Independent Evaluation Office
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IMF Performance in the Run-Up to the Current Financial and Economic Crisis

Preliminary Draft Issues Paper for an Evaluation by the Independent Evaluation Office (IEO)

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I. INTRODUCTION

1. The IEO will undertake an evaluation of the effectiveness of the IMF in the run-up to the current global crisis. This evaluation will look at the IMF's technical work, as well as governance issues such as evenhandedness and the institution's willingness and ability to convey difficult messages to large countries. This draft issues paper is an attempt to define the scope and the main questions to be addressed, and to propose some of the material and methods that will be used in conducting the evaluation.

2. 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. Such behavior, seen by some to 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—something that had been visible for many years. 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 assets bubbles to develop, and that large current account imbalances contributed to propagate, if not to breed, the crisis. Finally, the wealth effect and supply shock from the rapid rise in the price of oil and other commodities through mid-2008 is seen as having contributed to the subsequent economic slowdown. This evaluation 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] Instead, the evaluation

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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 (2009); "Initial Lessons of the Crisis," IMF (2009); and "Why Banks failed the Stress Test," Haldane (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 1990's, 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.

will focus on what the IMF did or did not do, or more specifically what it said or did not say, to help the membership anticipate, prepare for and mitigate the crisis.

3. Preventing crises, or at least 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. Many analysts 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.[5] Many in the IMF, on the other hand, have claimed that the IMF issued warnings but that they were not heeded. The evaluation will explore this question and try to understand what could be done to enable the IMF to be more effective in the future.

II. Scope of the Evaluation

4. The evaluation will assess the IMF's performance in identifying the problems that brought about the crisis and in providing advice to the membership on how to avoid or mitigate it. The focus will be on diagnosis and advice 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 (e.g., rapid change in mix of financial assets and other financial innovations, low risk premia and volatility in global markets, and rapid growth in cross-border trade in financial instruments) were raised in different ways by IMF officials and in IMF documents, even though 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. The study will also examine the IMF's views and recommendations on fiscal policy, savings imbalances, and the oil shock—factors that are seen as having contributed to, or been a catalyst of, the crisis.

5. The evaluation will assess IMF performance in both bilateral and multilateral surveillance. It will examine formal and public communications, e.g. reports, conferences, seminars and Management's speeches, and it will also try to assess the content and impact of informal interactions, e.g. informal policy discussions and gatherings such as the multilateral consultations. The evaluation will be centered around three pillars, each studying a different segment of IMF surveillance activities: surveillance in advanced economies, surveillance in emerging market economies, and multilateral surveillance.

[5] 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."

6. On bilateral surveillance, the focus will be on Article IV consultations, the cornerstone of IMF surveillance. The study will also examine the IMF's diagnosis and recommendations in the Reports on Observance of Standards and Codes (ROSCs) and, in particular, in the Financial Sector Assessment Program (FSAP) reports and Financial System Stability Assessments (FSSAs), and how they were integrated into staff and Executive Board (the Board) appraisals in the Article IV consultations. The evaluation will explore whether the IMF warned advanced economies of the vulnerabilities in their own financial sectors and of the risk of spillover from a potential crisis in other countries. It will review whether it warned the U.S. and other systemically important countries that their policies could have been contributing to an asset bubble. It will also examine the messages to emerging markets regarding the possibility of a sudden interruption in capital inflows, and of the possibility of a sudden collapse in export demand.

7. On multilateral surveillance, the focus will be on the analysis and messages in the World Economic Outlook (WEO) and the corresponding regional studies (REOs). These reports are published twice a year and present staff's analysis of global/regional economic developments. The Board discusses the WEO reports and a summary of its discussions is included in the WEO's disclosed version. The evaluation will also examine the parallel studies focused on financial issues, the Global Financial Stability Reviews (GFSRs) and its updates, which appear on a quarterly basis. The GFSRs focus on current market conditions and highlight systemic issues that could pose risks to financial stability and sustained market access by member countries. The evaluation will assess whether the IMF devoted sufficient resources to multilateral surveillance relative to bilateral surveillance, to be able to foresee the critical systemic issues that were emerging. In parallel, it will evaluate whether the assessments developed in the context of multilateral surveillance were derived primarily from an aggregation of bilateral surveillance, or whether they were informed by independent analyses of the global situation and outlook.

8. The evaluation will examine the period up to the crisis, when the IMF was largely focused on surveillance of the world and national economies, but it will not address the IMF's ongoing performance as a crisis manager nor as a lender of last resort.[6] To this end, it is proposed to focus mainly on the four-year 2004–07 period.[7] Other periods will be reviewed only as they are relevant to understand developments in the run-up to the crisis either globally or in a particular country, but making sure that the study does not interfere

[6] It is too early to assess the IMF's contribution to the management and resolution of the current crisis. In addition, the IEO's terms of reference state that it "should avoid interfering with operational activities, including programs, or attempting to micro-manage the institution."

