INTERNATIONAL MONETARY FUND

TSR External Study—IMF and Global Financial Stability[1]

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[1] This paper represents the views of the author and does not necessarily represent IMF views or IMF policy. The views expressed herein should be attributed to the authors and not to the IMF, its Executive Board, or its management.

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EXECUTIVE SUMMARY

This report aims to provide an independent view of how the Fund is discharging its multilateral surveillance responsibilities, including its contribution to global financial stability and crisis prevention, working in coordination with other relevant international groupings/institutions such as the FSB and BIS. As we emerge from the global financial crisis (GFC), the Fund has regained much of its credibility and relevance. The GFC caught many, including the IMF, by surprise. Since then, the Fund has done considerable self-analysis and taken active steps to strengthen its surveillance and policy advice and to improve traction with policy makers. The IEO report on the Fund's performance in the run-up to the financial and economic crisis identified various shortcomings that needed to be addressed. One of its key findings was the inability of the Fund to connect-the dots, to deliver hard-hitting messages and the difficulty experienced by the Fund in thinking beyond mainstream/official views. Many of the IEO's findings have relevance to this review.

The GFC has shown the importance of paying more attention to macro-financial linkages, cross-border risks and spillovers as well as interconnections among global SIFIs. There are many actors and institutions, including the IMF, that seek to enhance global, regional and national financial stability. But with many actors, each pursuing subjects of special interest, there is a danger that some risks and other potentially problematic developments could "fall between the cracks" and escape the attention needed to prevent or mitigate another serious financial crisis. There is clearly a need for somebody to play an overarching role to connect-the-dots and fill in the cracks. We argue in this paper that the Fund is the only organization with the potential to carry out the overarching role[1], working hand-in-hand with other bodies, such as the FSB, BIS, OECD, national/regional risk boards and national authorities. Only the Fund has a truly multilateral and universal perspective – one that encompasses countries at different stages of development and one that cuts across borders, markets and sectors.

Can the IMF perform this overarching role? We believe that the Fund is, in many ways, already playing the overarching role that is needed to enhance the effectiveness of multilateral surveillance and strengthen global financial stability. The quality of its surveillance work is high and depth and breadth are improving. The Fund is increasingly effective in encouraging countries to take needed actions to address problems with cross-border implications. The Fund is able to work cooperatively with other international, regional and national financial stability actors providing analytical support for their projects and also offering advice to them when it becomes aware of gaps and opportunities for improvement in their work.

[1] The potential for the Fund to plan an "overarching role'" is also discussed in the Fund's Mandate paper –IMF (2010c).

The Fund is making efforts to look at systemic risks on a holistic basis and sharpening its toolkit and ability to spot threats and vulnerabilities that could become serious tail risks. However, important weaknesses remain. These include: (1) the Fund's multilateral surveillance products, while widely-read, do not always reach key decision makers directly because they are too voluminous; (2)much of the Fund's surveillance work is carried out in subject-area silos, which may impede the Fund's ability to connect-the-dots; (3) there are important institutional impediments (such as being too close to the official view, consensus-seeking culture) to the identification and discussion of emerging risks outside the mainstream, (4) the Fund as whole is not close enough to markets and tends to be behind the curve on what is taking place; (5) its culture and traditions are such that it approaches issues from a conceptual macroeconomic framework, which may impede its ability to spot risks in the financial sector and identify potential tail risks; (6) issues have to be analysed, thought through carefully, peer reviewed and finally published in carefully written and peer-reviewed documents, making it difficult for the Fund to monitor fast-moving events in the financial sector and to develop contingency plans and solutions for potential tail risks; (7) these institutional impediments weaken the Fund's ability to be a candid truth-teller.

How can it get there? Our recommendations fall into five broad areas:

(1) Strengthen the Fund's Analytics and Flexibility. The Fund will need to be nimble and capable of thinking "out of the box" in uncovering risks and proposing solutions. To do so would require breaking down silos and changing the work culture. We propose three new initiatives which could go some way towards breaking down the silos in the Fund. Incentives structures within the Fund must also be aligned to support these new initiatives**. Without changes to the Fund's structure, incentives and culture, there will be limits on how much can be accomplished and how effective the Fund can be in preventing the next financial crisis.** These three initiatives are: **(a) setting up a team (Pre-cogs) to uncover tail risks to complement the EWE work in the Fund.** This team would be geared toward market-based intelligence gathering instead of model-based research. It would spot emerging threats and risks, assess whether work is needed to better understand the nature of the threat or risk, including probability and impact issues, and bring the issue to the attention of senior management; **(b) study new and emerging risks through ad-hoc, issue-specific and temporary working groups, after the Pre-cogs have identified potential risks that need further investigation**; **(c) create a new summary report to top public and private decision-makers to be called the Global Policy Note (GPN), to be issued on a timely and frequent basis**. The GPN would be a distillation of the surveillance work taking place throughout the Fund, including new work on connecting the dots and emerging threats.

(2) Strengthen Traction and Impact. Strengthening the impact and traction of the Fund's multilateral surveillance efforts would involve several elements. One is to make sure the IMF's messages reach the decision-makers (by tailoring the products to target audiences). The second is to be build trust and rapport with key decision makers in both the public sector and global FIs. The third is to ensure that messages are delivered with sufficient clarity and candour.

(3) Work more effectively with the FSB. In working with the FSB, the Fund should "relax". It should work to support FSB initiatives without seeking credit while remaining confident in the understanding that the FSB and the Fund have reasonably distinctive mandates and most of the Fund's work is not threatened by the FSB. At the same time, the Fund should, where appropriate**,** comment independently on the effectiveness of FSB initiatives, despite its membership in the FSB.

(4) Adopt a threefold strategy to the resolution of data issues. The Fund should avoid an aggressive stance but instead adopt the following approach with regards to enhancing data disclosure of global SIFIs: (a) play an active role in the G20 Data Gaps Initiative, including the plan to develop a data template for Global SIFI's, while remaining mindful of the need to involve non-G20 countries at the appropriate time; (b) continue to work with existing data from both published and proprietary sources and do more analysis on interconnectedness; (c) add its strong voice to those calling for more extensive public disclosure by European and other non-North American financial groups. Over time, this strategy should enhance the credibility and expertise of the Fund in helping to monitor Global SIFIs.

(5) Strengthen the legal foundation. The Fund's mandate should be strengthened to give it more explicit authority to take on an expanded and overarching financial stability role. This could be done by amending the Articles of Agreement and/or adopting a Multilateral Surveillance Decision that clarifies the Fund's responsibility, role and scope of multilateral surveillance of the financial sector. When amending the Articles, consideration should also be given to amending Article VIII, Section 5 which precludes the Fund from requiring its members to report certain information required for effective surveillance, such as information relating to financial groups. This might be accompanied by a further change that would permit the Fund to protect confidential supervisory information. To promote timely and independent non-mainstream work, consideration should be given to a review process that is fast-tracked and separate from the Board. There is also merit to reviewing the role of the Board in the context of its ability to support the revised mandate and all aspects of the Fund's role as a Global Financial Stability Advisor.

Transforming the Fund will take time and resistance will be encountered even as new risks lurk around the corner. The Fund should seize the day and muster the wisdom, energy and fearless spirit to perform its role as the guardian of global economic and financial stability.

A. Introduction

1. As we emerge from the Global Financial Crisis (GFC), the Fund has regained much of its lost credibility and relevance. Now is the chance for the Fund to build on the positive role it played during the GFC and reach its full potential to become a Global Financial Stability Advisor. In this ever changing and complex world, there needs to be an independent voice that warns about the cracks in the system and the risks and vulnerabilities that threaten global economic and financial stability.

2. The aim of this review is to provide an independent view of how the Fund can ensure it is well positioned to make an effective contribution to global financial stability issues over the medium term, in coordination with other relevant international groupings/institutions (e.g. FSB/BIS). Section B explores the case for the Fund to play the role of a Global Financial Stability Advisor; Section C presents the evaluation methodology and sources, Section D assesses the Fund's effectiveness in performing the Global Financial Stability Advisor role and discusses some important factors which may limit the Fund's ability to play this role. Section E offers recommendations on how it can get there and Section F concludes.

B. The Case for a Global Financial Stability Advisor

3. **We have seen this movie before.** Following several very serious regional financial crises in the nineteen nineties, culminating with the Asian Financial Crisis of 1997, there was a flurry of international activity directed at preventing or reducing the chances of a recurrence of such serious crises in future (see Tietmeyer Report)[2]. This activity included the formation of the Financial Stability Forum (FSF)[3] and a number of stability-oriented projects spawned by the FSF and carried out by the Fund, the World Bank, the standard-setting bodies, and national authorities.[4] Initiatives included the introduction of the Financial Stability Assessment Program in 1999 by the Fund and the World Bank[5], enhanced surveillance activity carried out by the Fund and national authorities and often reported in publications such as the Fund's Global Financial Stability Report (started in 2002) and the Financial Stability Reviews of many national central banks around the world.

[2] Hans Tietmeyer, President of the Deutsche Bundesbank; Report to the G7 Finance Ministers and Central Bank Governors, 2 November, 1999.
[3] The first meeting of the Financial Stability Forum created by the G7 Ministers and Governors at their meeting in Bonn on 22 February 1999, was held at the IMF in Washington on 14 April, 1999.
[4] The list of initiatives covered the following areas: (1)Promoting transparency and disclosure;(2)strengthening prudential regulation and supervision;(3)enhancing market infrastructure and functioning;(4)improving crisis prevention and management. See FSF (1999b).
[5] IMF(2001).

4. All this activity and more were carried out with energy and determination. Useful actions were taken to address potential sources of global and national instability. However, it is the impression of the authors and others that as time passed and the world entered a long period of relative stability, complacency set in and the surveillance work carried out by the Fund and other actors became less effective [6].

5. There are similarities between the responses of international and national authorities to the regional crises of the nineteen nineties and their response to the Global Financial Crisis (GFC). While the response to the GFC has been more forceful and broad-based, led by the G20 rather than the G7, there are many common elements, particularly in the leadership roles played by the then-FSF and later the Financial Stability Board (FSB). The seriousness of the GFC and the challenges still facing many countries during a long and painful recovery phase suggest a need to continue to look for ways to improve the global response to the GFC and ensure that long term, sustainable steps are taken to enhance multilateral surveillance and reduce the risk of future crises. As we will explain, we believe that the IMF must play a central role in this process.

6. **Need for a Global Financial Stability Advisor.** There are many actors and institutions that seek to enhance global, regional and national financial stability. In addition to the Fund, other organizations making contributions to financial stability include the World Bank, the Bank for International Settlements (BIS), the Financial Stability Board (FSB), standard-setting bodies such as the Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS), the Organization for Economic Cooperation and Development (OECD), regional development banks and national/regional systemic risk bodies (such as the European Systemic Risk Board, the Financial Policy Committee (UK) and the Financial Stability Oversight Council (US)). All have roles to play.[7] But with many actors, each pursuing subjects of special interest, there is a danger that some risks and other potentially problematic developments could "fall between the cracks" and escape the attention needed to prevent or mitigate another serious financial crisis. For instance, before the GFC, unsustainable global imbalances were identified as a key source of instability, but the Fund did not connect this with the buildup of financial and housing market imbalances in the advanced economies. It did not "connect the dots" between the real economy and the financial sector and it did not link the

[6] See Turner Review, IEO Report on the IMF Performance in the Run-Up to the Financial and Economic Crisis (2011), Initial Lessons from the Crisis (IMF 2009b).

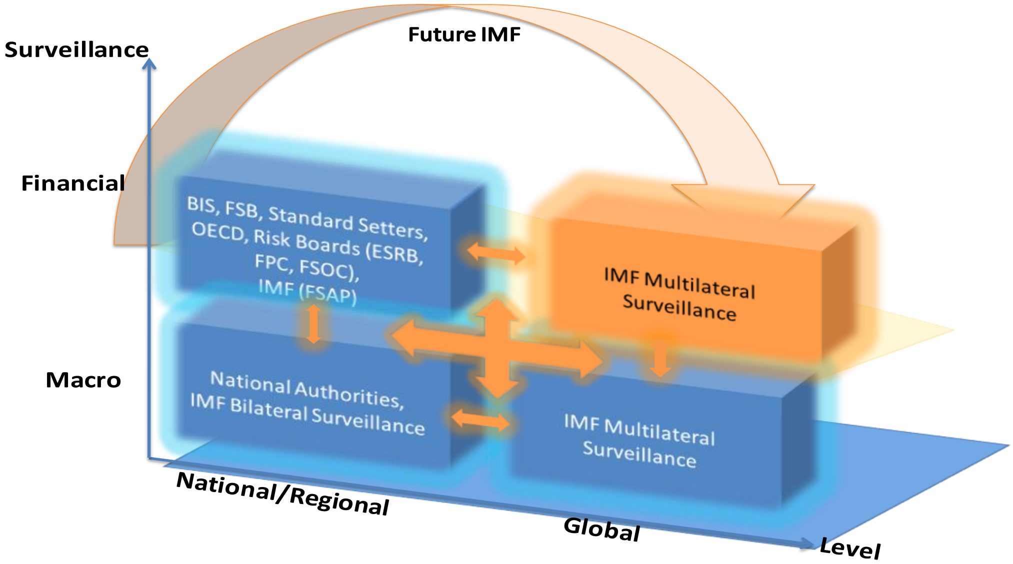
[7] The mission of the FSB is: "to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies"; the standard-setting bodies seek to enhance understanding of key supervisory issues and improve the quality of supervision worldwide and the OECD participates in various initiatives to enhance the resilience of the global financial system such as, amongst other things, drafting the Principles of Corporate Governance and enhancing the market stability of Highly-Leveraged Institutions. The role of the Systemic Risk Board is to identify, monitor and take action to remove or reduce systemic risks in the financial system.

ultra-low interest rate environment to increased risk-taking behavior by financial institutions and individuals which eventually became a systemic problem.

7. To minimize the possibility that important threats to financial stability will escape the attention of the various financial stability actors, there is a need for one organization to play an overarching role: monitoring all risks and potentially problematic developments with cross-border implications as well as the work carried out by the other actors to ensure that sufficient attention is being paid to any risks and other developments that could conceivably contribute to a financial crisis.

