INTERNATIONAL MONETARY FUND

TSR External Commentary—Surveillance by the International Monetary Fund[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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SURVEILLANCE BY THE INTERNATIONAL MONETARY FUND

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"With countries naturally reluctant to cede any control over their own monetary and fiscal policies, it is likely that the IMF will have as instruments only the powers of analysis, persuasion, and, in Keynes' own favourite words, "ruthless truth-telling". That phrase does not conjure up many memories of any of the many international meetings I have attended. But unless the IMF has the self-confidence to play that role, its deliberations and statements will carry little weight. The Fund requires an independent, respected and clear voice." Mervyn King, 2006.[2]

"It ain't so much what we know that gets us into trouble. It's what we know that just ain't so." Attributed to Mark Twain.

Constitutional Monarch

1. The International Monetary Fund has long been the queen of international economic organisations: the most influential, most respected and most professional. Yet the Fund does not possess - and, in all probability, never will be given - the right, nor possess the capacity, to steer the world economy. Nor can it hope to dictate to governments, other than those in actual or imminent receipt of its loans. Over two classes of states, its direct influence is of necessity extremely limited: creditors; and the world's principal debtor, the US, which is also issuer of the principal reserve currency and, for the present at least, "the sole superpower". Thus, while a monarch among international economic organisations, the Fund possesses, at bottom, no greater capacity to rule the

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[1] Associate Editor & Chief Economics Commentator, *Financial Times*, London

[2] "Reform of the International Monetary Fund", At the Indian Council for Research on International Economic Relations (ICRIER), New Delhi, 20 February 2006.

world than the 19th century British constitutional monarch whose role was defined by the great Victorian journalist, Walter Bagehot. The sovereign, he argued, possessed only "'the right to be consulted, the right to encourage and the right to warn".[3] The Fund possesses exactly those rights in relation to its most potent members. The question is whether it exercises them effectively.

2. Anybody who examines the state of the world economy today would conclude that the answer has to be: no. It is not just that the economies of high-income countries are in evident trouble: their financial sectors escaped collapse in 2008 only after rescue by governments; those governments, in turn, are suffering from severe fiscal pressures; and the "great recession" that began in 2008 is, on many dimensions, far from over, with unemployment elevated, output either below or only little above its pre-crisis levels and growth feeble. It is far more that the Fund did not warn of those looming dangers. If, like Cassandra, it had warned, but been ignored, the Fund could hold its head up high. It did not and so it cannot.

3. Moises Schwartz, director of the Independent Evaluation Office states baldly in his foreword to the report on the Fund's performance in the period before the crisis:

> "Warning member countries about risks to the global economy and the buildup of vulnerabilities in their own economies is arguably the most important purpose of IMF surveillance. This IEO evaluation found that the IMF fell short in delivering on this key objective in the run-up to the financial and economic crisis that began to manifest in mid-2007 and that reached systemic proportions in September 2008. During the period 2004-07, the banner message of IMF surveillance was characterized by overconfidence in the soundness and resiliency of large financial institutions, and endorsement of financial practices in the main financial centers. The risks associated with housing booms and financial innovations were downplayed, as was the need for stronger regulation to address those risks.

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[3] Walter Bagehot, *The English Constitution*, 1867, http://www.gutenberg.org/ebooks/4351

"The IEO found that the IMF's ability to identify the mounting risks was hindered by a number of factors, including a high degree of groupthink; intellectual capture; and a general mindset that a major financial crisis in large advanced economies was unlikely. Governance impediments and an institutional culture that discourages contrarian views also played important roles." [4]

4. This is an acutely embarrassing episode for the Fund, indeed for orthodox economics, more broadly. For the principal institution dedicated to the analysis and promotion of global macroeconomic stability to have missed the most devastating financial and economic crisis since the 1930s is more than disturbing. It is calamitous. If not then, when? If not this, what? If not the Fund, who? How could this have happened not least when the Fund's economic counselor, Raghuram Rajan, was warning of these dangers at precisely that time?[5] Indeed the Independent Evaluation Office itself comments on how little effect prof. Rajan's warnings had on the Fund that employed him.[6]

