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INTRODUCTION

1. The International Monetary Fund is thinking about surveillance a lot these days, and rightly so.

2. The Fund's central mission, historically and necessarily, is crisis management. It was originally conceived of as an emergency lending agency, providing foreign exchange to countries suffering severe balance of payments problems while imposing conditionality to ensure that its clients made good use of the breathing room thus created. In effect, it was the world's financial firefighter. With the rise of large-scale private capital mobility the Fund's direct financial contribution became less important, but its seal of approval—linked to conditionality—remains very important both to private lenders and to other official financing. So the Fund is still most crucially the institution nations call when in crisis—and thanks to rising international capital mobility, crises are happening more than ever.

3. Unfortunately, a clear lesson from three decades of crises, ranging from the Latin crisis of the 80s through the Asian crisis of the 90s and up to the ongoing euro crisis, is that fighting fires when they happen is a very poor substitute for preventing fires—or at least minimizing their potential extent— in the first place. The evidence is now overwhelming that recovery from crisis, even when crisis management seems successful in the sense that major disruption is avoided, tends to be both slow and incomplete. Or to put it a bit differently, even "contained" crises tend to cast a long shadow over subsequent economic performance.

4. Hence the case for surveillance. The best way to deal with crises is not to have them; the next best way is to ensure that they're not too serious; failing that, we'd like to mitigate whatever factors cause the shadow of crises to be so dark and long. What we'd like the Fund to do, then, is offer analysis and advice to countries not, or not yet, in crisis that reduces the risk of crises, their severity when they nonetheless happen, and the damage they do.

5. Obviously this is no easy task, on multiple levels. We know far less than we'd like to about what causes crises and what determines their cost. And even if the Fund believes that it sees clear evidence that a dangerous situation is developing, surveillance will almost always take place from a position of weakness: the Fund can sometimes have great power after crisis strikes, because countries desperately need its approval, but faces both practical and political obstacles to effective intervention before the fact. Yet this doesn't mean that nothing can be done.

6. In what follows I will first talk about what we now know about the aftermath of crises and the case for surveillance. I will then talk about the difficulties, intellectual and political, that the Fund faces. Finally, I'll try to suggest what can be done.

CRISES AND THE CASE FOR SURVEILLANCE

7. To appreciate how the case for surveillance in advance of crises has strengthened, it's useful to consider how the issue seemed to look in the immediate aftermath of the last global crisis, the East Asian crisis of the late 1990s (which seemed like a big deal at the time, although it looks trivial by post-2008 standards). This crisis was contained through a combination of emergency loans, bank standstills, and (in the case of Malaysia) temporary capital controls. And following stabilization there were V-shaped, "phoenix miracle" (Calvo, et al, 2006) recoveries, leading to the famous Time cover portraying Robert Rubin, Lawrence Summers, and Alan Greenspan as "The Committee to Save the World."

8. The widespread impression left by that apparent success was that firefighting was an effective strategy—that even if crises happened, fast, aggressive action to contain the damage meant that the losses would be limited and temporary. And my sense—which is, I'm aware, difficult to prove—is that belief in the effectiveness of firefighting helped feed policy indifference to fire prevention. The Greenspan Fed, for example, was notably cool to warnings about subprime lending and a developing housing bubble, and at least part of the reason, I'd argue, was confidence that quick action could greatly limit the damage from a bursting bubble.

9. Unfortunately, that confidence has proved clearly false. Even when crises are contained, they cast a long shadow over the future.

10. This was true even in the case of the East Asian crisis, as documented in the IMF's fall 2009 World Economic Outlook (IMF 2009). Despite a period of rapid growth following stabilization, on the eve of the 2008 crisis all the Asian economies caught up in the late-90s troubles were producing far less than one might have expected given the pre-1997 trend. Meanwhile, Reinhart and Rogoff (2009) showed that the aftermath of major financial crises tends to be difficult and prolonged.

11. Post-mortems on the 2008 crisis paint an even more dismal picture, because they suggest not just that recovery from crisis has been slow almost everywhere, but that the crisis has quasi-permanently depressed potential output. Ball (2014) has documented the sharp decline in estimates of real potential GDP across the advanced world. A quick calculation: if we look at the spring 2008 World Economic Outlook, we find the IMF predicting potential output growth in major advanced countries at approximately a 2.1 percent annual rate through 2013. If we look at the current WEO database, it shows not just the persistence of a large output gap five years after the crisis, but potential growth marked down to less than 1.1 percent over the same period.

12. And bear in mind that this happened even though aggressive intervention avoided large scale financial system breakdown, with markets returning more or less to normal by the summer of 2009.

13. One can argue, and I would, that the crisis response, although quick, was inadequate—that there should, in particular, have been much more fiscal offset and debt relief, to minimize the output

losses. But the political and ideological constraints that prevented stronger action are themselves facts of life, and a good reason to take precautionary steps to make crises like this rare.

14. This, however, raises two big questions: What would such precautionary steps look like? And what can an external party like the IMF do to promote such steps?

WHAT DO WE KNOW ABOUT CRISIS PROPHYLAXIS?