8. This overarching role is illustrated in Figure 1 below (orange arrow). Currently, the many actors occupy slightly different yet overlapping spaces. The FSB and the standard setting bodies operate in the "national/regional-financial" space; setting regulatory standards, addressing vulnerabilities and developing and implementing strong regulatory, supervisory and other policies in the interest of financial stability. The national and regional stability bodies, including the new financial stability boards in the U.S., EU, and U.K., are mandated to support financial stability in their respective jurisdictions. The IMF, on the other hand, operates in the global-macro, national-macro space through its multilateral and bilateral surveillance. Through its work on the FSAP to assess financial regulation and supervision, it occupies the national-financial space and through its financial stability analysis in the GFSR, it occupies the global-financial space. In the area of financial stability analysis, there is some degree of overlap between the FSB and IMF. We argue in this paper that the IMF's role in financial stability is to fill the gaps in the global-macro-financial space by working together with and supporting the work of the various actors and by fully integrating its own bilateral and multilateral surveillance activities (orange box and arrow).

Figure 1: The Role of the IMF in Financial Stability



9. The GFC has shown that there are multiple gaps in our understanding of the world -- regulatory and supervisory gaps, data gaps, gaps in understanding inter-linkages. These gaps call for an integrated view of the world and a global response, a view that is not divided by geography, stage of development or academic disciplines. There needs to be an overarching agency to bring together the proliferation of international, regional and national bodies charged with different aspects of financial oversight. This agency would play the role of the Global Financial Stability Advisor – to be an independent, unbiased umpire; objective commentator; trusted, confidential advisor and ruthless truth-teller on key issues and policies that have a bearing on global financial and economic stability. There are obvious tensions between some of these roles, particularly those arising from the Fund's lending and surveillance roles. We will discuss these tensions and how they can be managed later in this report.

10. The Global Financial Stability Advisor would be the independent voice on things that "fall between the cracks" such as the need for robust supervision (see Section D below) and the development of macroprudential tools. It would provide a platform for discussions of global policy issues, foster global policy coordination and provide the intellectual leadership to connect-the-dots such as (see Appendix 4 for examples of recent Fund work in this area):

- analyse and research macro-financial linkages such as the impact of the level of interest rates on risk-taking behaviour, explore the channels of transmission from interest rate developments to risk-taking behavior, explore the impact of financial system risk-taking on the macro economy;
- analyse cross-border spillovers ;
- identify sources of systemic risks and sources of increasing risk concentrations and trace through the effects of their realisation;

- aggregate financial exposures and develop a system-wide picture of interlinkages among the major global institutions;
- map out the interlinkages between major players in the financial system and the risk transmission channels;
- identify cross-cutting themes that group countries according to financial exposures, systemic importance, risk profile;
- identify crisis triggers and articulate adverse scenarios that may play out, such as a default in the periphery European economies or the risk of a hard landing in China.
- play the role of an "objective commentator" on regulatory reforms, as a counterweight to the key countries which have the greatest influence and vested interests in shaping regulatory reforms.;
- propose solutions and mitigating actions to address threats to financial stability.

11. **Who can play the role of Global Financial Stability Advisor?** In our view, the Fund is the only organization capable of carrying out the overarching role described in the previous paragraph. Only the Fund has the deep macroeconomic and financial sector expertise to monitor global and cross-border developments and to understand the linkages between developments in different countries and between economies and financial sectors. Only the Fund has a truly multilateral and universal perspective – one that encompasses countries at different stages of development and one that cuts across borders, markets and sectors.

12. The Fund's role began to shift after the crisis. From its macroeconomic role, the Fund has risen to become a leader in cutting-edge research on macro-financial risks. Who else but the Fund could play this role? One of the authorities interviewed said the Fund should feel confident about its "unassailable position in the world", with its "wealth of PhDs and multilateral perspective" as well as the growing number of finance and macro-finance experts. There is so much to do in this area and the Fund has its work cut out for it right from the start.

13. In addition, only the Fund has the "bully pulpit" and influence through its lending capacity and ability to "name and shame[8]" to be able to encourage necessary actions by country authorities. While other organizations have special competencies and important roles to play in the search for greater financial stability, such as the vital role of the FSB and the standard setters in strengthening financial sector resilience, none can match the capacity and reach of the IMF.

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[8] Under the existing legal framework, publication of country specific documents, e.g., Article IV consultation reports, requires consent of the member, and the Fund also cannot publish without the consent of the relevant parties, information that it obtains on a confidential basis. Despite these limitations, it can and does do so, using public information. Further, because members understand the importance of transparency, the prospect of discussions about publication can give the Fund leverage with members.

14. This does not mean that the Fund should attempt to cover all financial sector issues and nor should it try to become a global regulator. However, it should monitor the work of other financial stability actors and seek to fill gaps in their work when necessary. And it should concentrate its considerable resources on all that bears on macroeconomic and financial system stability, the two being intertwined.

15. **Is the Fund playing the role of Global Financial Stability Advisor now?** We believe that the Fund is, in many ways, already playing the overarching role that is needed to enhance the effectiveness of multilateral surveillance and strengthen global financial stability. The quality of its surveillance work is high and depth and breadth are improving. The Fund is increasingly effective in encouraging countries to take needed actions to address problems with cross-border implications. The Fund is able to work cooperatively with other international, regional and national financial stability actors providing analytical support for their projects and also offering advice to them when it becomes aware of gaps and opportunities for improvement in their work, such as the paper on the need for robust supervision[9].

16. But there is much more to do. Although the Fund is making efforts to look at systemic risks on a holistic basis, linking macro-economic, fiscal and financial sector risks and challenges, much of its work is still carried out in subject area silos by departments devoted to one stability product. There are also important institutional impediments to the identification and discussion of emerging risks outside the mainstream consensus. Further, while the Fund's multilateral surveillance work is well researched and thoughtfully reported in various publications and fora, it has not achieved enough traction with decision makers (See Box 1).

Box 1: Quotes from Interviews with Authorities – IMF's Role as a Global Financial Stability Advisor

- The IMF's mission should be to link the macro-economic and the macro-prudential – to show how things fit together.
- The Fund needs to look for interlinkages. Now, responses tend to be differentiated by the separate disciplines.
- Where the Fund adds unique value to financial stability is its expertise in macroeconomic policy and its ability to understand the role of global imbalances as drivers of financial instability.
- The Fund needs a better framework for understanding the interconnectedness of financial systems and issues of contagion.
- The Fund's comparative advantage is its integrated view of the world.
- Don't ask the Fund what is (really) going on. It can't answer. (Context was Fund's ability to explain interlinkages)
- The Fund is in the best position to advise when to trigger the counter-cyclical buffer.
- There is a need to get people in different disciplines to share expertise. Staff need to work more closely together and to develop a common view. Must have the culture and expertise to better understand (economic and financial) systems.

[9] IMF (2010g).

C. Evaluation Methodology and Sources[10]

17. To review the role of the IMF as a Global Financial Stability Advisor, we carried out an independent assessment of Fund surveillance on global financial stability issues, specifically on whether it has provided sufficient thought leadership since the Global Financial Crisis (GFC) in terms of offering timely, candid and effective analysis and advice. We examined the Fund's multilateral surveillance activities since 2008, when the last surveillance review was carried out, and considered existing surveillance activities as well as trends and future plans. We gathered information from three main sources: interviews with IMF staff, interviews with authorities and experts[11] and a review of key IMF multilateral surveillance and related products. In selecting interviewees from the policymaking community, emphasis was placed on senior public sector decision-makers who are in a position to take action in response to Fund recommendations. Within this limitation, efforts were made to obtain a mix of backgrounds and experience and to achieve reasonable representation from advanced and emerging countries with varying sizes and in different geographical regions. Given the diverse and interconnected nature of multilateral surveillance, we reviewed a wide range of products including the GFSR, the WEO, Fiscal Monitor, G20 discussions on financial stability issues, thematic reports, the Early Warning Exercise, initial findings of spillover analyses, past IEO reports and vulnerability assessments, Article IV Consultations Reports and FSSA Reports of various countries. We also reviewed other competing or similar reports such as OECD, BIS and FSB reports, credit rating agencies' reports and Financial Stability Reports of various central banks. Please see Appendix 1 and 2 for the list of interviewees and the list of references.

18. To our interviewees, we posed the following key questions:

- Do you think the Fund is well-placed to be the Global Financial Stability Advisor? If so, why?
- What are the impediments that are preventing it from fulfilling its role?
- What are your suggestions for getting there?
- How has the Fund's analysis and advice improved during and after the Global Financial Crisis?
- Has IMF's advice on the financial sector been timely, candid and effective?
- In terms of analytical content, do the flagship products give sufficient attention to macro-financial linkages, spillovers and contagion risks?
- To what degree are warnings issued in a specific and actionable manner?

[10] The IMF placed important limitations on the scope of our work, precluding us from reviewing matters directly related to ongoing financial operations and from reporting the substance of certain internal deliberations relevant to the extent of transparency. Thus we have not been permitted to comment directly on specific questions relevant to Fund surveillance in certain European countries currently receiving financial assistance from the Fund.

[11] The authors would like to express their gratitude to the authorities for their valuable time and insightful responses. The authors would also like to thank Mr George Pineau of the ECB for information on the ESRB.

- How can it best coordinate and work with other international groupings such as the FSB, G20 on surveillance in the financial sector?

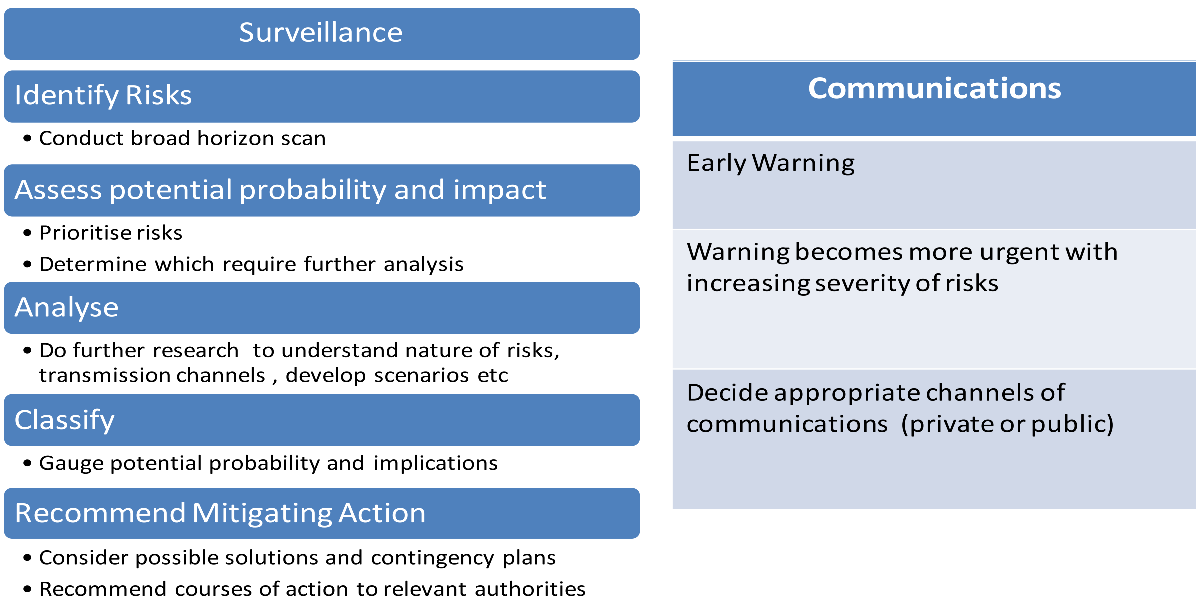
19. Our understanding of the nature of the multilateral surveillance process is consistent with that adopted by the Independent Evaluation Office in its 2006 review of the Fund's multilateral surveillance activities[12] . The goal of multilateral surveillance is to identify and mitigate threats to financial stability and, as distinct from bilateral surveillance, concentrates on threats that could affect more than one country or could spill over from one country to another. There are several elements to multilateral surveillance, including issue identification, assessment, analysis, classification, communication and action. These are graphically represented in Figure 2. A brief, generic discussion of each element follows:

- Identification: The first step in the surveillance process is to do a broad horizon scan to identify potentially high impact issues that could pose a risk to financial stability. Because, at least initially, such issues may appear to have a low probability of occurrence, they may not be readily apparent.
- Assessment: At any time, there may be a number of low probability and potentially high impact issues that should be considered. An initial assessment is needed to identify those that pose the most serious potential risks in order to determine which require further analysis.
- Analysis: Analysis includes studying the issue to understand its characteristics, the nature of the risks it poses, potential transmission channels and impacts. This may include the creation of scenarios and stress testing.
- Classification: Once the issue has been analysed, it becomes possible to understand the potential impacts and the seriousness of the risks posed to financial stability. It should also become possible to determine mitigating actions to reduce both probability of occurrence and the potential impacts of the particular issue.
- Communication: There is a need to communicate emerging threats to financial stability at various stages of the surveillance process. Communication can occur following the identification stage in the form of early warning communications. It can also occur following the assessment and analysis stages. As the understanding of threats deepens, and seriousness is confirmed, the nature of the communication should change. Warnings should become more urgent and more strident. Communications can take place through public and private channels. Typically, the latter will be more pointed and more specific, but both should be used to deal with emerging threats.

[12] IEO (2006)

- Action: The ultimate goal of surveillance is to encourage action to mitigate the probability and/or impacts of an emerging threat. The Fund can and does encourage action by considering solutions, including mitigating strategies and contingency plans, to address emerging threats and exercising moral suasion backed by authoritative research, the application of private and public pressure, and through imposing conditionalities in its financing operations.

Figure 2: The Surveillance Process



D. What are the key successes, opportunities for improvement and limiting factors?

20. Based on our own reviews of IMF surveillance products, discussions with staff and senior decision makers, we believe that the IMF's multilateral surveillance work has improved significantly since the GFC. It is of high quality and is having a positive impact on global and cross-border financial stability. However, we also see gaps in the IMF's surveillance performance and an opportunity to have an even greater positive impact on financial stability. This section will outline where we think the IMF is doing well, where it might improve and will discuss some of the factors that may stand in the way of improvement.

What is the Fund doing particularly well?

21. **The quality of work going into the IMF's surveillance products is very high.** From our review of the IMF's existing surveillance products, we formed a positive impression of the quality and rigour of the analysis, the clarity of writing, and the effectiveness of the report organisation. Reports are

generally well-structured and intelligently summarised. They are usually very long and full of information, but boxes, charts and headings make it reasonably easy to follow the arguments without having to read the entire document. Although the senior decision-makers that we interviewed had some criticisms and many suggestions for improvement, they started from a common position that the existing products are of high quality and have improved in recent years (see Box 2).