5. Yet it must always be thus, at least to some degree. It seems inconceivable that crises will not recur. A severe crisis is also always to a high degree unexpected: otherwise, actions would have eliminated, or at least reduced, the consequences of the feared event. Thus it seems inevitable that the Fund, as mouthpiece for sound orthodox opinion, will miss crises. Should it succeed in identifying the possibility with sufficient force, the crisis is itself unlikely to happen. The Fund's most convincing prophecies of doom will then prove self-denying. Maybe a big crisis every 80 years is simply the

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[4] Independent Evaluation Office of the International Monetary Fund, *IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07* (Washington DC: 2011) www.imf.org, p. vii.

[5] Raghuram Rajan, "Has Financial Development Made the World Riskier?", paper presented at the Kansas City Fed Conference (Jackson Hole, Wyoming) August 27, 2005, http://www.kc.frb.org/publicat/sympos/2005/PDF/Rajan2005.pdf. This paper was notoriously condemned by almost all the assembled worthies. See, on this, the following blog: http://blogs.wsj.com/economics/2009/01/01/ignoring-the-oracles/

[6] IEO, *IMF Performance in the Run-Up to the Financial and Economic Crisis, op. cit.,* p.10.

inevitable price of market capitalism. But the better the Fund is at its job of surveillance, the rarer such crises will be. That at least is worth attempting.

6. The question, then, to be addressed is how to make surveillance more effective. In this note, I will focus specifically on "systemic surveillance": surveillance of individual economies with substantial effects on the world economy; surveillance of the interaction among such economies; and surveillance of the global economy as a whole. The founding fathers established the IMF at the Bretton Woods conference in 1944 to promote a co-operative relationship among such countries and so enable the world economy as a whole to function better. The Fund is a forum, ideally, *the* forum for such discussions, particularly now that large emerging countries play so large a role. But it also has a voice whose function is to animate and inform that forum. The Fund has both the duty and the opportunity to speak for the world as a whole. But if it is to speak, it has to have something to say. That is what its surveillance is about.

Impediments

7. Unfortunately, as the crisis has shown, it is extremely hard to make such surveillance effective. It is vital to understand why that should be so. I will analyse those reasons in terms of what I shall call the six "I"s – ignorance, ideology, insularity, incentives, intimidation and impotence.

Ignorance

8. Economists are ignorant. This is true of all economists, even those who work for the International Monetary Fund! Their ignorance is both broad and deep. But the ignorance is not complete. Economists do know some things that are true. Unfortunately, this is offset by their conviction that they know things that, in Mark Twain's words, "just ain't so".

9. It is important to appreciate the dimensions of that ignorance. Economists use grossly simplified theoretical models that, albeit revealing, do not begin to match the complexity of human motivation or interactions. Efforts are being made to buttress those models with more realistic assumptions. Yet the result is to add complexity without, necessarily, more understanding. The economic system itself is an extraordinarily

elaborate adaptive network. Yet, unlike other complex adaptive systems – ecological ones, for example – the driving force behind those adaptations is human purposes, understanding and invention. The most important variables in the economic system are, therefore, in people's heads and so, by definition, unknowable. Moreover, the global economy is constantly changing. Today's world economic system is different from that of a decade ago. Human beings are, of course, still human. But the rise of the emerging countries, developments in technology, innovations in finance, changes in opportunities for work and ageing of populations mean that how we thought the system worked even in the recent past is likely now to be inaccurate. Policy regimes change, too, and so alter people's understanding of how the system works. Last but not least, the available data are incomplete, unreliable and, by definition, about the past. Steering the world economy is like driving with only a distorted rear mirror.