[7] The April 2008 GFSR, when the IMF first forecasted financial sector losses of almost a trillion dollars, probably represented the shift in the IMF's view of the global situation to one of crisis (rather than the pre-crisis period that is being studied in this evaluation), although the WEO at this point was still relatively muted regarding the severity of the crisis.

with management of the ongoing crisis (e.g., in considering the IMF's views on financial innovations and regulatory regimes, as well as on lessons from earlier crises). The 2004–07 period was one of robust global growth with rising current account imbalances among key economies. During this period, there was a significant reduction in the demand for IMF resources, and the IMF was focused on surveillance.[8] Many stakeholders began arguing for a shrinking of the institution, as they saw little likelihood that it would again become an important lender.[9]

A. Evaluation Questions and Methods

9. 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, and it will attempt to assess the influence that these messages had on country authorities and country groupings (e.g., G-8, G-20, and G-24). 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's assessment of the global situation in the period preceding the crisis? To what extent was this assessment framed by, and an influence on, multilateral consultations? Did the crisis simulations that IMF management and staff had performed bear any relevance to the actual crisis?

- How was the IMF assessment conveyed to the G-7, G-20, G-24, and the membership at large? How did it compare with the assessment and messages of other organizations, public or private, that prepare assessments at the national or global level?

- To what extent did management and the Board address and convey difficult messages in cases when the staff pointed to evolving risks? When 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 in important member countries to discount these warnings?

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[8] Lending from the IMF's General Resources Account dropped from an average of almost SDR 20 billion in 2000–03 to less than SDR Three billion in 2004–07. Lending under the Poverty Reduction and Growth Facility (PRGF) and other highly concessional resources to low income countries is not funded from the IMF's General Resources Account (GRA).

[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.

- The IMF repeatedly warned the membership of potential risks from global imbalances, a concern also raised by the G-7 and others. Still little was done by the most affected members. Where the IMF messages backed by sufficient technical work, e.g., scenarios on the specific policy changes that were needed and on the potential results? Were there alternative ways to convey these messages that would have had more traction?

- 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 recession around the world. Did the IMF anticipate or consider such an outcome? What were its recommendations, respectively, to deficit and surplus countries to mitigate the consequent global economic slowdown?

Financial sector: analysis and advice

- How effective was the IMF in conveying emerging risks in the financial sector to the authorities in the U.S. and in other countries whose financial sectors would be directly impacted by a crisis in the U.S.?

- Were there technical weaknesses that prevented the staff from identifying systemic problems in the financial sector? Did IMF research address these issues? If so, was it 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?

- In particular, did the IMF point to the risks associated with the rapid growth in use of instruments such as asset-backed securities, 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?

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

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 (and other "deficit currencies"), 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? What messages, if any, did the IMF draw from this analysis?

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

10. To address these questions, 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 surveys, focus groups, and structured and semi-structured interviews with key stakeholders within and outside the IMF. Surveys and interviews will be conducted with country authorities, Board members, 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).

III. WORK PLAN

11. As mentioned above, the overall evaluation will be centered around three pillars, each studying a segment of IMF surveillance activities: bilateral surveillance in advanced economies, bilateral surveillance in emerging market economies and in advanced economies that subsequently utilized IMF-supported programs, and multilateral surveillance. Initially, the evaluation team will prepare background papers on each of these pillars. Below is a brief description of the issues to be covered in each of these studies. These studies are inter-related and together will shed light from different angles on the issues and questions mentioned above, which will allow for triangulation of the findings. Based on the results of this work, together with the results of surveys, evaluation workshops, and other consultations, the evaluation team will prepare a *chapeau* report with the main findings and recommendations.

12. ***Bilateral surveillance in advanced economies***. Case studies will be prepared to cover a series of advanced economies. These studies will focus on the analysis, diagnosis, and recommendations provided as part of IMF surveillance to advanced economies whose developments have systemic/global impact, either because of their size or because of their having an important role in capital markets. The evaluation will study the U.S., the U.K., selected Euro-zone countries and a sample of other advanced economies that have been affected in different manners by the current crisis. Given the nature of the crisis, it will focus on financial sector issues, but it will also assess more generally whether the IMF was looking at other issues that eventually proved to be relevant. It will examine the corresponding Article IV consultations, FSAPs and other relevant documents, and it will assess the extent to which systemic risks were identified. It will examine whether there were technical weaknesses or constraints in conveying difficult messages to powerful members.

13. In the case of the U.S., it will necessarily include the governance-related question of why no FSAP was prepared and whether the IMF insisted sufficiently

about the importance of such an assessment. It will also assess how much attention was given to financial sector issues in the course of Article IV surveillance. The study will examine the degree and quality of information exchange and collaboration with other organizations involved in financial surveillance (e.g., FSF, BIS, the ECB and some national authorities).