Box 2: Quotes from interviews with authorities – Comments on IMF's Surveillance Products

- *If you want to know what is going on in the world, the IMF has no rivals.*
- *Quality from a technical point of view is of a high standard; vastly better than five years ago; reports are quite uniformly rigorous and well researched.*
- *The quality, precision and candour of the Fund's surveillance have improved. The IMF has made a lot of strides in recent years; publications are good.*
- *The Fund has improved its coverage of financial risks.*
- *IMF products are unrivalled in the world.*
- *We have seen many improvements in the last year, especially in the GFSR.*
- *GFSR is an extremely good document, with good detail and thoroughness. It introduces many complex issues in a way that is understandable.*
- *The WEO is the IMF's flagship publication and should remain so.*
- *The EWE was useful from the start and continues to develop; it is pointed in analysis and presented well.*
- *The WEO is a worthy product.*
- *The Fiscal Monitor is best. It doesn't mince words.*
- *G20 Surveillance notes are a useful document.*
- *G20 Surveillance notes are focused and crisply-written.*
- *The Spillover Reports are really promising.*

22. **The IMF surveillance products are widely read**. Anecdotally, we have observed that IMF surveillance products and pronouncements are attracting increasing media attention, well-covered in editorials and articles in major newspapers such as the *Economist*, the *Financial Times* and the *Wall Street Journal*. These observations are supported by EXR media data which showed that in the recent April 2011 Spring Meetings, IMF's flagship products generated 75,598 mentions over a more than six-day period. Also, media references to WEO tend to be much greater than other reports covering similar territory; for instance in 2005 coverage of the WEO was about three times larger than coverage of the OECD Economic Outlook.[13] This is a reflection on the effectiveness of the Fund's efforts to ensure that its findings and advice reach its stakeholders. Those efforts include speeches, presentations and press conferences by the Managing Director, the First Deputy Managing Director, the Economic Counsellor

[13] IMF (2007).

and the Financial Counsellor. From our own observations and discussions with our interlocutors, these communication initiatives have been effective and well received. However, effective reach is just a first step towards achieving traction with policymakers. We will address the issue of traction in paragraphs 44-45 and in the next section.

Where do we see opportunities for improvement?

23. The next paragraphs outline potential opportunities to improve the effectiveness of the Fund's multilateral surveillance, including impediments that may stand in the way of effective surveillance. These are not necessarily paragraphs about areas of weakness. In most cases, the opportunities identified build on **existing strengths** and **improving trends**.

24. **Some IMF Surveillance Products tend to reach decision-makers indirectly rather than directly.** Based on our interviews with 19 senior public sector decision-makers[14], they are aware of the flagship products but do not have the time to read them systematically and thoroughly[15]. (See Box 3). For the longer publications, like the WEO and GFSR, they tend to read overviews and summaries prepared by their own staff, or newspaper articles, press releases and texts of speeches given by senior IMF officials. For shorter products, like the G20 surveillance notes or those delivered at meetings like the Early Warning Exercise (EWE), the exposure tends to be direct. We chose to focus our limited interview time on senior decision-makers because they represent the type of individuals who are in a position to take action on recommendations made by the Fund. In our view, it is important that such individuals receive the Fund's key messages directly. This appears to be happening to some extent, but it is also apparent that some of the messages are being filtered by others, such as the media or staff preparing summaries for their bosses. The issue here is whether the Fund is controlling the delivery of its messages to those in a position to act on them. While the Fund is making some important and increasingly effective efforts to do so, such as by press conferences and press releases, it may not be as effective as it could be in this regard.

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[14] Most of them are central bank governors or finance ministers, some with Fund experience, and in a few cases with senior private sector experience as well.

[15] This is supported by the IEO's review of the Fund's Multilateral Surveillance, IEO (2006), which found, on the basis of interviews with major countries, that " less than 25% of ministers and governors and their deputies actually read the WEO and GFSR"; and from their survey of G7 countries, none of the G7 countries policymakers read the WEO and only one country reported that senior policymakers read the GFSR.

Box 3: Quotes from Interviews with Authorities – Do decision-makers read the flagship products?

- *I don't read a large amount of IMF material. It tends to be rather voluminous and dense. I don't know where to start.*
- *I will read an IMF publication when someone refers it to me or when it is covered in the press.*
- *I don't read the Fiscal Monitor or the GFSR. I may read summaries of the WEO to compare with our own analysis. Working level people will read these. I do read the G20 Surveillance notes because they are an easy read.*
- *I skim the GFSR and the WEO, looking at headings and boxes.*
- *You can't read everything but you can read the overviews and have staff prepare summaries.*
- *The analytical chapters of the WEO and GFSR read more like published internal notes.*
- *Publications are oriented to mid-level technical people.*
- *I feel a tremendous sense of guilt in not reading the WEO and GFSR.*

25. **Much of the IMF's surveillance work is carried out in subject-area silos.** Each of the Fund's flagship products has a distinct focus. The WEO tends to concentrate on the real economy and tracks baseline trends as well as a range of other possible outcomes. The Fiscal Monitor addresses important fiscal developments and trends around the world. The GFSR analyses risks and vulnerabilities in the global financial system. The EWE concentrates on tail risks in a more focused manner and, because it is presented to private audiences, can be more pointed and action-oriented. The emerging Spillover Reports are intended to deal with both macroeconomic and financial risks in systemically important countries that can have effects on other countries or the financial system. The WEO is prepared and published by the Research Department, the Fiscal Monitor by the Fiscal Affairs Department and the GFSR by the Monetary and Capital Markets Department, while the EWE and the Spillover Reports are jointly produced by interdepartmental teams. There is some cross-fertilisation between departments, such as inputs from country desks and information provided by functional departments, particularly for bilateral surveillance and cross-country analysis, but the "ownership" of each product tends to lie with one department. This functional specialisation produces deep subject matter expertise and departmental pride in "its product". The silo effect may be exacerbated by the different backgrounds of those Fund staff members with financial expertise and those with macroeconomic expertise, and even by possible incompatibilities in models used by the different departments. This was evident in our interviews with Fund staff and discussions of our preliminary findings. It was also apparent that Fund departments tend to hold their own products in higher regard than those of other departments to a degree that could undermine interdepartmental cooperation.

26. The distinctive focus of some of the Fund's flagship surveillance products may handicap efforts to fully understand the transmission of risks. Crises rarely pause at the border between the financial sector and the real economy. In the recent GFC, global imbalances contributed to high levels of liquidity, excessive household borrowing and excessive financial sector leverage. The crisis erupted in the

financial sector but severely impacted the real economy in a number of countries. As authorities struggled to contain the crisis, public sector leverage was needed to replace private sector leverage and now, as we emerge from the tail of the crisis, we are facing new imbalances and a close link between highly indebted and fiscally constrained sovereigns and weak and undercapitalised banks. The Fund is well aware of this and is making serious efforts to break down barriers between products through interdepartmental work and increasing cross-referencing between products. New and emerging products like the EWE and the Spillover Reports are intended to view risks on a cross-sectoral basis. It is also evident that IMF messages are becoming more integrated "at the top of the house" particularly in the G20 surveillance notes and in speeches and presentations given by the Managing Director. However, much of the IMF's analytical capability continues to operate within sectoral silos and we are of the view that not enough is being done to understand and address cross-sectoral linkages and transmission channels (Box 4).

Box 4: Quotes from Interviews with Authorities – The 'Silo-Effect'

- *There is too much internal competition within the IMF.*
- *It is hard to solve turf issues within the Fund.*
- *The MCM silo effect is worse than in other units.*
- *The reason for the Spillover Reports is because SPR needs its own report.*
- *Internal politics are an impediment for the Fund.*
- *The Fund does not have an effective set of products as it stands now.*

27. **The Fund could do more to explore tail risks, recognising that the seriousness of a risk is not always evident on first appearance.** This is what the joint IMF-FSB's Early Warning Exercise (EWE) seeks to do -- to detect vulnerabilities and warn about tail risks. By drawing lessons from previous crises, the EWE aims to be a forward-looking, "flag-raising "exercise, connecting the dots between different risks, "uncovering the scope for potential spillovers and to understand their systemic impact."[16] The EWE is still in its early days and so far it has focused on the risks from the GFC that have already materialised. This may have given the impression to some of the authorities interviewed that the EWE is focusing on obvious tail risks. Others have expressed the view that this is indeed appropriate as we are still in the tail, suggesting that **"***the time to be looking more broadly"* is when things have stabilised. Indeed, as the Fund states in the EWE design paper,[17] it will place greater focus on tail risks and "new sources of systemic risks" when conditions have stabilised and it will do so by combining *"rigorous empirical analysis with surveys of experts and market intelligence".* We welcome the Fund's efforts in this area. However, we believe that the Fund does not have the luxury of concentrating on the known tail risks until the GFC is behind us. In our view, it must try to do both – continuing to monitor efforts to address the known tail risks while actively scanning the horizon for emerging threats. While we are impressed

[17] IMF(2010k)

with what we have been told about the EWE to date, and believe that the process, as designed, will make a valuable contribution to the Fund's surveillance activities, we are not convinced that the EWE will be fully effective in scanning the horizon for emerging threats. While, as noted above, Part I of the EWE design paper suggests that the Fund will combine empirical analysis with market intelligence, Part II, which describes the EWE methodology, is heavily weighted to the former. When we take into account that the process is largely driven by economists, who tend to see the world through a conceptual framework that starts from the macro economy, we worry that the Fund will miss important developments in markets if its methodology is limited to that described in Part II of the paper. By their very nature, tail risks can arise from the most unlikely sources, including the financial sector and not just the economy. We would add that macro-financial modelling is still in its infancy and the Fund's current suite of models will not always capture market developments and complexities. To play the role of the Global Financial Stability Advisor well, we are of the view that the Fund will need to move away from its comfort zone and adapt to a certain messiness that arises from not knowing where something starts and ends, improvising as it goes along. We will discuss this in more detail in the next section.

Box 5: Quotes from Interviews with Authorities -- Exploring Tail Risks

- *The IMF is concentrating too narrowly on the Crisis. It needs to cast its net more broadly.*
- *The Fund should do more to test the robustness of the system.*
- *Very few issues are raised in the GFSR that are not familiar to senior people with responsibilities in financial stability.*
- *The WEO is not surprising or troubling and is sometimes behind the game.*
- *The Fund's analysis can go further. More has to be done to unearth connections between actions of major countries and the global economy.*
- *The EWE is a bit simplistic. Its focus on tail events is too narrow. Other events could present themselves and destabilise the economy.*
- *The Fund is focusing on obvious tail events.*
- *But:*
- *We are living in the tail. The biggest risks are known [and need to be addressed]. The time to be looking more broadly is when we are back in a 'great moderation'.*
- *It would be very demanding to ask the Fund to identify emerging tail risks. If the Fund can provide a deeper understanding of known tail risks, that would be quite a lot.*

28. **There are institutional impediments to identifying and discussing emerging tail risks.** Despite some worthwhile efforts by MCM to establish closer links with market participants and plans by the EWE to seek market intelligence, the Fund as whole is not close enough to markets and tends to be behind the curve on what is taking place. Further, our perception, supported by discussions with external authorities, is that the Fund's culture and tradition are incompatible with the timely identification and discussion of emerging tail risks. The Fund's normal approach is to do careful research

into each issue to be considered, including studying the issue, reading academic literature, developing a conceptual framework, creating models, testing the models and attempting to reach conclusions that can be supported quantitatively. Conclusions are thought through carefully, peer reviewed and finally published in well-written and closely reviewed documents. Part II of the EWE design paper, referred to above, is consistent with such an approach. This approach is laudable and forms the basis for the Fund's sound reputation. It can and must play an important part in multilateral surveillance, particularly in deepening our understanding of known risks. However, it is not well suited to the process of turning over rocks to look for potential tail risks, with the monitoring of fast-moving events in the financial sector and with the development of possible solutions and contingency plans for potential tail risks even before the full dimensions of the risks can be fully analysed and understood. There are also risks to the Fund in communicating concerns about emerging threats to financial stability that have not been thoroughly researched. The concerns might later prove to be exaggerated or unfounded, undermining the Fund's reputation for solid research and analysis. Public communication of such concerns by a body as authoritative as the Fund could have adverse market impacts, creating an understandable bias toward caution and taking the time necessary to be certain that the Fund's line is correct. An additional factor that may influence the Fund's ability and willingness to explore emerging threats outside the mainstream consensus is the Fund's member-owned and governed structure that may put pressure on the Fund to be sure it is right before challenging the views of members In an interview with the IMF, Carmen Reinhart said: "I am very sceptical that even if the Fund is more attuned to growing problems in the future, it can actually publicly be very open about exposing vulnerability."[18] In discussions with staff and our external interlocutors, other impediments were referred to. These include a tendency within the Fund to "group thinking", leading to self-censorship on the part of Fund staff and making it difficult for ideas to emerge that are not consistent with the group consensus. They also include reluctance on the part of members to take advice from the Fund when such advice does not fit existing beliefs or priorities, also contributing to self-censorship. In this increasingly complex and fast-changing world, if the Fund is to play all aspects of the overarching role of Global Financial Stability Advisor, it will have to find ways to overcome these impediments and become nimble and capable of thinking "out of the box" in uncovering risks and proposing solutions. Without changes to the Fund's structure and culture, there will be limits on how much can be accomplished and how effective the Fund can be in helping to prevent the next financial crisis.

29. **The candour with which the IMF communicates its findings is improving, but it can be further enhanced in some cases.** In evaluating the effectiveness of the Fund's multilateral surveillance activities, a very important criterion is whether the Fund's findings are delivered clearly and candidly, particularly to those who need to take action to address emerging risks. This issue is linked to the question of whether the Fund is seen as fair and unbiased, discussed in paragraph 35, below. Past assessments of

[18] We thank Mr Willy Kiekens for sharing this quote with us.

the Fund's multilateral surveillance performance[19] have concluded that the Fund was insufficiently frank and candid about its concerns, especially to advanced economies. Those we interviewed were conscious of the delicate balance that the Fund needs to maintain between public candour about threats to financial stability and the need to preserve public confidence and avoid precipitating that which the Fund and the authorities are trying to avoid. We would also acknowledge that some issues can be more sensitive than others in the eyes of the country or countries most affected, requiring careful handling on the part of the Fund. Some stressed that the Fund can and should deliver messages more candidly in small, private groups and in its bilateral dealings with individual countries rather than in its flagship publications. Taking these factors into consideration, most believe that the Fund's candour has improved in recent years but still falls short of what is needed in both public and private fora (See Box 6).