10. The conclusion, then, is simple: authoritative surveillance is impossible. One is always at – if not beyond - the limits of understanding. More important perhaps, a trade-off always exists between being more comprehensive and so more complex, on the one hand, and more focused and so simpler, on the other. The tendency to focus on just one aspect of a complex economic reality – fiscal positions, for example, or the external balance – is natural, inevitable and almost always wrong. Yet attempts to gain a clear understanding of how the system fits together is impossible. At every stage, however, people engaged in surveillance need at least to ask themselves what are they assuming, what they fail to understand and what they might be ignoring. Accept ignorance. Do not assume it away.

Ideology

11. The simplest way to try to escape ignorance is to assume away complexity. In the case of economics, there exists a way of simplifying reality that is particularly attractive, both intellectually and politically: it is to assume that liberalized markets cannot go wrong. Once one had made that assumption, one could ignore prof Rajan's worries about the way incentives could work in the financial system. Problems of asymmetric information, adverse selection or moral hazard, though well understood in theory, could be assumed away as irrelevant for the financial system as a whole, in practice. The

advantage of such assumption is that they not only simplify the analysis but also that they are what powerful interests want the world to believe. It is no great secret that a set of simplifying assumptions – rational expectations in macroeconomics and efficient markets in finance – became orthodoxies. These were heroic and convenient simplifications. Unfortunately, they were wrong. They ruled out the massive bubbles and subsequent collapses that actually occurred. In sum, there was a strong tendency to adopt the ideology of Voltaire's Dr Pangloss, who believed that everything was for the best in the best of all possible worlds. After all, if everything was not for the best, someone would have made a deal to improve it. And if that deal could not be done it had to be because the costs of doing so were greater than the benefits. This everything did indeed have to be for the best in the best of all possible worlds.

Insularity

12. The economists at the Fund suffer from insularity on at least five levels. First, they suffer from the insularity of all economists, who despise the perspectives of non-economists. Second, they suffer from the insularity of orthodox economists, who despise the contributions of fringe thinkers, such as the followers of the post-Keynesians, Hyman Minsky or the late Wynne Godley, on the one hand, or the followers of the Austrian economists, Ludwig von Mises and Friedrich Hayek, on the other. Third, they suffer from the insularity of policy economists, who mostly despise the economics done by people working in markets. Fourth, they suffer from the insularity of an institution that despises the ways of thinking and concerns of other institutions, such as the World Bank and other development agencies. Finally, they suffer from insularity within the institution itself, with particularly important difficulties in integrating the ways of thinking of macroeconomists with those of financial specialists.

Incentives

13. Then there are individual and institutional incentives. At the individual level, it is never a good idea to challenge institutional orthodoxies. The more powerful, cohesive and structured an institution, the more that has to be the case. When I worked at the World Bank in the 1970s, I was struck that the Fund operated like an army, with a

manual that everybody tried to implement. The Bank, by comparison, was a relatively chaotic environment. This gives the Fund great coherence. But the cost can be grave error. Of course, there is always a tension between the need to allow people to think for themselves and the need to have a co-ordinated and consistent view across the world. The compromises between the two aims are sure to lead to mistakes. Beyond this, incentives operate in deeper ways. Fund economists consider themselves respectable professionals and, as such, want the approval of other respected professionals. They do not want to entertain or promote ideas too far out of the current professional mainstream.

14. Incentives do not just work at the level of individuals. They also work at the level of the institution. The costs for the Fund of going against the views and interests of important players are high. At best, it risks simply being ignored. At worst, it risks being attacked, with budgets reduced and legitimacy undermined.

Intimidation

15. If the worst comes to the worst, the Fund can be bullied. It is no great secret that some governments have tried to cajole or bully Fund staff into giving the assessment they want. Gordon Brown, former prime minister and Chancellor of the Exchequer of the UK, was well known for this. More broadly, it is very uncomfortable for the Fund to take on its more powerful members over any issue. If it had warned the US or UK of how dangerously exposed they had become to a financial crisis, it risked ridicule, at best, and outright conflict, at worst. Discretion is always the better part of valour. This is not a criticism. It is a reality.