15. While the case for precautionary steps to prevent severe crisis is strong, there is an obvious problem: economists, whether or not they work for international organizations, aren't very good at predicting crises or their severity. From Irving Fisher's proclamation that stocks had reached a permanently high plateau to Alan Greenspan's declaration that a broad decline in housing prices was most unlikely, history is full of tales of crisis risk brushed off.

16. Yet, it's possible to overdo the debunking. While economists may not have much of a track record on the timing or depth of crisis, their record on identifying vulnerabilities may not be as bad as all that. It would be helpful to have a systematic review, but casual reading of Article IV consultations on the eve of crisis presents a more favorable picture of the Fund's analytical capacity than one might have expected. For example, the preliminary conclusions of the 2007 consultation for Spain (IMF 2007), while obviously not predicting the tripling of unemployment that lay in the near future, correctly identified "the large external deficit and related high private sector indebtedness" as major risks to the outlook. Indeed, current account imbalances and high leverage appear to have played a key role in many crises, not just recently but in the 1990s and before—and Fund economists, at any rate, have been relatively well aware of this connection.

17. An interesting and important point about these leading indicators of crisis, however, is that they essentially involve voluntary private sector actions—which poses special difficulties for any effort to nudge countries into taking precautionary action.

18. It's easy for the Fund, or outside voices in general, to argue against obviously irresponsible public policies—excessive budget deficits, or guarantees and other policies that distort investment and encourage risky behavior. For the most part, however, major crises at least since 1990 have not involved obvious public-sector irresponsibility. This is a proposition some find difficult to accept—witness the insistent efforts to "Hellenize" the euro crisis and maintain that it was all about fiscal irresponsibility even though Spain and others had low debt and fiscal surpluses, or the efforts to place blame for the U.S. housing bubble on government-sponsored lending even though subprime lending (and losses) overwhelmingly involved private-sector securitization. For the most part, however, crises have been preceded by private-sector, not public-sector, overreach.

19. This in turn makes calls for precautionary action a hard sell, because they involve second-guessing market participants. Consider three examples of crises preceded by large external deficits: Mexico 1994, Southeast Asia 1997, Spain 2008. In each case there were a fair number of outside economists warning that the capital inflows looked unsustainable and dangerous. In each case, however, local authorities argued that these inflows represented a choice by private investors, who

evidently saw large opportunities in the relevant countries and weren't too worried about crisis risks. How could the Fund have persuaded nations to take defensive action against what we now know were severe risks?

LIMITS OF AND POSSIBILITIES FOR IMF ACTION

20. The fundamental difficulty of surveillance may be illustrated with a hypothetical example, albeit one that closely matches a number of cases over the past 25 years. Suppose that a country has low public debt and what looks like a sustainable fiscal position, but is receiving large inflows of capital that have as their counterpart a loss of competitiveness and a large external deficit; a further consequence is that private-sector leverage is rising quickly.

21. Analysts at the Fund may well look at this situation and see it as problematic, maybe even dangerous—history suggests that the Fund isn't too bad at making such determinations, and that they are often right. Local authorities, however, are likely to balk both at the diagnosis and at any suggestions for action. They are likely to insist that the capital inflows are well-grounded in their nation's excellent fundamentals; they will not like proposals that they, say, impose new financial regulations both because they're enjoying the boom and because private-sector interests will oppose anything that limits what is currently a highly profitable game.

22. And the Fund's influence in such situations is very limited. Countries in trouble need the IMF's money or at least its seal of approval, so they can be subjected to conditionality. Countries that are booming and getting a lot of love from international bond markets can brush off external advice—even though such countries are, experience suggests, precisely the ones most likely to experience a nasty crisis further down the road.

23. The Fund could conceivably try to burst bubbles through its bully pulpit: dire warnings about sustainability might puncture private-sector complacency. It might not, however—Greenspan's famous "irrational exuberance" speech did little to curb the tech bubble, even though he had far more direct authority than any external source of advice. And in any case the Fund can't do that for obvious and justified political reasons; undermining growth, even unsound and unsustainable growth, isn't an acceptable role.

24. Yet this need not mean that there is nothing the Fund can do. It cannot dictate policies to nations without current difficulties in attracting capital. It can, however, play a useful, discreet role in domestic policymaking. In many cases, one suspects, there are important players within a country with justified misgivings about developments that may be making the country vulnerable to future crisis. The IMF, which maintains a level of analytical capacity few governments can match and which has wide experience with crises, is in a position to lend credibility to these concerns. Obviously the Fund's role can't be too strong, but reports highlighting risks and drawing parallels with other cases could have a significant impact.

25. What would it take for surveillance to play such a role? First, the IMF's work must clearly be of high quality. Second, it has to be carefully objective—there is no way to take the politics

completely out of the political economy, but the IMF (unlike, say, economists expressing their own opinions) has to bend over backwards to depoliticize its own role as much as possible. But third, governments have to accept such analyses in the right spirit. It's OK for them to disagree, but putting pressure on IMF staff to change inconvenient conclusions undermines not just individual country assessments but the broader role the Fund should be playing.

26. If this ends up sounding like a more restricted, limited role than one might have hoped for, that's because it is. The IMF is, in the end, still primarily a firefighting agency, with not much besides moral suasion available to promote fire prevention. But it should do whatever it can.

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