Box 6 : Quotes from Interviews with Authorities – On Candour

- *In delivering its messages, the Fund needs to balance between public disclosure and small group consultations.*
- *The EWE was pretty hard hitting.*
- *The Fund has been very blunt about what they thought (re private communications regarding European sovereign debt concerns)*
- *The Board receives a sanitised version of the EWE.*
- *The WEO is too timid on spillover effects.*
- *Staff need to be more adventurous and aggressive. Staff are rational and accept the realities of countries. This affects outcomes.*
- *If things are not said with clarity, they are not worth saying.*
- *Many members of FSB were not happy with what the Fund wrote (on Basel III). The Fund got an earful. This has affected frankness and caused the Fund to mute its conclusions.*
- *On the G20 Surveillance Notes, the IMF is doing the minimum. It could be more direct.*
- *The G20 notes have been softening up their critiques of European initiatives.*
- *Candour is improving; The Fund is trying hard to be candid without bringing on that which (through candour) they are trying to prevent.*
- *The Fund moderates messages for political purposes.*
- *The GFSR stopped doing the table on post-GFC bank write-downs.*
- *The IMF is too close to the official view.*

30. On the issue of candour, an example of the considerations to be balanced by the Fund is provided by the European stress tests results, which were published by the CEBS in July 2010. The European stress tests were seen by many as a confidence-building exercise. There was a widespread

[19] IMF (2011a)

consensus by private sector commentators and analysts[20], as well as in the non-European supervisory community, that the European stress tests had been reverse-engineered to produce a high pass rate and were less stringent than the US stress tests[21]. The Fund's comments, at the time, were more positive. In the July 2010 GFSR Update, the Fund referred to the need to "pursue greater transparency and credible stress testing of European banks" to address the uncertainty about individual European banks' exposure to sovereign debts and expressed the view that the publication of the results of the ongoing stress tests was "a very important step". In the Oct 2010 GFSR, the Fund indicated that the results of the stress tests "helped to reassure markets". However, in the April 2011 GFSR, it spelled out a long list of parameters that should be included in the new round of European stress tests, implicitly suggesting that the earlier tests were inadequate. We can understand why the IMF might not have wished to undermine the efforts of the European authorities to boost confidence in their banks, but given widespread scepticism of the stress tests, it seems unlikely that constructive criticism of the tests by the Fund, at the time they were carried out, would have surprised any one. Instead it would have enhanced the Fund's reputation and therefore its influence as an independent commentator on financial stability matters.

31. We have, on the other hand, noted some good examples of strong, pointed messages delivered publicly, such as the need to restore fiscal balances to a more sustainable path in the US and Japan (see Box A). We also heard from our interlocutors about the general frankness and candour of messages on a variety of issues delivered by the Fund in private sessions.

Box A: What the Fund said about the United States

There is a "structural break" in the Fund's tone on the US before and after the crisis. In August 2007, at the start of the GFC, the Article IV report on the US was still rather sanguine, predicting a "soft-landing" for the US and that "innovations under the "originate-and-distribute" business model have helped dispersed risk and raise capital adequacy of core institutions."

In contrast, the Article IV report and FSSA report in 2010 sounded a more cautious and urgent tone (with the benefit of hindsight). The Article IV report urged the authorities "to cautiously complete the exit from extraordinary policy support and decisively deal with long-term legacies, namely fiscal imbalances and (as identified in the Financial Sector Assessment Program (FSAP)) gaps in financial regulation, to secure stable medium-term growth, limit adverse international spillovers, and contain risks of new financial excesses."

On the financial sector, the Fund highlighted that "banks remain vulnerable to shocks and will need additional capital to lend when credit demand recovers...." Stress tests illustrate important

[20] Wolfgang Munchau (2010), "A test cynically calibrated to fix the result", Financial Times, July 25.

[21] Emma Saunders (2011), "Stress test: US vs Europe", March 18.

vulnerabilities in the bank and nonbank sectors" and that "...even a modestly adverse scenario could leave important parts of the system—especially the regional and smaller banks—facing further difficulties".

The same candid messages were delivered in the flagship reports on the need to restore fiscal balances to a more sustainable path in US and also in Japan.

Fiscal Monitor, April 2011: "The United States will be the only major advanced economy implementing procyclical fiscal policies this year, albeit in the face of a still-sizable output gap. Moreover, getting on track to achieve the Toronto Declaration commitment to halve the deficit by 2013 will require a significant adjustment next year."

GFSR April 2011: "....Meanwhile, public debt is also on a problematic trajectory in other parts of the world, notably in Japan and the United States."

WEO Update, Jan 2011: "The recently implemented stimulus measures in the United States and Japan make it more challenging to ensure medium-term fiscal sustainability. Therefore, it has become even more important to formulate more credible plans to bring debt down over the medium term."

WEO Update, Jan 2011:"For the United States, it is critical to immediately address the debt ceiling and launch a deficit reduction plan that includes entitlement reform and revenue-raising tax reform. Should the recovery threaten to turn out substantially weaker than currently projected, the pace of fiscal adjustment should be modified accordingly, within the envelope of a credible medium-term consolidation plan."

WEO Update, June 2011:"Fiscal challenges continue to pose various risks for the recovery. A first set of concerns revolves around fiscal imbalances in the euro area periphery. A second set involves the large near-term fiscal adjustment in the United Sates against a still-fragile recovery. A third set of concerns centers on medium-term fiscal sustainability in the United States and Japan. In the United States, these risks are rising because of the absence of credible consolidation and reform plans, while Japan's plans must be made sufficiently ambitious and be implemented. In Japan, the fiscal response to the earthquake has raised challenges to attaining medium-term fiscal sustainability. Some credit rating agencies have already put U.S. and Japanese sovereign credit ratings on negative watch."

32. Another issue complicating the Fund's ability to deliver clear and candid messages on potential stability issues is a possible conflict between its lending and surveillance roles. When the Fund is providing financial support to a country, it is conflicted in that it cannot comment on the likelihood of success (or failure) of its own lending program or the broader stability implications if the program fails. Such comments could become a self-fulfilling prophesy. However, this conflict could prevent the Fund from developing contingency plans. A good example is Argentina. In its 2004 evaluation of the Fund's

program for Argentina, the IEO[22] questioned whether the Fund should not have developed a contingency plan to address the possibility that the stabilisation efforts of the authorities would not succeed. The IEO concluded that, because of many difficulties, "there may well have been no feasible actions by the IMF that would have enabled the adoption of a meaningful Plan B. But this possibility is not an adequate justification for failing to think about, let alone design and actively promote, such a plan." (See Box B)

Box B: Learning from the Argentine Crisis

Extract from the IEO report on Argentina: *Lesson 6*

"Decisions to support a given policy framework necessarily involve a probabilistic judgment, but it is important to make this judgment as rigorously as possible, and to have a fallback strategy in place from the outset in case some critical assumptions do not materialize. In the absence of a well thought-out alternative strategy, and with only an ill-defined exit strategy, it took the IMF a long time to change gears in the face of the demonstrated failure of the program to achieve its stated objectives. This led to repeated attempts to use the same strategy when it was evident that it had failed. The need for contingency planning in a program designed to deal with a capital account crisis has already been noted in the staff report on this topic. The additional lesson of the Argentine experience is that contingency planning efforts should encompass not only alternative strategies but also "stop-loss rules"—that is, a set of criteria to determine if the initial strategy is working and to guide the decision on when a change in approach is needed."

33. We think these issues remain highly relevant today. If a similar situation were to recur, we would argue that the Fund should be developing a contingency plan to address the possibility of failure, including the spillover effects on other economies, and should consider how to communicate the risks and consequences of failure and the need for preparation to those likely to be affected. We would also argue that the IMF should consider the extent to which risks and consequences of failure could be discussed publicly, given the likelihood that others would be commenting on such issues in the media and other fora. We will address this question in our recommendations (See paragraph 64-66).

34. On balance, we would conclude that the Fund is conscious of the need for clarity and candour in the delivery of its findings and strives to meet those objectives in both public and private fora. In making sometimes difficult judgements about how candid to be, the Fund carefully weighs competing objectives and, in most cases of which we are aware, makes decisions that are defensible. Nevertheless, our conclusion is that, in some cases, the Fund goes too far to suppress or dilute important findings and recommendations in an effort to support or not to undermine the work of the authorities.

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[22] IEO (2004)

35. **The Fund is not perceived to be even handed**. Our interviews with senior decision- makers suggest that a perception of lack of even handedness is a lingering issue among the membership, advanced or emerging. Views about the lack of even handedness are understandably divergent and reflect, inter alia, the continuing debate over the reallocation of voting rights. In our interviews, we heard comments that the IMF favours systemically important countries and is too harsh on emerging countries. We also heard that the IMF is blunt with developed countries and tiptoes around issues affecting powerful emerging countries. Reference was made to the IMF as the “European Monetary Fund” with a tendency to take a softer stance on European issues. Similarly, while references in flagship publications have been made to the potential for overheating and credit bubbles in large emerging countries such as China and Brazil, in our view they did not go far enough to “connect-the-dots” and trace through the implications if all the risks materialised (See Box C). This is an important issue as perception of greater even handedness in Fund surveillance would likely increase the acceptance of candid advice (See Box 7).

Box C: What the IMF said about China and Brazil

On emerging markets such as China and Brazil, the Fund warns of signs of a credit boom, overheating pressures, a shift towards wholesale funding in banks and a build-up of vulnerabilities in the corporate sector. However, with the exception of the stress tests referred to in the April 2011 GFSR, referred to below, it does not go far enough to “connect-the-dots” and trace through the implications if a confluence of these risks factors were to materialise such as the consequences of an asset market correction, capital flow reversal on the Brazilian/Chinese economy and outward spillover effects. For example, a more effective approach to issues such as capital flow reversals and asset market corrections would have been to develop plausible tail scenarios and extend stress testing to consider the impact on bank solvency, credit contraction and economic growth.

Build-up of Debt Vulnerabilities

GFSR April 2011: Box 1.4. Are Debt Vulnerabilities Building in the Emerging Market Corporate Sector?

“Available data for 2010 suggest leverage in the BRIC countries has not recently been building at the scale typically observed ahead of sudden stops. However, leverage ratios could deteriorate rapidly if the growth of assets or earnings were to weaken. *Stylized stress tests of the nonfinancial sector suggest that a 300 basis point increase in funding costs*—driven by a normalization of interest rates in mature markets or a widening of emerging market spreads—would have a significant negative effect on interest rate coverage ratios and increase the average share of uncovered debt to 18 percent, somewhat higher than the levels seen in the run-up to sudden stops.”

Signs of credit boom and overheating pressures

GFSR April 2011: **Box 1.5 Emerging Market Banks: Fuelling Growth or Frenzy?**

“Bank lending in some emerging market economies, particularly in Asia and Latin America, grew at a faster pace between 2007 and 2010 than in the five years leading up to the global financial crisis....Larger banks, especially state-owned banks in China and Brazil, have been primarily responsible for the sharp rise in credit. Major banks in those two countries expanded their balance sheets by more than 100 percent during the 2007–10 period, reaching sizes comparable to those at large banks in the United States and Europe.”

“Meanwhile, the capital positions of the big lenders remained relatively healthy and benefited from the relatively easy access to capital markets. Regulatory capital ratios for the bigger banks in emerging markets were at relatively comfortable levels in the second quarter of 2010, although state-owned banks in some emerging markets might need to bolster their capital ratios to sustain current rates of balance sheet growth. The accelerated credit growth has come with an increase in vulnerabilities at banks. They have increased their reliance on external financing, shifted away from deposits into wholesale funding, and increased financial leverage while allowing asset quality to deteriorate.”

“Easy access to alternative financing options and ample growth opportunities are luring some banking systems away from deposit-driven asset growth, suggesting that banking-driven credit bubbles may be developing.”

WEO April 2011: “Brazil, Colombia, India, Indonesia, and Turkey have experienced a noticeable pickup in real credit growth, generally close to or well into a 10 to 20 percent range (more in the case of Turkey). Over the past five years, credit almost doubled in real per capita terms in these economies.”

Property Market Overheating

REO (Asia and Pacific), Oct 2010: “Given the awareness of China’s authorities of the risks posed by excessive property price growth, and their experience in containing them, the threat of a housing price bust and consequent financial instability is not immediate. However, with structurally low real interest rates in the face of rapid income growth, no property taxes, lack of alternative investment possibilities, and the surging mortgage-to-GDP ratio, rapid property price growth in China is likely to continue. While we do not see evidence of significant and broad-based overvaluation in China’s residential property today, financial imbalances take time to build. As home ownership rises in this financial environment, policymakers are facing an ever growing challenge to financial stability.”

WEO, Oct 2010: “More recently, some governments in the region have taken measures to tame real estate markets. The Chinese government deployed a range of regulatory tools in the spring of 2010, including increases in transaction taxes and stricter controls on lending. The government will need to evaluate the impact of these measures over time and to fine-tune them to keep risks in check while avoiding excessive restraint on real estate investment.”

Box 7: Quotes from Interviews with Authorities – Even handedness

- *The IMF is blunt with developed countries but coded when it comes to emerging countries.*
- *The Fund is overly responsive to EC objections.*
- *The Fund will not address the issue of massive reserve accumulation and domestic rebalancing.*
- *The WEO makes no reference to currency misalignments.*
- *The U.S. QE II is damaging the global economy, contributing to massive liquidity going around the world (the Fund is not saying enough about this).*
- *The Fund may not be as persistent and even-handed with systemically important countries (as with emerging economies). You cannot blame the staff for this. The Board has to take some responsibility.*
- *Even-handedness is improving. The IMF realised it had to change after the Asian crisis.*
- *Even with the right direction, we have yet to see a proper balance of voting rights between advanced and emerging economies.*

36. **The Fund's relationship with FSB is reasonably effective but the Fund could add more value.** In attempting to optimise the effectiveness of multilateral surveillance and measures to enhance financial stability, the relationship between the Fund and other bodies with mandates to contribute to financial stability and in particular the FSB, is of crucial importance. The FSB relationship is a matter of concern to Fund staff, some of whom feel that the Fund's stability work has been subordinated to that of the FSB. There are concerns that the Fund's membership on the FSB, which some believe makes the Fund a kind of junior partner, has muzzled it and made it difficult for the Fund to offer independent views on FSB initiatives. There is also unease that the FSB is duplicating the work of the Fund, particularly with the FSB's peer review programme and vulnerability exercises [23] that the FSB is carrying out.