Impotence

16. Last, we have the simple fact of impotence. The Fund can call attention to risk but, in relation to its more powerful members, its power consists only of its voice. The exercise of the ability to advise and to warn is the art of a courtier, not of a sovereign. For this reason, indeed, it must often be tempting to make any critical judgments privately. This might even be the more effective way to make such judgments. But the ability to guide the public debate is then necessarily lost. In the long run, moreover, the only hope of being listened to with respect is by gaining a reputation for being fair, honest and,

above all, right. The Fund must take risks if it is to make its surveillance more effective – intellectual risks and political risks.

Directions

17. Successful surveillance is hard, at every level, intellectual, organizational and political. Here, however, are some simple suggestions of how the Fund might dare to proceed.

Acknowledge ignorance

18. The first requirement is to be intellectually honest, which means admitting the limits of knowledge. It is perfectly right for the Fund to argue for its preferred conclusions. But it should also admit how and why it might be wrong. To take a salient example, it has, inevitably, aligned itself with the voices now calling for fiscal tightening in a large number of advanced countries. To its credit, the Fund has published work undermining the claim that this is likely to prove expansionary. But it needs to admit, because it is evidently true, that this policy carries risks. It needs to assess how far, for example, fiscal tightening can be credible without being immediate. It needs to consider the potential social and economic costs of austerity.

19. Similarly, before the crisis, the Fund needed to be far more circumspect about the consequences of financial liberalization. Again, the need was for the Fund to challenge its own orthodox assumptions. That would have been hard to do. But it might at least have led to greater circumspection. It is particularly astonishing that some of the best questioning was coming from its own economic counselor. But somehow this became lost within the organization.

Welcome unorthodoxy

20. The second requirement is to welcome unorthodox ideas. Inevitably, the dominant intellectual paradigm within the Fund is going to be that of orthodox economics. But even that is, by now, a very diverse set of opinions. Beyond that we have post-Keynesians, Austrians and many other bodies of thought. The Fund needs to make a serious effort to understand these ideas and work out which of them might make sense. It

would not be hard for this institution to invite exponents of such opinions to enter its portals and explain why they differ with Fund orthodoxy.

21. Personally, I found the late Wynne Godley and Hyman Minsky the most interesting unorthodox thinkers in the run-up to the crisis, the former for his emphasis on the flow of funds and the latter for his analysis of bubbles. But Austrians also have interesting things to say about money and banking. The point is that there is much more to reality than was contained in dynamic stochastic general equilibrium models of the macro-economy or the efficient market hypothesis, as it pertained to financial markets. The Fund has to expose itself to such unorthodox ideas systematically. It does not have to accept them. It does have to understand them. In this crucial respect, analysts at the Bank for International Settlements were unquestionably more daring and so closer to the truth than those of the Fund.

Embrace outsiders

22. The third requirement is to reach out systematically to outsiders. This should include economists and financial analysts who do not work in the faculties, finance ministries and central banks of powerful advanced countries. The Fund should talk to economists in other countries about their views not just of their own economies, but of the world economy. It also needs to talk to people who work in financial markets, as both commentators and active investors. Beyond the world of the "megabanks", it will find a range of interesting opinions in the world of hedge funds, private equity and, for that matter, trades unions.

Reward questioning

23. If the Fund is to do a better job in future, it has to reward questioning by its staff. This is hard – perhaps impossible – within a well-organised bureaucracy. But the attempt has to be made. It is incredibly easy in such a top-down organization for debate to be stultified. That will matter most, evidently, when the conventional wisdom of the organization is incomplete or plain wrong. It is also in such circumstances that holders of powerful positions are likely to be most defensive. But, at least internally, questioning of the current orthodox view of what is happening or how to think about the economy needs

to be encouraged and even rewarded. This should not be incompatible with forming ranks around a specific point of view when a decision has been reached.

