Crisis Prevention and Management: Lessons from the IMF Experience in the Great Recession

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1 Introduction[1]

This note examines aspects of the IMF experience in the run-up and in response to the global crisis. It discusses the main factors that prevented the IMF from being able to detect and warn about the vulnerabilities that brought about the crisis and presents lessons from this experience. It then describes the main elements of the IMF response to the crisis and points to how lessons from earlier crises were incorporated.

In September 2008, in the aftermath of the Lehman collapse, the world entered the deepest financial and economic crisis since the Great Depression. The financial crisis led to a sharp global economic downturn in 2009 that gave rise to fears of a protracted recession as in the 1930s. The financial panic, however, was contained as central banks provided massive liquidity to rescue financial institutions and extended currency swaps to each other. An economic rebound in 2010 was followed by slower global growth, and performance since has been uneven across countries and regions. Unemployment remains above pre-crisis levels in most advanced economies; and growth in emerging market economies also slowed, with many

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witnessing significant capital flow and exchange rate volatility. The global economy has continued to grow, albeit at a slower pace and with less growth in employment than in earlier recoveries.

The global costs of this crisis, referred to as the Great Recession, have been significantly higher than those of a regular downturn in the business cycle. However, it is already clear that its impact has been more moderate than initially feared, i.e., a second Great Depression, largely due to the concerted policy response of countries and institutions across the world.

It is now widely accepted that the IMF failed to identify the risks and vulnerabilities that in 2008 brought about the Great Recession. The 2011 IEO evaluation on IMF Performance in the Run-Up to the Financial and Economic Crisis shows that the IMF's banner message right up to the outbreak of the crisis was of a benign macroeconomic situation and that its risk analysis was focused on the possible disorderly unwinding of global imbalances. At the same time, the IMF held the view that financial markets were self-stabilizing, and it was sanguine on the risks from high leverage and the possibility of a housing bust.

Other analysts were more prescient, including some academics and journalists, as well as senior officials at the European Central Bank and the Bank for International Settlements. While no one predicted (nor could have) the exact characteristics of the crisis, analysts pointed to the risks of bubbles in financial markets (e.g., Papademos, 2004) and housing markets (e.g., Case and Shiller, 2006). In fact, the Economic Counsellor at the IMF warned about how the fragility of financial markets could lead to a crisis (Rajan, 2005), but his analysis was not embraced by the institution.

As for the global response to the crisis, the IMF has played a central role. It has been involved as a leading force in numerous aspects of the response that have mitigated the crisis impact, including coordinating global and regional initiatives, channeling its surveillance into the recovery effort, and providing financial support to impacted countries.

Following this introduction, Section 2 presents an overview of the main factors that contributed to the IMF not detecting the risks and vulnerabilities that eventually led to the global crisis. This is followed, in Section 3, by examples of similar conclusions reached after previous crises and the recent run-up period. Section 4 describes the IMF's role in the global response to the crisis and discusses the extent to which lessons from the past were taken into account in this response. The note concludes with some general remarks about possible lessons moving forward.

2 Why Did the IMF Miss the Mounting Risks and Vulnerabilities?

How could the IMF, an institution whose surveillance mandate calls for warning the membership about risks to global stability, and which comprises over one thousand of the best economists in the world, miss the mounting risks and vulnerabilities? IEO (2011a) identified three main factors that contributed to this failure: cognitive biases, governance and organizational issues, and analytical weaknesses. At the same time, lack of data and political pressures, while problems, were not found to be core reasons behind the IMF's failures.

Cognitive biases are errors in reasoning and decision-making that occur when a person (or group of people) holds to his or her preferences and beliefs regardless of contrary information (Haselton et al., 2005). While many forms of cognitive bias may have interacted to blind the IMF to the mounting risks in the years leading to the crisis, IEO (2011a) identified three that played a critical role: groupthink, intellectual capture and confirmation bias.

Groupthink refers to the tendency among homogeneous, cohesive groups to consider issues only within a certain paradigm and not challenge its basic premises (Janis, 1982). Individuals often find it difficult to get out of their comfort zone and challenge established paradigms, as they withstand group pressure to conform. The prevailing view among IMF staff – a cohesive group of macroeconomists – was that market discipline and self-regulation would be sufficient to stave off serious problems in financial institutions. They also believed that crises were unlikely to happen in advanced economies, where "sophisticated" financial markets could thrive safely with minimal regulation of a large and growing portion of the financial system.

IMF staff was essentially in agreement with the views of authorities in the USA, U.K. and other advanced countries that their financial systems were sound and resilient. They also concurred that these systems could not only allocate resources efficiently but also redistribute risks among those better prepared to bear them. Moreover, even the (few) IMF staff uneasy with this paradigm felt uncomfortable challenging the views of authorities in advanced economies on monetary and regulatory issues, given the authorities' greater access to banking data and knowledge of their financial markets and the large numbers of highly qualified economists working in their central banks. Thus staff and the IMF as a whole were overly influenced by (and sometimes in awe of) the authorities' reputation and expertise; this was perhaps a case of intellectual capture.