37. Most of the external authorities interviewed understood the Fund's concerns but felt them to be overblown. While acknowledging tensions between the Fund and the FSB, most felt that the relationship is working reasonably well and making a positive joint contribution to financial stability. There was recognition that the Fund and other FSB members bring different and quite complementary skill sets to their joint work. The role of the FSB is principally to strengthen the resilience of financial systems and not to carry out multilateral surveillance, which is a role and competency of the Fund.

38. It is also our view that the relationship between the Fund and the FSB is working reasonably well. We note many areas of effective cooperation, including the joint IMF/FSB EWE, discussed in paragraph 28. We also believe that some of the Fund's concerns are misplaced. In particular, we do not believe that the Fund should regard vulnerability exercises conducted by the FSB or anyone else to be

[23] See FSB Press Release, March 2010 on Thematic and Country Peer Reviews. See also FSB (2009) on setting up of the Standing Committee for Assessment of Vulnerabilities (SCAV) and Analytical Group on Vulnerabilities (AGV).

competitive. An important takeaway from past financial crises is that few saw them coming. In our view, the more eyes that are looking for vulnerabilities and emerging threats, the more likely we will be to predict and prepare for the next crisis. While we are urging the Fund to rise to the challenge of becoming the world's Global Financial Stability Advisor, we do not see this as a monopolistic role. Instead we see it as a complementary and backstopping function, encouraging and supporting the contributions of other groups to the cause of financial stability, while monitoring their work and attempting to ensure that gaps are filled. Having said this, we do see a need to improve the IMF/FSB relationship. The FSB has made a significant contribution in a short period of time to the enhancement of global financial stability. It has moved with energy and intensity to launch a host of important initiatives, working with standard-setters and national authorities, to strengthen the resilience of global and national financial systems. However, that does not mean that FSB initiatives should be beyond criticism or immune from independent advice. In our external interviews, a few references were made to domination of FSB decision-making by a small number of large countries and a "fragile consensus" around FSB decisions. In that context, one area that needs to be resolved is the IMF's willingness to speak up on regulatory and supervisory issues. While we accept that there is no formal policy of muzzling the Fund at FSB meetings and working groups, it is also clear that some Fund staff feel that their comments on regulatory initiatives may be unwelcome during internal FSB discussions. Further, given the Fund's status as an FSB member, some staff feel that their ability to challenge FSB initiatives publicly has been compromised. In fact, the IMF has already been taking independent positions on some FSB initiatives, and this should continue. For example, the FSB's first set of priorities[24], with the exception of supervisory colleges, included virtually no initiatives to strengthen supervision, the weakness of which in a number of countries has been seen as an important contributor to the GFC.[25] More recently, the FSB established a working group on supervision, supported subsequently by a useful paper prepared by the Fund.[26] The new Basel III rules, developed by the BCBS with the encouragement of the FSB, are well intended and should help to strengthen banks and banking systems, but they are not beyond criticism, particularly their long glide path to full implementation [27] The Fund, with more supervisory expertise, particularly in MCM, than some of our interlocutors are prepared to acknowledge, must be prepared to offer independent views on these issues, both within the FSB and in public communications. (See Box 8).

[24] FSF Press Release (1999), "The Forum has been established to promote information exchange and co-ordination among the national authorities, international institutions and international regulatory or experts' groupings with responsibilities for questions of international financial stability. Its initial membership includes the finance ministries, central banks and leading regulators of each of the G7 countries, together with the chairs of the international regulatory organisations, and representatives of the international financial institutions."

[25] John Palmer (2009), "Can we enhance financial stability on a foundation of weak supervision", Establidad Financiera, # 17, pp 45.

[26] IMF (2010g)

[27] Anat Admati, Martin Hellwig (2011) and Michael Pomerleano (2011), Financial Times Economist Forum

Box 8 : Quotes from Interviews with Authorities – IMF's Relationship with FSB

- *The relationship and division of labour between the IMF and FSB is not clear.*
- *There is a good balance between the FSB and the Fund.*
- *The FSB and the Fund should work together for financial stability.*
- *The FSB is not subject to the Fund's institutional straightjacket – this creates a healthy tension.*
- *The Fund did not speak out on the pro-cyclicality of Basel II. It needs to speak out on the macro-prudential implications of Basel III.*
- *There needs to be closer coordination between the Fund and the FSB and a more unified agenda. Why not merge MCM and the secretariat of FSB?*
- *The IMF needs to stick to its skill sets. It is not tuned in to markets. It is not a supervisor. It does assess compliance with standards and will have insights into compliance with Basel III. There is no need for the IMF to compete with the FSB.*
- *The Fund should not feel a need to get the credit or to compete (with other stability bodies).*
- *There is a need for the Fund to play a role at the FSB. FSB initiatives, such as regulatory standards and SIFI initiatives are driven by particular countries that have special interests. Some FSB members have reservations about these initiatives. The consensus is pretty fragile. There is no reason why the Fund should not speak up at meetings on these issues and no reason why it should not have an independent position.*
- *The Fund does put forward ideas at FSB discussions but has to select its points of entry because it is not a regulator and supervisor. In some cases, it is not able to deliver substantive input at FSB working groups.*
- *Generally, the IMF-FSB relationship has been productive and mutually supportive.*
- *In working with the FSB, the Fund should bring its special expertise to bear on stability issues: macro-economic policies, global imbalances and its work on FSAP's and ROSCs.*

39. Good data and good analysis are necessary for good surveillance. Over the years, the international community, including the IMF, has made much progress in strengthening the collection and dissemination of macroeconomic statistics (real sector, external sector, monetary and financial and government finance), using the System of National Accounts (SNA) as the organising framework. A similar framework for macro-prudential statistics in not in place yet, but the IMF, together with other international organisations, is developing a consensus among data users on key concepts and indicators, including in relation to the SNA. In the area of macro-prudential statistics, the IMF has made much progress in developing the Financial Soundness Indicator (FSI) and encouraging greater disclosure of FSIs through the Co-ordinated Compilation Exercise (CCE). Other initiatives that improve disclosure include the GDDS and the SDDS. Following a recent Board Decision[28], the SDDS will be enhanced to include seven FSIs to strengthen information about the financial sector and better detect system risks. The Fund is also considering the possibility of creating a SDDS plus which will help to address the gaps identified during the GFC. Other initiatives by the Fund, such as the Data Quality Assessment Framework play an important role in enhancing the quality and consistency of data across the membership.

[28]IMF (2010p)

40. As in other crises, the GFC has demonstrated once again that data gaps, while not the cause of the crisis, impede effective surveillance. As a result, the international community has embarked on various data initiatives to plug the data gaps. Amongst them[29], the G20 Data Gaps Initiative, in collaboration with IMF and FSB, identified various data gaps, grouped into four areas: (1) monitoring risks in the financial sector; (2) international network connections; (3) sectoral and other financial and economic datasets; and (4) communications of official statistics. Plugging these data gaps is a mammoth task and requires multilateral cooperation. Some of the steps to plug the data gaps can build on existing initiatives; others require new initiatives and additional data collection. Some of the implementation would raise confidentiality issues that need to be addressed. It is beyond the scope of this paper to discuss all these areas and we will focus our discussion on **the second area which is the work on understanding international financial connectedness.**

41. The GFC has demonstrated the importance of global SIFIs to financial stability. The complex interlinkages and exposures of global financial institutions create a potential for contagion that cannot be ignored in an effective surveillance regime. The Fund has recognised this potential and has been carrying out extensive work in this area. For example, there have been papers on cross-cutting themes and papers on interconnectedness and large banking systems. An MCM team is working on the SIFI issue and SPR and other departments are conducting cross-cutting theme exercises. We understand that stress tests have been conducted and reported in past GFSRs. In the US FSAP, stress tests were carried out on North American Financial Groups. However, the Fund and others are handicapped in their ability to understand and monitor potential contagion channels. The best home supervisors supervise on a consolidated basis and may have an understanding of major group exposures to other counterparties, including other financial groups. But there is presently no reliable mechanism for aggregating such exposures and developing a system-wide picture of interlinkages among the major global institutions. The supervisory colleges that the FSB and standard-setting bodies are encouraging should improve group supervision and the understanding of internal and external exposures of a major financial group. But they do not create a mechanism for informing those responsible for the supervision of other financial groups about potentially threatening intergroup exposures. There is clearly a need for an overview of the intergroup exposures of all major financial groups but there is currently no mechanism in place for achieving such an overview.

42. The Fund believes that it is well-placed to monitor the activities and intergroup exposures of major global SIFI's. Conceptually, we agree. However, we found virtually no support among the external experts that we interviewed for assigning such a role to the Fund, and some opposition on the grounds that the Fund is not a supervisor and does not have the legal framework to require its members to report certain information that would be useful for surveillance purposes, including information

[29] Other data initiatives include the Interagency Group on Economics and Financial Statistics (IAG), chaired by the IMF, comprising the BIS, ECB, Eurostat, OECD, UN and WB.

regarding financial groups[30], or to guarantee the confidentiality of supervisory information submitted to it for systemic monitoring purposes.

43. It was pointed out during our interviews that the ability of the Fund to monitor the systemic exposures of Global SIFI's would be enhanced if all institutions were required to follow disclosure standards similar to those in the U.S. and Canada. Those disclosure standards require the disclosure of extensive information regarding financial exposures of a publicly listed financial institution. If European and Asian financial institutions were required to meet these standards, the IMF would be able to enhance the quality of its off-site monitoring of global SIFI's, without requiring access to as much confidential supervisory information. We will address this issue further in Section E (See Box 9).

Box 9: Quotes from Interviews with Authorities – Monitoring Global SIFIs

- *Acknowledges that someone should be looking at global banking risks, but does not support IMF involvement in the oversight of global SIFI's.*
- *The IMF should be pushing for standardised data (that would make it easier to understand the exposures of SIFI's without access to supervisory information).*
- *A lot of work is already underway to obtain data to make conjunctural assessments of SIFI's. The IMF is very active in this work.*
- *National authorities have concerns about giving the IMF access to confidential data on SIFI's.*
- *The scale of damage that can be done to financial systems by SIFI's suggests the need for lots of eyes to look at these exposures*.

44. **The overall impact/traction of the Fund's multilateral surveillance has improved considerably since the GFC but there is room for further improvement.** What do we mean by impact and traction in the context of the IMF's multilateral surveillance activities? As discussed in paragraph 20, the ultimate goal of surveillance is to encourage action to mitigate the probability and/or impacts of an emerging threat. In assessing impact, we consider whether the IMF's findings and recommendations are delivered to those who can respond to them in a compelling way that encourages action and behaviour changes. There are several elements to impact and traction, all of which have been discussed in earlier findings. One is whether the IMF's messages reach the decision-makers – those in a position to respond to the Fund's messages- without being filtered by others. A second is whether the messages are seen to be authoritative and correct, based on comprehensive, competent and informed analysis of the problem to be addressed. A third is whether the messages are delivered with sufficient clarity and candour that decision makers can understand what action is needed and with what degree of urgency. A final

[30] Article VIII, Section 5 of the Fund's Articles.

element is trust: whether the Fund's messages are seen to be correct and balanced with appropriate consideration given to the country or groups of countries that are invited to take action.

45. In paragraph 25 above, we conclude that the key decision-makers are generally aware of the Fund's key messages but do not always receive them directly. We suspect that, from time to time, something may get lost in translation. In paragraphs 22, 27 to 28, we conclude that, although the Fund's existing work is believed by decision-makers to be of very high quality, it does not go far enough to connect the dots and address the links between real economy and financial sector risks. We also conclude that the Fund could be doing more to scan the horizon for risks that could develop into future tail risks. In paragraph 29, we conclude that despite improvements in the candour with which key messages are delivered, the Fund may still be handicapped by a reluctance to challenge the official view on important risks and risk-mitigating measures. And finally, in paragraph 35, we conclude that, although progress has been made in the last decade, the Fund is not always seen as fair and unbiased. This may undermine the trust necessary for Fund recommendations to be accepted and acted upon. In summary, we would conclude that the impact and traction of the Fund's work has improved and the trend is encouraging. However, more needs to be done for the Fund's multilateral surveillance work to have the impact and traction that it deserves and the world needs (See Box 10).

Box 10: Quotes from Interview with Authorities -- Traction

- *The IMF has a name and shame power*
- *The Fund has successfully exerted pressure on countries to repair their policies.*
- *The EWE's get across focused messages and generate good focused discussions.*
- *If you are suggesting vulnerabilities, you have to suggest how each vulnerability relates to financial stability. You also have to clearly suggest what to do. It is easy to walk away after raising the issue.*
- *The IMF has an impact. It can reinforce our priorities.*
- *There is not enough focus in the Fund on solutions.*
- *The Fund does a good job at G20 meetings, without dominating.*
- *In a crunch, people want to know what the IMF thinks.*

46. **The Fund's existing surveillance mandate does not give the Fund clear and sufficient legitimacy to carry out surveillance of the financial sector**. In a recent Fund paper entitled: *The Fund's Mandate—An Overview*[31] , the Fund's mandate for multilateral surveillance is discussed as follows: "What is termed multilateral surveillance originates in Article IV, Section 3 (a)'s requirement that the Fund 'oversee the international monetary system in order to ensure its effective operation. " Under this mandate, "the Fund's responsibility is narrowly cast over the international *monetary* system. This concept is limited to official arrangements relating to the balance of payments—exchange rates, reserves, and regulation of current payments and capital flows—and is different from the international

[31]IMF(2010c)

financial system. While the financial sector is a valid subject of scrutiny, it is a second order activity, derived from the potential impact on the stability of the international monetary system." Following the regional financial crises of the 1990's, the Fund, along with the World Bank, was encouraged by the FSF[32] and the G20 Finance Ministers and Central Bank Governors[33] to play a more active role in the surveillance of the financial sector, making use, inter alia, of Financial Sector Assessment Programs (FSAPs) which included Reports on Observance of Standards and Codes (ROSCs). Working with the World Bank and others, the Fund developed a voluntary pilot FSAP that was treated as technical assistance to members. In December 2000, the IMF Board reviewed the results of the pilot programme[34] and concluded "that the FSAP process provides a coherent and comprehensive framework to identify financial system vulnerabilities and strengthen the analysis of domestic macroeconomic and financial stability issues", "agreed that the FSSAs are the preferred tool for strengthening the monitoring of financial systems under the Fund's bilateral surveillance" and "encouraged the staff to press ahead with the work being undertaken in the context of the FSAP to develop analytical techniques, including macroprudential indicators [and] the use of stress tests and scenario analysis". Despite the Board's endorsement of the FSAP's, they remained "preferred" and not mandatory tools. The Board did not support a staff recommendation to make the FSAP mandatory, and it remained a voluntary programme[35] with the frequency of assessments limited by resource constraints.[36] As technical assistance was available only to those members that volunteered to be assessed, the FSAPs did not become part of the Fund's formal surveillance mandate. In our view, as suggested in the Mandate paper referred to above, this has contributed to a fund culture in which financial sector surveillance continues to be a second order activity, despite growing recognition in the Fund of its importance in a financial stability context and a significant ramping up of financial sector surveillance activity by the Fund since the GFC. We suspect that this has been one of a number of factors impeding the Fund's ability to foresee and forewarn of financial crises, as the recent IEO report[37] has concluded. There are also obvious gaps between bilateral and multilateral surveillance such as follow-ups of important issues and coverage of financial and systemic issues that the IEO report finds problematic. These gaps need to be bridged in order for the Fund to play the overarching role of a Global Financial Stability Advisor.