Co-ordinate better

24. The fourth requirement is to integrate perspectives better. The Fund focused much of its attention before the crisis on global imbalances. Now the view is widely accepted that this was a mistake, because it ignored what was happening within the financial systems of advanced countries. But the real mistake was rather the failure to integrate the analysis of the global balance of payments with the flow of funds within countries and with the structure and growth of the balance sheets of financial sectors. In other words, we need a coherent and integrated analysis of the global and domestic flow of funds, the structure of the national and sectoral balance sheets and movement in asset prices, including exchange rates. It is only then that one can hope to have a reasonable picture of the stresses emerging within the system and, in particular, of possible connections between changes in asset prices, the risks of insolvency and the threat of a panic. The Fund is better placed than any other institution to carry out such an integrated view of the world economy. Indeed, it is the only institution with any chance of doing so.

Speak truth

25. The fifth requirement is to dare to speak the truth, as the Fund perceives it, however unpopular. It is, of course, a question whether it is more effective to do so in private rather than publicly. It is always easier to do so in this way. But there are strong arguments for making judgments publicly. Governments make policy. But they are ultimately accountable to the people. This is particularly evident for democracies. Judgments by the Fund are to improve the ability of governments to exercise their duties on behalf of their people. How well is this likely to work if the people themselves do not know what the Fund is saying? Ultimately, therefore, it is via its public documents and the discussion these create that the Fund will exercise its influence on policy.

Admit error

26. The final requirement is to admit error. The Independent Evaluation Office is an important innovation. It has produced superb evaluations of what has happened. But it is

also important for those who write standard documents, such as the *World Economic Outlook*, the *Global Financial Stability Report*, Article IV consultations and Financial Sector Assessment Programs, to look back, as a matter of course, at their earlier judgments, in order to assess how and why they went wrong.

Task

27. The International Monetary Fund was created to be the keeper of the flame of global macroeconomic stability within a co-operative and open global economy. That task has become no less important, though perhaps even more difficult, in today's world of liberalized financial markets, global capital flows and upheavals in the relative economic weight of countries.

28. In a speech delivered in Delhi in 2006, the governor of the Bank of England, Mervyn King, argued that the Fund has three tasks in assisting national policy-makers. "First, it should provide and share information about the balance sheets of all major countries, their composition and size, and the links between them. . . . That analysis should lead to an assessment of the risks to the world economy as a whole. The second task is to encourage countries to abide by their commitments to each other by promoting greater transparency about national policies. . . . And by making their national policy frameworks sufficiently transparent, countries will be making it possible for the IMF to hold them to account and to fulfill its role as an umpire. The third task is the provision of a forum for national authorities to discuss risks to the world economy. To build a common analysis of balance sheet positions and a shared understanding of the implications of that analysis for the world economy, a trusted, independent and expert secretariat is needed to facilitate those discussions."[7] To this I would add a fourth objective, to give an authoritative alternative perspective to those of the authorities of the countries, or groups of countries, it is advising. It does not only serve governments and central banks. It serves the peoples of these countries and so of the world.

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[7] "Reform of the International Monetary Fund", *op. cit.*, pp.9-10.

29. It has turned out that the risks were much bigger and the instability far greater than most analysts imagined five years ago, when Mr King delivered his speech. It turned out, too, that the biggest mistakes lay in the widely shared views of what we knew that were just not so, as Mark Twain warned. The problem was not just "known unknowns" or "unknown unknowns", but "unknown knowns". The widely shared hubris about the "great moderation" proved to be another example of intellectual pride going before a fall. Fortunately, when the crisis hit, the Fund played an admirable role in promoting a powerful reaction, though this also meant going back to ideas that fell out of fashion 40 years ago. It would be unfair to describe the Fund's response simply as "too little too late". But it would have been better if the Fund had played a better role in identifying the looming catastrophe or at least the risks of such a catastrophe.

30. This is what global systemic surveillance is about. In trying to carry out this task I am arguing that the Fund needs to be more humble and yet braver, more open to outside ideas and yet more determined to put forward its own, more skeptical of orthodoxies and yet a central player in official discussions among and within the great powers. Is this feasible? The answer is: probably not. But it would be far better for the Fund to fail trying than not to try at all.