14. In some large advanced economies, staff identified significant risks, both in its bilateral surveillance and in various vulnerability exercises. This study will explore whether the IMF Board, management, and staff conveyed these findings clearly to the corresponding authorities and to the membership at-large. In particular, it will address the often-raised issue of "even-handedness," i.e., whether the IMF treats all members—large and small, advanced and developing countries—equally. In this context, the question is whether the IMF conveyed its messages on advanced economies in as open and a clear-cut manner as it did elsewhere. Finally, the study will examine whether the staff, management and the Board brought up these risks and their potential spillover effects as part of multilateral surveillance.

15. This study will be based on reviews of internal and Board documents on advanced economies and a comparison with documents prepared in other organizations and the private sector. It will be particularly interesting to compare Fund documents to those prepared by the authorities to assess whether the Fund offered technical value-added, and more importantly whether the Fund was more or less candid than other organizations (e.g., OECD and BIS) and the authorities about the risks and the need for corrective policies. In addition to document reviews, interviews would be conducted with staff working in those countries, with Executive Directors and with relevant authorities as well as officials in other international organizations and in private financial institutions. The study will draw on the IEO evaluation of the FSAP program, as well as the background work done on surveillance for the IEO Evaluation of the IMF Governance.

16. ***Bilateral surveillance in emerging market economies (and in advanced economies that subsequently utilized IMF-supported programs).*** The first study in this pillar will review the analysis and advice in bilateral surveillance provided to emerging markets that are now facing crises, due at least in part to the spillover of the global crisis. The period 2004–07 was one of prosperity for most emerging markets and developing countries, fueled by rapid global growth and easy availability of private financing. This study will look at the messages the IMF gave during this period to developing and emerging market economies that subsequently were severely affected by the crisis; and it will focus on some of those that eventually required IMF financial support in 2008 or 2009 (e.g., Hungary, Iceland, and Latvia) and a couple of countries that availed themselves of contingent IMF financing (e.g., Poland and Mexico). The study might also examine emerging markets that were severely affected by the crisis, but which so far have not chosen to pursue IMF financing (e.g., in Asia).

17. This study will compare the messages given to these countries during the period under review with the messages of the preceding five years, when some of them were in a program relationship with the IMF. It will explore whether the IMF adjusted its messages to the global situation facing these countries. Did it focus sufficiently on 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? Were the risks to funding disruptions in parent banks stressed in cases where foreign subsidiaries comprised significant shares of the banking system? Did the IMF raise concerns about over-sized financial sectors such as in Iceland? The study will distinguish between those countries that had been in a program relationship with the IMF in the five years before the start of this period, e.g., Latvia, and those that did not have an IMF-supported program before (or at least not for a long time), e.g., Iceland. By comparing these two types of countries, it will examine whether the analysis was more accurate and the messages more candid in countries that have had a closer relationship with the IMF. It will also explore how similar countries have so far avoided an IMF-supported program. Is this because they followed earlier IMF recommendations more closely? Or because the authorities pursued more prudent policies on their own?

19. This study will be based on reviews of internal and Board documents, both surveillance and program related, on emerging economies and program countries. These documents will be compared with those of previous years, as well as documents on these countries prepared in other organizations (e.g., the World Bank) and the private sector. In addition to document reviews, interviews would be conducted with staff working in those countries, with Executive Directors and with relevant authorities as well as officials in other international organizations and in private financial institutions. It will also draw on past IEO evaluations and in particular the evaluations of the role of the IMF in Argentina and of the capital account crises in Indonesia, Korea, and Brazil.

22. ***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 were multilateral consultations and vulnerability exercises in sharpening the diagnosis and as an early warning mechanism.

23. *Prima facie*, it appears that any warnings the IMF may have sounded were not effective in preventing the global crisis nor in bringing about policy changes that would mitigate its effects. It is important, therefore, to examine why this was the case.

Was this because of technical weaknesses, i.e., the IMF was not aware of the risks that materialized in the crisis? Or perhaps, the IMF did not transmit clear messages to the membership.[10] This could have happened due to a lack of appropriate channels to communicate difficult messages or because of political push-back. Finally, this study will 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.

24. This study will be based on reviews of WEOs, REOs, and GFSRs during 2004–07 and comparisons of these documents with those issued by other organizations that produce global forecasts and projections, (e.g., Federal Reserve, ECB, and the OECD); the private sector and academia. 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 structured interviews, workshops and focus groups. The study will draw on several IEO evaluations, including the evaluations on Exchange Rate Policy Advice, Multilateral Surveillance, and the Approach to Capital Account Liberalization.

[10] The case of the U.K. (where an FSAP was conducted and financial sector issues were regularly covered in Article IV surveillance but seemingly did not detect the vulnerability of the financial sector to the subsequent downturn in the real estate market) suggests that there were technical weaknesses in integrating macro and financial sector analysis to understand an economy's vulnerabilities—which may have been magnified by the difficulty in conveying clear messages.