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[32] FSF(1999b)
[33] Communiqués, Meetings of G20 Finance Ministers and Central Bank Governors, Berlin, Dec. 15 & 16, 1999 and Montreal, Oct. 25, 2000.
[34] IMF(2000b)
[35] IMF(2000a)
[36] The FSAP was made mandatory in 2010 for members with financial sectors designated by the Fund to be systemically important. Such members were given five years after such designations for FSAP's to be carried out. See Decision No. 14736-(10/92), adopted on September 21, 2010.

E. How to get there?

47. **Enhance the Fund's capacity to connect the dots.** In Section B, we explain our concept of the overarching role, including what we mean by "connecting the dots", and why we believe the IMF is equipped to play important aspects of the role of a Global Financial Stability Advisor. Although some of this is already taking place, more needs to be done to develop the necessary research and analytical capabilities to support this work and to communicate findings in an effective manner. But for this to take place in a sustained and effective way, the IMF must accept the overarching role we are proposing and which it is increasingly playing, acknowledge the significant institutional impediments that will prevent it from completely fulfilling this role, and then take steps throughout the organisation to focus efforts on becoming the Global Financial Stability Advisor.

Strengthen the Fund's Analytics and Flexibility

48. To undertake the overarching role described above, the Fund will need to be nimble and capable of thinking "out of the box" in uncovering risks and proposing solutions. To do so will require breaking down silos and changing the work culture. We propose three new initiatives which could go some way towards breaking down the silos in the Fund if actively supported by senior management of the Fund and underpinned by incentive structures that are aligned with the focus of the new initiatives. Without changes to the Fund's structure, incentives and culture, there will be limits on how much can be accomplished and how effective the Fund can be in helping to prevent the next financial crisis.

49. **The first new initiative is to establish a small team (the "Pre-Cogs[38]") to complement the work of the EWE in the Fund**. As we mentioned in paragraph 27, to uncover tail risks, the Fund needs to move away from its comfort zone and do penetrating market-based intelligence gathering in addition to model-based research. This Pre-Cogs group would **spot emerging threats and risks, assess whether work is needed to better understand the nature of the threat or risk, including probability and impact issues, and bring the issues to the attention of senior management**. This proposed team was described by one Fund staff member as a group "paid to be paranoid". The role of the Pre-Cogs team would not be to carry out the necessary research but to do an initial assessment of whether a risk deserves further study by the Fund. The Pre-Cogs team would be made up of staff assigned on a short-term basis (say one to two years) from various Fund departments with an interest in financial stability issues. Ideally, the team would be separate from any Fund department. Given the orientation of the Pre-Cogs group toward market intelligence, members of the Pre-Cogs team should have recent financial sector and

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[38] Pre-cogs is a term that comes from Steven Spielberg's movie:"The Minority Report", in which a team of pre-cogs who can see the future, assist the police to prevent murders before they are committed. We are not suggesting that the Fund can predict financial crises but the name appropriately captures the Fund's role to prevent crisis by being ahead of the curve in identifying potential threats to financial stability.

preferably private sector experience so as to be close to markets and in touch with emerging developments. The Pre-Cogs team would attempt to cultivate multiple internal and external sources of information about emerging risks, including attending weekly surveillance meetings, reviewing market information, and closely monitoring the work of other actors in the financial stability field**. We would also recommend that the Pre-Cogs team be given a fast-track review and reporting structure to ensure that its findings reach senior management on a timely basis and are not subjected to normal interdepartmental review and consensus seeking traditions**. By their nature, the Pre-Cogs team's findings will likely be controversial and subject to challenges. Such challenges should be addressed during the research process as described below and not by suppressing findings. Given the tendency of the Fund toward group think and institutional barriers to "thinking outside the box", the Pre-Cog team would need to be empowered by senior management to raise issues that might seem premature or not well-founded by others within the Fund.

50. **The second new initiative is to do a study of new and emerging risks through ad-hoc, issue-specific and temporary working groups, after the Pre-Cogs Team has identified potential risks that need further study**. Depending on the finding, the study of a new or emerging risk could be carried out by the existing EWE/VE working groups, or a new, issue-specific interdepartmental working group could be formed. In some cases, we believe that a separate working group will be needed, particularly where the nature of the risk is not currently susceptible to running models or empirically testing hypotheses. In such cases, analysis will have to consist of back-of-the envelope assessments and calculations, developing scenarios and formulating contingency plans. Timeliness of the research will be key if the Fund is to be an effective harbinger of pending risks. Regardless of who carries out the study, the work should be closely linked to the EWE and results should inform the EWE output and be tabled at EWE deliberations.

51. Where a new working group is formed, a leader, drawn from one of the departments and with appropriate experience, should be assigned to the group. **What reporting relationships would be put in place for these working groups?** We suggest that a sponsoring department be established by senior management for each working group, based on where the preponderance of supporting resources might be required. But we think it important not to institutionalise working group reporting relationships to any one department. Such groups should also be under the strong guidance of senior management and would need involvement from the heads of relevant functional departments (FAD, MCM, RES, and SPR) to ensure that good work within the groups was rewarded. **When would studies of emerging risks be published?** As with the existing EWE, work on other emerging risks would first be communicated through the Fund's private channels, but, once the Fund was comfortable that publication would not undermine stability, publication should be considered even where the studies were tentative in nature and did not meet the Fund's traditional research standards. However, the nature and quality of the research should be clearly disclosed. **Where would the studies be published?** As some studies would cut across macro-economic and financial lines, the decision about which publication should host them might be somewhat arbitrary, and could be based on practical considerations such as the availability of space in each publication or more doctrinal criteria, such as

whether the research was weighted more heavily to economic or financial issues. To readers outside the Fund, where the study was published would likely not matter. If the study was seen as topical and important, reference might be made to it in the proposed GPN, described in paragraph 52. We anticipate that the guidelines we are proposing will be seen as messy and rather unsatisfactory within the Fund. However, in other professional service organisations, interdepartmental working groups are a normal way of getting work done. For the IMF, which appears to the authors to have greater institutional rigidity than many other organisations, the "messiness" of the proposed arrangements may be necessary to break down barriers between departments and enhance existing efforts to see risks and risk transmission on an integrated basis.

52. **The third new initiative would be to create a new summary Global Policy Note.** We propose that the Fund prepare a new publication to be issued on a timely and frequent basis, to be called the *Global Policy Note (GPN)* directed at the top public and private sector decision makers. We do not see this as a new flagship publication that would replace the WEO, the GSFR or the Fiscal Monitor. Instead, we see this as an authoritative note that would pull together surveillance work taking place throughout the Fund, including new work on connecting the dots and, where appropriate, work on emerging threats described above, and distil that which is most relevant to key decision-makers in a reasonably short, readable and hard-hitting publication. Like the Pre-Cogs's teams' findings, the GPN should also be subject to a fast-track review process.

53. In our view, some of the work that would be required to create this new publication is already being done now. Messages from the Managing Director, the First Deputy Managing Director, the Economic Counsellor and the Financial Counsellor delivered at G20 meetings and in other fora, as well as in press conferences and media interviews, already embody some of the characteristics of messages that we believe should make up the proposed GPN. These messages reflect the views of the Fund's top management on what is most relevant, most timely and most important for decision makers to hear. These messages are not simply summaries of findings in flagship publications but are based on everything the Fund is doing. They may reflect the results of recently completed research and analysis or they may reflect more ad hoc but informed reactions to fast-moving current events.

54. The proposed GPN should create interest in other Fund surveillance products rather than competing with them for the attentions of senior-decision makers. Although it would not be simply a synthesis of messages in other products, it would draw from them and would be cross referenced to its sources, inviting readers to access other publications to view and understand the research behind the messages in the GPN.

55. **Who in the Fund would produce the GPN?** We understand that the public communications of the MD and other senior Fund officials are developed by an ad hoc group of senior managers, including the head of EXR, meeting regularly to decide what messages particular audiences need to receive from the Fund. We believe that the GPN should be prepared in a similar manner. We would propose the creation of a small team of officers, drawn from various Fund departments and assigned to the team on

a short-term rotating basis, in order to foster teamwork and an integrated view. The small GPN team could report directly to the MD or the First Deputy MD, but would take directions on key messages from the Fund's senior management team, including the Financial and Economic Counsellors and the Head of EXR. It would work closely with the Pre-Cogs team, whose role has been described above.

56. **Address organisational issues to support a more integrated approach to multilateral surveillance. As we discuss in paragraphs 25 and 26, we believe that deep-rooted silos within the Fund are impeding the ability of the Fund to really "connect-the-dots" and "fill in the cracks".** Efforts should be directed at encouraging cultural changes within the Fund that are supportive of a more integrated view of risks. Such efforts should include the adoption of human resource policies to encourage more frequent interdepartmental transfers and compensation policies that recognise good teamwork as well as initiatives to achieve the Fund's expanded mandate that we are recommending in this study. Also essential will be a strong commitment from senior management to make the departmental silos less insular and encourage closer cooperation and integration of effort. Some efforts are already being made in these areas such as through cross-referencing publications to other Fund publications and through the involvement of all departments in reviewing surveillance publications. The Financial Surveillance Group and weekly interdepartmental meetings on surveillance issues also contribute to more effective integration. These initiatives should continue.

57. Further down the road, there may be merit to considering a more fundamental organisational realignment of departments to achieve a more integrated view of risks to financial stability, but offering advice on how this could be done goes beyond the scope of this paper. A more fundamental reorganisation should be approached with caution. In the not inconsiderable experience of the authors, organisational reorganisations tend to have unintended consequences, not always positive.

58. **Implement above recommendations within the current resource envelope.** A key objective of the above recommendations is to break down barriers between departments and encourage all departments to emerge from their silos to coordinate more effectively on multilateral surveillance and, in particular, to better understand the transmission of risks between the real economy and the financial sector. Because we believe that the Fund will not be able to function effectively as the Global Financial Stability Advisor unless this objective is met, and because we also believe that it is crucially important for the Fund and for the world that the Fund play this role, we think it follows that there should be some shift of effort away from traditional Fund activities toward the integrated approach to multilateral surveillance that we are proposing. This can be accomplished by finding the resources needed for the activities we are recommending from existing departments, forcing them to reprioritise their existing activities.

Strengthen Impact and Traction

60. **Strengthen the impact of and traction from the Fund's multilateral surveillance efforts.** Strengthening the impact and traction of the Fund's multilateral surveillance efforts involves several elements. One is to make sure the IMF's messages reach the decision-makers (see review target audiences below). The second is to be build trust and rapport with key decision makers in both the public sector and global FIs (see outreach below) which is linked to the issue of the Fund's perceived even handedness. The third is to ensure that messages are delivered with sufficient consistency, clarity and candour (see dealing with candour below).

61. **Review target audiences and refocus existing surveillance products.** There is a case for rationalising the Fund's various surveillance products, and some support both within the Fund and from the external authorities that we consulted for doing so. Benefits of rationalisation could include improved focus and better deployment of resources. Combining certain products, such as the WEO and GFSR, could facilitate a more holistic approach to macroeconomic and financial issues, making it easier to connect the dots. However, at this stage, we do not recommend immediate, major changes to the Fund's existing flagship surveillance products, including eliminating any of them or merging two or more. Most of these products are well regarded and seem to have a large enough following to justify their existence. The insights provided by each publication are useful and well-researched. There could also be risks in combining products, such as the loss of valuable capacity in the internal in-fighting that would likely accompany any decision to merge products, and the possibility that a large, unwieldy and unreadable publication could result. As one of our external interlocutors put it: "Who is going to read a 1000 page publication with a 10 page executive summary?" Further, because products are identified with departments, a rationalisation of products might have to be accompanied by an organisational realignment, which we would not support at this time (see paragraph 57). What we do suggest is that the Fund carry out a review of the purpose of each product, as well as the target audiences, to ensure that the content of each is appropriate to the purpose and the audience. Over the medium term, and even absent a formal review of the purpose of each product, we believe that our other recommendations, if implemented, will lead to a more fluid demarcation between products and could set the stage for a more formal integration or consolidation of products.

