAP.

- Did the IMF point to concerns about oversized financial sectors or parent-bank funding disruptions in smaller advanced economies or emerging markets?

Integration of macroeconomic and financial sector risks

- Many IMF publications stressed the macroeconomic risks emanating from large global imbalances, specifically the risk that a change in portfolio preferences could result in rapid depreciation of the dollar which would disrupt global foreign exchange markets. But did the IMF emphasize the risks posed by these imbalances to the financial sector, in particular the role of capital flows in prolonging or magnifying the housing boom, and the linkages to the new financial instruments and the "extreme" leverage that they facilitated?

- Did the IMF have sufficient resources for effectively integrating macroeconomic and financial sector considerations (e.g., enough financial sector experts available to participate in Article IV missions)?

- What was the nature of the IMF's advice on the use of counter-cyclical macro prudential regulation?

III. WORK PLAN

8. The evaluation team will gather information through review of IMF documents and past and ongoing IEO evaluations as well as documents from member countries, other international organizations, private sector research and investment outfits, and academia. Evidence will also be gathered through structured and semi-structured interviews with key stakeholders within and outside the IMF. Interviews will be conducted with country authorities, Board members, and current and former management and staff. The evaluation team will also conduct interviews and organize workshops and seminars to elicit the views of colleagues from other public (e.g., BIS, OECD, the World Bank) and private organizations (e.g., commercial and investment banks, academia).

9. The evaluation will be centered around three pillars, each studying a segment of IMF surveillance activities: bilateral surveillance in systemically-important advanced economies where the crisis originated, bilateral surveillance in select other advanced economies and emerging economies that were affected by the crisis, and multilateral surveillance. Below are descriptions of background studies that will be prepared on each of these pillars. Together with additional consultations, these studies will serve as the basis for a *chapeau* report that will integrate their findings, lessons, and recommendations.

10. ***Bilateral surveillance in systemically-important advanced economies where the crisis originated***. These studies will focus on the analysis, diagnosis, and recommendations provided to the U.S., the U.K., and select other important financial centers. They will assess whether the IMF identified key vulnerabilities and emerging risks; if so, whether the IMF was more or less candid than other organizations (e.g., OECD and BIS) about the risks and the need for corrective policies; and whether the IMF offered technical value-added to the authorities. The study will assess the IMF's diagnosis and recommendations in staff reports of Article IV consultations, in the Financial Sector Assessment Program (FSAP) reports and Financial System Stability Assessments (FSSAs), and will examine how the analysis in FSAPs and FSSAs were integrated into the Article IV consultations. In addition to document reviews, interviews would be conducted with country authorities, Board members, and IMF staff, as well as officials in other international organizations. The study will draw on the IEO evaluations of the FSAP Program and of Interactions with Member Countries, as well as the background work done on surveillance for the IEO Evaluation of IMF Governance and the ongoing evaluation of IMF research. It will also draw on the IMF's 2008 Triennial Surveillance Review.

11. ***Bilateral surveillance in select other advanced and emerging economies that were affected by the crisis.*** This pillar will focus on the messages the IMF gave to select advanced and emerging economies that subsequently were significantly affected by the crisis; with a focus on some of those that eventually required IMF financial support in 2008 or 2009 (e.g., Hungary, Iceland, and Latvia). It will explore whether the IMF analysis and messages considered the risks from a sudden change in external circumstances, or did it only look at domestic economic conditions? Given the nature of the problems facing these countries, this study will cover the advice the IMF was giving on capital account issues, exchange rate management, and financial sector regulation. Was adequate concern expressed about the growth of foreign exchange exposure fostered by households taking on mortgages in foreign currency? And about the risks of a sudden interruption in capital inflows or of a sudden collapse in export demand? Did the IMF raise concerns about over-sized financial sectors, such as in Iceland? This study will also draw on past IEO evaluations—in particular, the evaluations of the capital account crises in Indonesia, Korea, and Brazil and of Interactions with Member Countries—and on the IMF's 2008 Triennial Surveillance Review.

12. ***Multilateral Surveillance.*** This study will examine the IMF's performance in overseeing the international monetary and financial system through the different tools and processes that it has for multilateral surveillance. First, it will describe and assess the analysis and diagnosis in the documents and processes at the center of the IMF's multilateral surveillance. It will ask whether the IMF emphasized the linkages across the membership and the spillover impact from policies in large economies to other members, and it will explore how effective multilateral consultations were in sharpening the diagnosis and as an early warning mechanism. This study will also assess how well the findings of multilateral surveillance were integrated into the messages of bilateral consultations, and conversely, how well multilateral surveillance built on findings from these bilateral consultations. Finally, it

will assess whether the IMF devoted sufficient resources to multilateral surveillance relative to bilateral surveillance, in light of the systemic risks that were emerging.

13. This study will be based on the analysis and messages in the various multilateral documents produced by the IMF, in particular, the *World Economic Outlook (WEO)* and the *Global Financial Stability Reports (GFSRs)*, which are published twice a year and present staff's analysis of global economic and financial developments, respectively. Other aspects of multilateral surveillance will also be examined, including the World Economic and Market Developments (WEMD), reports on the Multilateral Consultation, *Regional Economic Outlooks*, and other internal communications/discussions. In addition, the study will seek the views of authorities and other relevant stakeholders on how to enhance effectiveness of surveillance. This will be done through interviews and workshops. The study will draw on other completed and ongoing IEO evaluations, including on Multilateral Surveillance, Interactions with Member Countries, and IMF Research, as well as other internal and external reviews.