62. **Enhance the Fund's outreach to senior decision-makers.** In an effort to ensure that the Fund's key messages reach those decision-makers that can influence global financial stability, as well as to raise the Fund's profile and influence with decision-makers, we recommend that the Fund continue to enhance its efforts to meet and exchange views on stability issues with both public and private sector decision makers, in public and private fora. Such encounters could include public seminars and private meetings/dinners. To have an impact, the focus would have to be on the most senior decision-maker in any organisation, for example, governors of central banks and chief executive officers of global SIFI's. Our impression is that the Fund's existing outreach efforts tend to engage people one or two levels down, who may have significantly less decision-making authority. Of necessity, in order to attract the most senior individuals, the MD would have to play a central role in such outreach initiatives, along with

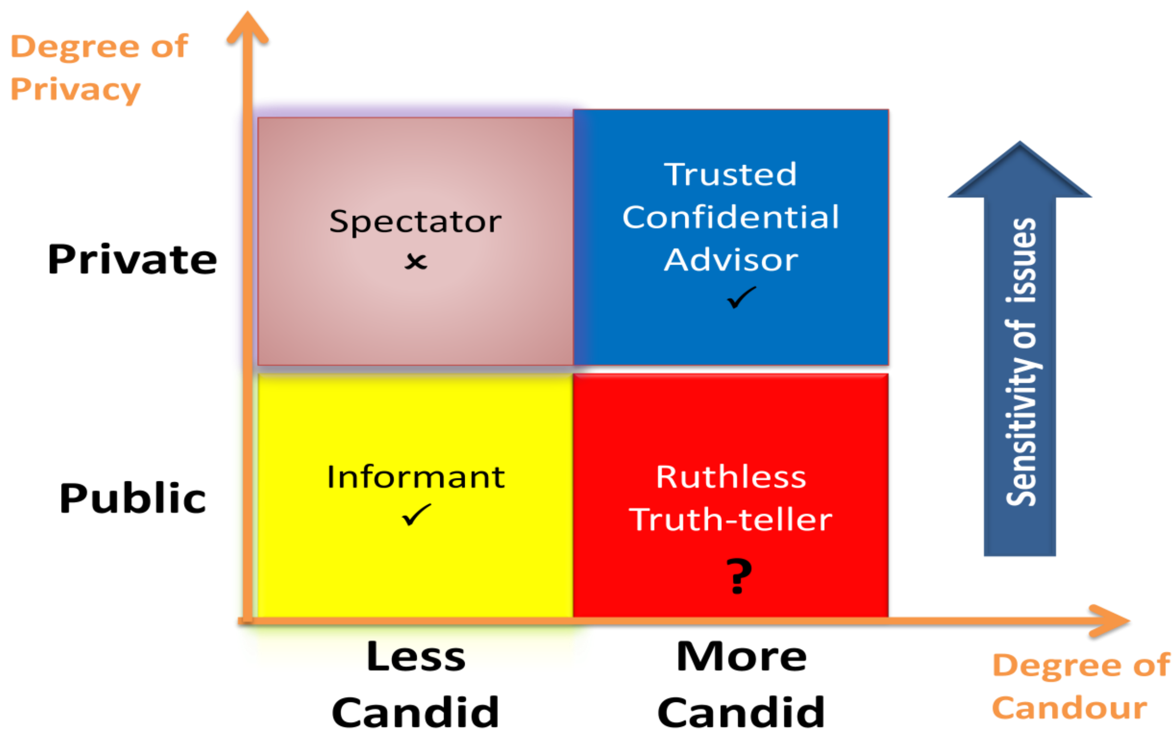
the First Deputy Managing Director and the Financial and Economic Counsellors. This could place an additional burden on these busy people, but, as a practical matter, outreach to the most senior public and private sector-decision makers cannot be delegated as senior people tend to prefer to deal with those they consider to be peers. We are aware that the Fund has carried out similar initiatives, including the Financial Institutions Consultative Group, FICG, which meets with CEOs or chairs of GSIFIs, usually via conference call and dinners at the Annual/Spring meetings. This kind of initiative should continue, with an emphasis on face-to-face meetings.

63. **We would also recommend that outreach initiatives be extended to regional groups of senior decision makers and to the new financial stability boards in Europe, the U.S. and the U.K.** While not all the countries and organisations represented on regional groups will be of systemic importance, more regular contacts with such groups would deepen the understanding of the Fund's leaders of views beyond the G20, enhance acceptance of the Fund's key messages and improve the perception of the Fund as a fair and unbiased Global Financial Stability Advisor. In the case of the new systemic risk boards, it will be important for the Fund to closely monitor their work and engage them to discuss emerging threats and risks. For all such groups, outreach efforts are likely to be more effective if there is a strong informal element built on personal relationships in addition to institutionalized outreach involving pre-set meetings and presentations. For all such organizations, the Fund's role should be consistent with the overarching role we have described. The Fund should seek to complement their activities, avoiding unnecessary duplication, building on work that is region or country specific to explore broader implications, and seeking to fill important gaps wherever they manifest themselves.

64. **We conclude in Section D above that the Fund could be doing more to explore tail risks and be more candid in communicating those risks. A clear protocol is needed that would allow the Fund to publish research on tail risks without suggesting that the risks are necessarily seen by senior management as serious possibilities. We recommend that consideration be given to the adoption of a Board-approved policy by which the Fund can make clearly-labelled public statements in its various multilateral surveillance products, including the proposed GPN, about emerging threats and Fund work-in-progress on such matters.** It will also be possible, as occurs now, for the Fund to make use of private channels to communicate concerns that are judged too preliminary or potentially destabilising to communicate publicly. This will be particularly important as the Fund improves its identification of tail risks that have not yet been recognised within mainstream opinion and which have not yet been subjected to the full depth and rigour of traditional Fund analysis. While there are concerns both within and outside the Fund that any issue raised publicly by the Fund will be seen as reflecting the consensus views of senior management and even the Board, the Fund must find a way to talk publicly about issues that are speculative or where work is in progress. Failure to do so will doom the Fund to remaining behind the curve and unable to warn about potentially serious threats to financial stability. Concerns about painting adverse or worst case scenarios that might unsettle markets or raise false alarms ("crying wolf") are valid, but should not be overplayed as such scenarios are hypothetical and already a "must-have" in scenario planning by countries and global corporations.

65. There are difficult trade-offs in deciding between public and private channels of communication. Inevitably, there will be difficult, sensitive issues where the Fund must deliver its warnings in private, while issuing more muted or coded messages in public. As shown in Figure 3, as the sensitivity of the issues increases, the private channel is better suited for delivering candid messages (trusted, confidential advisor – blue box). However, we would point out that public communication can be a powerful source of leverage to encourage authorities to take action. When authorities recognise that, under the Fund's transparency policy, they could be "named and shamed", they may be more willing to take remedial action than if they believe the Fund will never discuss its concerns in the public arena. Thus if the Fund is too reluctant to make use of the public channel (i.e. to be the ruthless truth-teller - red box) it may lose leverage in the private channel. If the Fund cannot be candid even in the private channels, then its role will be that of a "spectator "(pink box), with a loss of traction with the authorities.

Figure 3: Trade-off Between Public and Private Channels of Communications



66. The tradeoffs between private and public candour become acute when the Fund is participating in financing operations. As long as this conflict exists, the Fund's will be seriously handicapped in functioning as the Global Financial Stability Advisor. The Fund needs to squarely address this issue. An important step, consistent with the recommendation in the 2004 IEO report on Argentina[39], would be for the Fund to institute a formal policy of assessing internally and documenting the risks and consequences of failure of any financing operation. The next step would be to assess the systemic impact of failure and to consider mitigating actions that could be taken by countries potentially affected, such as strengthening bank capital and liquidity. The third step would be private communications regarding the need for mitigating actions by the countries affected. And finally, the Fund should consider the extent to which and how the Fund's concerns could be made public without undermining the potential success of the financing operation. As discussed in paragraph 58, the Fund needs a mechanism for publishing research with conclusions that run counter to mainstream opinion and may not support the official position of the Fund. The Fund attempts to do so now through disclaimers in its flagship surveillance publications[40], but it seems likely that most readers do not fully accept such disclaimers. As suggested above, a Board-approved policy and a fuller explanation of that policy might help, making it clear that Fund staff members are encouraged to hold contrarian opinions and carry out and publish clearly-labelled research and analysis that may not support official positions. Consideration might also be given to using other media for communicating contrarian views, such as the recently introduced blog: *IMF Direct*.

67. The perception of the Fund's fairness among members seems to be improving as memories of past performance, particularly in the Asian Financial Crisis and the GFC, fade away. We see no "silver bullet" that will accelerate this improving trend, except perhaps through further rebalancing of voting rights between developed and emerging market economies and an end to the European and US dominance of the two top positions in the Fund, recommendations for which go beyond the scope of this study. For both independence/candour and perceived fairness, improvement will, at minimum, require a strong commitment from the new Managing Director and senior Fund management to maintain and enhance the Fund's reputation as an independent actor and commentator in the financial stability arena, and as fair and unbiased in its dealings with every member.

[39] IMF (2004)

[40] Disclaimer in the WEO:" However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities"; GFSR: "However, the analysis and policy considerations are those of the contributing staff and should not be attributed to the Executive Directors, their national authorities, or the IMF."

Working with the FSB and Data Issues

68. **Deepen the effectiveness of the relationship with FSB.** As discussed in paragraphs 36–38 of Section D, we believe that the Fund's relationship with the FSB is more effective than some in the Fund currently believe. Generally, the Fund adds significant value to the work of the FSB and, for the most part, the FSB does not undermine or threaten the work that the Fund carries out in the financial stability area. As one of our external interlocutors put it, the best thing for the Fund to do is relax, work to support the efforts of the FSB, without seeking credit for FSB initiatives, confident in the understanding that the FSB and the Fund have reasonably distinctive mandates and most of the Fund's work is not threatened by the FSB. However, for the relationship to be as effective as it should be, some clarification of roles and understandings is needed. Despite the Fund's membership in the FSB, the Fund should be prepared to comment independently on the effectiveness of FSB initiatives both within the FSB fora and publicly, including standard-setting initiatives. As discussed in a Fund paper[41]: "Financial regulation standard-setting is largely sector-specific and national in implementation. With this approach comes the potential for regulatory gaps across sectors and countries, arbitrage, and for nationally sensible but globally inefficient outcomes. As evidenced during the recent crisis, in a world of financial interdependencies, the potential for systemic risk from these sources is material. More systematic analysis of global regulatory efficiency and its implications for stability could provide value added to the standard-setting process, and the Fund is uniquely placed to provide this", making use of the Fund's special competencies: its research expertise, its capacity to address cross-cutting and spillover issues and FSAP work and Article IV reviews which give it access to information regarding compliance with standards that should inform the work of the FSB and standard-setters. For example, the Fund could study the longer term impact of FSB or FSB-inspired initiatives and, based on research, suggest mid-course adjustments that might be considered. We are aware of concerns within the Fund about some aspects of the Basel III measures. Such concerns are shared by many outside the Fund and even within the FSB and Basel Committee. The validity of such concerns could be tested by developing future stress scenarios and assessing the impact of the Basel III measures at various stages of implementation. Such research could also act as a counterweight against the inevitable efforts at both the political and institutional levels to water down the Basel III measures.

69. **Play an active role in encouraging more data disclosure and surveillance of global SIFI's.** We have discussed in paragraphs 39 to 43 of Section D the data gaps arising from the GFC , including those for global SIFI's and the Fund's credentials for filling these gaps. In our view, as long as the gaps remain unfilled, there will remain an important hole in the dyke the authorities are trying to build against the threat of future crises. We also recognise that there are important hurdles to cross regarding the sharing of global SIFIs data. These include sensitivity and confidentiality issues as well as doubts about whether the Fund should be the repository/aggregator of this data. Moreover, the Fund has

[41] IMF (2010e)

traditionally not been the organization that collects international banking statistics. This has been the role of the BIS which has the first mover advantage and track record in this area. These hurdles will take time to address. In the short term, we recommend that the Fund adopt the following approach whose benefits will unfold over time and help it along its quest for data.

70. This strategy would involve the following steps: (1) play an active role in the G20 Data Gaps Initiative [42], including in the plan to develop a data template for Global SIFI's, while remaining mindful of the need to involve non-G20 countries at the appropriate time; (2) continue to work with existing data from both published and proprietary sources and do more analysis on interconnectedness; (3) add its strong voice to those calling for more extensive public disclosure by European and other non-North American financial groups. Over time, this strategy would enhance the credibility and expertise of the Fund in monitoring Global SIFIs. In addition, greater efforts by the Fund's senior management to reach out to the CEOs of global SIFIs, as recommended in paragraph 62, would also be a good opportunity for the Fund to build rapport, exchange views and agree on areas of mutual interest. Once the CEOs and national authorities see how the data can help to create a better "global risk map" that enhances their understanding of the world, resistance to sharing data with the Fund could diminish. In our view, this strategy is likely to be a more effective approach than taking a more aggressive stance from the start.

71. **Strengthen the legal foundations for the Fund's role in macro-financial surveillance. This could be done either by amending the Articles of Agreement or by adopting a Multilateral Surveillance Decision that clarifies the Fund's role in financial stability, namely, to promote global economic and financial stability**. As suggested in the Mandate paper, referred to in paragraph 46, such a Board decision should make it clear that "the financial sector is an integral, even if derived, part of the Fund's systemic oversight mandate". In the context of the legal framework review[43] that is underway, it is important that the scope of multilateral surveillance be clarified to include both the macroeconomic and financial sectors, including all matters covered in FSAP's and ROSC's. This, in turn, would include financial sector supervision and regulation, to clarify the Fund's right to include the impact of such issues in its surveillance activities. Ideally, the Fund's responsibility to carry out surveillance of the financial sector should be clarified in the Articles of Agreement. When amending the Articles, consideration should also be given to amending Article VIII, Section 5, which precludes the Fund from requiring its members to report certain information required for effective surveillance, such as information relating to financial groups. This might be accompanied by a further change that would permit the Fund to protect confidential supervisory information, the absence of which is one of a number of factors blocking the Fund's access to information about individual financial groups. In order to promote timely and independent non-mainstream work, there would be merit in incorporating into a multilateral

[42] The BIS, FSB and the Fund are working to identify and fill these data gaps. Agreement on a data template for global SIFIs, which contain information on the structure, exposures, and interconnectedness of their activities, is pending further consultations.

[43] IMF (2010a)

surveillance decision, a review process that is fast-tracked and separate from the Board. In this regard, consideration should also be given to review the role of the Board in the context of its ability to support the revised mandate and all aspects of the Fund's role as Global Financial Stability Advisor. Ultimately, the Articles of Agreement should be clarified to reflect these changes so as to cement the legitimacy of the Fund's advice in the financial sector.

72. **Seize the Day.** The ultimate recommendation of this study is that the Fund must shape its multilateral surveillance and financial stability efforts based on a commitment to act as the Global Financial Stability Advisor, working cooperatively with the other actors in the financial stability space to support their efforts but also to fill gaps and to carry out work that no other groups can effectively accomplish, particularly the Fund's unique capacity to link its macroeconomic and financial expertise to understand contagion channels between the real economy and financial sector. In many ways, the Fund is already filling this overarching role, despite the fact that it has not been clearly articulated within the Fund and is not as well supported as it might be by the Fund's existing mandate. We have recommended, in the previous paragraph, that the Fund's mandate be strengthened to give the Fund more explicit authority to take on an expanded and overarching financial stability role. But a strengthened mandate alone will not be enough. The Fund will have to muster the will to assume this expanded role and take a number of actions to fulfill it, as discussed in earlier recommendations. We also recognise that it may not be possible to change the Fund's mandate immediately. Therefore, our final recommendation to the Fund is that it should seize the day, without waiting for a change in mandate, and redouble its efforts to explore emerging risks and encourage action to prevent future financial crises.

F. Conclusion

73. In his speech at the first meeting of the Fund, John Maynard Keynes hoped that the Bretton Woods twins, Master Fund and Miss Bank, would receive three gifts from their fairy-godmothers: first, a many-coloured coat "as a perpetual reminder that they belong to the whole world"; second, a box of vitamins to encourage "energy and a fearless spirit, which does not shelve and avoid difficult issues, but welcomes them and is determined to solve them"; third, "a spirit of wisdom … *so that their approach to every problem is absolutely objective*"[44].

74. As the world deals with the legacies of the GFC, the Fund needs to rise to the challenges posed by one of its founding fathers. It needs to muster the wisdom, energy and fearless spirit to perform its role as the guardian of global economic and financial stability.

[44] John Maynard Keynes, as quoted by Mervyn King in "Reform of the International Monetary Fund", Speech at the Indian Council for Research on International Economic Relations, New Delhi, 20 Feb 2006.

Appendix 1: List of Authorities Interviewed

Name	Organisation
1.Svein Andresen	Financial Stability Board
2.Mike Callahan	Australian Treasury
3.Mark Carney 4.Graydon Paulin	Bank of Canada
5.Augustin Carstens	Central Bank of Mexico
6. Benoît Coeuré 7. Pierre Gaudin 8. Olivier Jonglez	Direction Générale du Trésor, Ministère de l'Economie, des Finances et de l'Industrie, France
9. Stanley Fischer	Bank of Israel
10. Willy Kiekens	IMF Executive Board
11.Andrew Large	Bank of England (former Deputy Governor)
12.Tharman Shanmugaratnam	Ministry of Finance, Ministry of Manpower, Prime Minister’s Office, Singapore
13.Andrew L T Sheng	China Regulatory Banking Commission National Economic Advisory Council of Malaysia
14. Glenn Stevens	Reserve Bank of Australia
15. Mark Sobel 16. Bill Murden 17.Trish Hagen	Department of Treasury, USA
18. Paul Tucker	Bank of England
19.Tarisa Watanagase	Bank of Thailand (former Governor)

Appendix 2: List of IMF Staff Interviewed[45]

Name	Department
Giovanni Dell'Áriccia	RES
Ritu Basu	SPR
Tamim Bayoumi	SPR
Jan Brockmeijer	MCM
Peter Dattels	MCM
Jonathan Fiechter	MCM
Rishi Goyal	SPR
Anne-Marie Gulde-Wolf	EUR
Robert Heath	STA
Isabelle Mateos y Lago	SPR
Kate Langdon	EXR
Luc Laeven	RES
Elena Loukoianova	MCM
David Marston	SPR
Reza Moghadam	SPR
Martin Mühleisen	SPR
Aditya Narain	MCM
Jonathan Ostry	RES
Ceyla Pazarbasioglu	MCM
Mahmood Pradhan	APD
Vasuki Shastry	EXR
Michele Shannon	SPR

[45] The authors would like to thank staff for their valuable and candid comments and SPR for arranging the interviews. If given the luxury of time, the authors would have endeavoured to interview staff from every area department in the Fund.

Ranjit Teja	SPR
Christopher Towe	MCM
Rodrigo Valdes	WHD
José Viñals	MCM
Claire Waysand	SPR

Appendix 3: Summary of Interviews with IMF Staff

1. After the global financial crisis, the Fund regained some of its lost credibility and relevance. It had new responsibilities thrust upon it by the G20 and FSB. However, the outbreak of the global financial crisis coincided with a massive staff restructuring exercise in the Fund and staff strength was at its weakest when it was needed most. Despite attempts to step up recruitment, a lot of the institutional memory that had been lost could not easily or quickly be replaced. Thus, the proliferation of new duties and new reports, in an environment of restricted resources, was placing great strains on the organisation and its ability to respond to the many demands.

2. One of the Fund's weaknesses was its insular culture that prevented it from integrating the intellectual capacities and knowledge across departments. While there was widespread recognition of what was wrong and needed to be fixed, nobody had the power to fix it. The Fund seemed to be frozen in time. There was a vacuum to be filled in the area of multilateral financial sector surveillance and the Fund was well-placed to fill this role. However, the Fund was so burdened by its legacies of silos, turf fights and lack of resources that it could not rise to the occasion. For instance, while many that we spoke to suggested that the GFSR, WEO and Fiscal Monitor be integrated into one product, it was less clear how this could be achieved. Several ideas had been tossed around before but to no avail. There was also a strong feeling that the Fund was weak in following-up on lessons learnt in a systematic way. One staff member suggested that there should be a group of people "paid to be paranoid" to look at threats to global financial stability in a consistent and systematic manner, free from political interference.

3. There was widespread but not unanimous support amongst the staff interviewed that the GFSR, WEO and Fiscal Monitor should be merged into a single product. After the crisis, there had been a proliferation of products with each department competing to roll out its own product. This was not helpful as messages coming out from these three products were not always consistent and nobody had the time and appetite to read all three lengthy reports which could total 1000 pages at one time. In addition, attempts to reach multiple audiences through the same publication posed challenges to effective communications.

4. Different views were expressed about the usefulness of the GFSR and WEO. Most felt that the GFSR and WEO, being public documents, had to walk a fine line between flagging risks candidly and unsettling markets. One problem was that the GFSR and WEO were written for audiences that were too diverse, ranging from academics to analysts to policymakers. The result was that they had little traction. One staff member felt that these products do not reflect "true multilateral thinking" and another felt that policy messages were not well-articulated.

5. A few said that the GFSR was an event-driven process, written by MCM (even though MCM did reach out to other departments for input) and had no real linkages with the rest of the Fund. As a

result, it was thematic-based, overly focused on the G7 and failed to connect the dots. It was suggested that the GFSR was like any investment banks' reports and was competing in that crowded space. It failed to have traction with policymakers. What some described as a disconnect between GFSR and the rest of the Fund was very much a reflection of how MCM was viewed within the Fund – as a group of consultants, not from "the same cloth", as the macroeconomists who dominated the rest of the Fund. It was suggested that the failure to integrate MCM into the Fund was at the core of problems to connect the dots. On the WEO, a few said that Chapter 2 on country and regional perspectives was not useful as the policy advice was too short and broad and there was limited space to deal with specific country issues unlike in Article IV reports. Moreover, Chapter 2 seems to replicate the work in the respective REOs.

6. A few expressed the view that the Regional Economic Outlooks could play a greater role in surveillance. As an international organisation with universal membership, the Fund could add value by distilling pertinent issues from the rest of the world for the different regions. The REO could play a useful role to help the Fund plug in to regional fora on surveillance where it was currently a peripheral player. However, the REO's, like the rest of the Fund's products, did not seem to have much traction amongst policymakers. Many staff members said that the G20 Notes were more effective products than the GFSR or WEO because they were more concisely written and delivered clearer policy messages.

7. Most of those interviewed said that the Spillover Reports, which would be written for the five largest economies (US, UK, China, Euro Area and Japan), were potentially useful but some were sceptical that they would be used effectively. A few suggested that it would be "a missed opportunity" if the results of the Spillover Reports were not aggregated for the world. With the world's financial system dominated by a few large global banks, the Fund needed to adopt a functional approach to its surveillance which was traditionally carried out according to geographical regions. It was felt that Spillover Reports could potentially add great value to FSAPs because of the formers' emphasis on outward spillovers, especially for financial centers that had large overseas exposures.

8. Some suggested that the EWE was an appropriate response to the Fund's failure to spot the GFC. The EWE had a "fear factor" which was lacking in the WEO and GFSR. The unique feature of the EWE was that it could flag how vulnerable each country was and yet preserve an element of anonymity because countries preferred not to be named. There was apparently some disagreement between the FSB and the IMF in the way risks were flagged in the EWE – FSB preferred to flag the normal risks while IMF preferred the tail risks. So there were two different versions of EWE reports tabled at different fora.

9. With the proliferation of regional forums, it was not clear how IMF could play a more active role beyond getting invited to do presentations. No matter how many flagship products the IMF produced, there was currently no viable IMF forum in which the Fund could engage with policymakers. The IMFC was too procedural and steeped in prepared speeches to be useful. There was scope for reforming the IMFC to be a forum for dialogue amongst policymakers.

10. Many of those interviewed said that the Fund needed to challenge the consensus; otherwise it would lose credibility. Some noted that there was an excessive urge to please authorities and in the process, IMF's policy advice lost traction because it was just endorsing what the authorities said. One staff member commented that "if we do not challenge the authorities, there's no meaningful dialogue". Another staff member noted that IMF had shifted from being the American Monetary Fund to the European Monetary Fund. On the other hand, others felt that there was a fine line between being overly critical and pleasing authorities. "We cannot sacrifice relations with authorities especially if warnings do not come true". This inability to be forthright but instead present a "balanced view" was seen by many staff as a cause of the Fund's failings during the recent financial crisis. This corroborated the finding of the recent IEO report on the Fund's Performance in the run-up to the Financial and Economic Crisis. One staff expressed the view that the Fund did not learn from "hindsight"" and no one followed up on the risks that Raguhram Rajan raised before the crisis.

11. There was a trade-off between transparency and candour. There was a strong sense that there should be a two channel approach. There should be a public channel where the Fund articulated its views on and concerns about the global financial system in a forthright manner but without jeopardising market confidence. There should always be another private, closed-door channel for the Fund to highlight those concerns which might be market-sensitive, directly to policy makers and discuss corrective policy actions. This second channel had always been used, for instance with countries that were on the verge of a crisis.

12. Overall, staff members felt that the culture in IMF provides for no room for dissent. This "cut from the same cloth" culture was constraining the institution from fulfilling its role as a ruthless truth teller. In addition, there was a cultural divide or "fundamental tension" between macroeconomist and financial experts, referred to above, that was preventing effective cross-departmental collaboration and cross-fertilisation of ideas. One staff member suggested that the Fund's drive towards diversity was quite artificial as it has not had an impact on diversity of views.

13. Many commented that a silo mentality was deeply-rooted and prevalent in IMF with big egos exerting themselves. There were instances when departments would end up writing two separate papers on the same topic. Another example was that during collaborative projects, the contributing department may hoard important input as the lead department got all the credit and did not give proper attribution to the contributing department. The egos and silos in the Fund were preventing it from performing its role effectively. The previous MD tried hard to change this with varying degrees of success but still the Fund was "not transforming from an army to a rock-band", as it needs to do.

14. After the crisis, there was a renewed effort by international organisations to fill the data gaps arising from the crisis. The Fund was playing an active role in this area. For the Fund to carry out meaningful surveillance of Large Complex Financial Institutions (LCFI), it would require institutions-specific data for LCFIs. But this was greatly resisted by countries as most supervisors were prevented by law from sharing the data with outside parties. The Fund had pushed hard, through FSB and the

international data gathering initiatives to collect this data but progress had been slow. One reason seemed to be that nobody trusts the Fund with the data as the Fund is a leaky place. The argument to use what's available in published financial statements was only valid to some extent because not all Financial Institutions practises the same degree of disclosure.

15. EXR had a comprehensive communications program for IMF's flagship products: WEO, GFSR and the Fiscal Monitor. The challenge was for EXR to ensure that messages were consistent across the three reports when the departments did not seem to be working together to check for consistencies. Staff members were prone to writing long papers without first thinking of the audience and the key messages. The communications process should ideally begin at the time of writing where the audience and key messages were identified from the start.

Appendix 4: Examples of Analysis of Spillovers and Transmission Channels

The membership has repeatedly called for the Fund to identify cross-country issues, share cross-country experience and do more cross-border analysis such as inward and outward spillovers and analysis of macro-financial linkages and transmission channels. This was evident from the interviews and surveys conducted. Since the GFC, the Fund has made some progress in this area. This box gives a sampling of the kind of output that connects-the-dot.

<u>Cross-Cutting Thematic Reports</u>

Since 2009, the Fund has started producing thematic reports on topics relevant to a group of countries such as: Cross-Cutting Themes in Major Article IV Consultations and Cross-Cutting Themes in Economies with Large Banking Systems. These reports have proved useful in distilling important issues and identify common factors for success and failure on key policy issues. For instance, in the paper on "Cross-Cutting Themes in Economies with Large Banking Systems", the Fund used the example of the highly financial integrated Benelux region to illustrate how the absence of cross-border resolution frameworks and burden sharing arrangements led to ad hoc and inefficient solutions. It used Fortis, a bank which was split on national, rather than business lines as an effective illustration.

The same paper also simulated cross-border spillovers through bank exposures for economies with large banking systems in the Europe and the US which are major global liquidity and capital providers in the interbank network. This enabled realistic simulations of inward and outward cross-border spillovers and provided useful benchmarks for comparison. The impact of two hypothetical shocks were simulated: (1) a credit shock in which the initial default by an institution may trigger additional rounds of defaults; and (2) a credit and liquidity shock, in which each credit shock is compounded by a liquidity shock.

<u>GFSR April 2010</u>

Box 1.1 of the April 2010 GFSR carried a useful analysis of measuring risk transmission among Euro Zone Sovereigns and came to these conclusions:

"The main sources of risk transfer— shown by the sum of the percentage contributions in the last row—were Austria, Ireland, Italy, and the Netherlands. In other words, the euro zone members that faced the greatest concerns regarding their exposures to eastern Europe, domestic financial systems (e.g., Ireland), or general fiscal conditions (in the case of Italy) transmitted the most sovereign risk to other countries. In contrast*, during the latest sovereign risk phase (see second table), Greece, Portugal, and, to a lesser extent, Spain and Italy became the main contributors to inter-sovereign risk transfer, reflecting the shift in market concerns from financial sector vulnerabilities to fiscal vulnerabilities".*

<u>Understanding Financial Interconnectedness</u>

This paper is an example of the Fund's valuable contribution to the emerging work on macro-financial linkages and spillovers. The paper mapped out the global architecture of funding networks and cross-border financial linkages. It showed, amongst other things, the highly concentrated nature of the global financial system, the increased scope for transmission of shocks across networks and the importance of conducting spillover assessments across common lenders and borrowers. The paper explored two related fault lines—funding models and ratings—that played a pivotal role in the global financial crisis.

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