Confirmation bias refers to the tendency to seek and notice only information that matches what one already believes and to ignore other information or to interpret it only in ways that are consistent with these beliefs (Bazerman and Moore, 2009). This type of bias may explain why IMF staff focused on how new information strengthened their concern with global imbalances (and a possible disorderly dollar decline), while at the same time they ignored new evidence (sometimes the same evidence) that pointed to risks of bubbles and financial sector fragility.

Governance and organizational impediments hindered the quality and effectiviness of IMF surveillance. These impediments refer to the structures, processes and incentives that apply to IMF management, staff and the organization as a whole.

The IMF, as most large organizations, is structured along vertical units that have geographical or thematic responsibilities. While this may sometimes be a good structure for carrying out the "routine" business of an organization, it fosters "silo behavior" and "turf battles" that make it difficult to integrate different disciplines, approaches, and information from across the organization. In the IMF, silo behavior made it difficult to integrate multilateral and bilateral surveillance, link macroeconomic and financial developments including the analysis of the *WEO* and the *GFSR*, and draw lessons from cross-country experience. This behavior was also blamed for the IMF failure to "connect the dots" in the run-up to the crisis, for example in that discussion of financial sector vulnerabilities never found its way into the bilateral surveillance of the largest systemic financial centers.

Already before the crisis staff had developed frameworks for assessing risks and developing policy scenarios, but these were applied largely, if not solely, to emerging markets and low-income economies and not to advanced countries. This lack of even-handed treatment was partly due to perception that such analysis would not be welcome by the more powerful IMF members.

Incentives were not well aligned to foster the candid exchange of ideas that is key for surveillance: staff were sometimes concerned about the consequences of expressing views contrary to those of supervisors, Management, and country authorities. This diminished staff's willingness to raise ideas outside of the institutional consensus and its ability to push issues that large members were not interested in, for example, conducting an FSAP for the USA while the authorities did not think it was necessary.

Analytical weaknesses also played a role in the IMF's shortcomings in surveillance. The linking of macroeconomic and financial sector analysis was inadequate. This reflected the lack of a suitable conceptual framework for analyzing such linkages within the economics profession at large; but perhaps more critical was the view among most IMF economists that financial issues were not central because financial markets were efficient and self-stabilizing and the impact of spillovers to the macroeconomy would be limited. There was also insufficient use of "balance sheet analysis", an approach that sometimes captures risks and vulnerabilities better than typical open-economy macro models.

Perhaps the most important gap was that IMF reports rarely referred to work by external analysts who pointed to the mounting risks in financial markets. Rather than a lack of awareness, it is likely that this was an example of the IMF's insular culture. An assessment of IMF research (IEO, 2011b) found that much of the surveillance-related analytical work over the prior five-year period made little reference to research from outside the institution.

Lack of data, while a problem, was not a core reason behind the IMF's failures. It is unclear how IMF staff would have used additional data given the prevailing conceptual framework on macro-financial linkages that led it to ignore or misinterpret available data pointing to mounting risks (e.g., credit growth, leverage, and the growth of high-risk instruments).

Political constraints (such as requests to alter messages in staff reports, demands by authorities to replace certain mission members, and perceptions of pressure from authorities leading to self-censorship) have always influenced IMF surveillance to different extents. However, there was no evidence of pressure to change or mute IMF messages on the issues at the center of the crisis.

3 What Can Be Done Better: Lessons from Previous Studies

This section describes the main lessons from the IMF experience during the run-up to the Great Recession. It then shows that most of the same conclusions and recommendations had been raised in earlier studies on IMF performance in surveillance and management of several past crises.

As explained above, the three main factors that led to the surveillance failure ahead of the Great Recession: cognitive biases, governance and organizational challenges, and analytical weaknesses. The 2011 IEO evaluation suggested a series of reforms and actions that would make it less likely that such a failure would recur. The following are some of the main such actions:

- To address **cognitive biases,** the IMF should promote greater openness and encourage diverse and dissenting views with the institution. While setting the right incentives is critical, outside expertise and establishing a dedicated risk assessment unit could mitigate problems of groupthink and reduce the risk of blind spots and confirmation bias.
- **Strengthening IMF governance** to enhance the legitimacy and effectiveness of the institution would require changes in the voting and Board structure which, for the meantime, remain elusive. There are, however, governance reforms that the IMF membership could agree to that would strengthen the effectiveness of surveillance. For example, the IMF could recalibrate its approach to risk assessment by giving greater emphasis to risks emerging from large systemic countries. It could also establish a clear legal framework to protect those who "speak truth to power", such as staff who raise issues that are not welcome either within the organization or in discussions with country authorities.
- A key **organizational challenge** is to establish an accountability framework specifying who is responsible for "connecting dots" across units and themes, and for ensuring that staff considers alternative points of view. Requiring staff to

come up with a clear and consistent message on the global outlook and risks when publishing the WEO and the GFSR may serve as a mechanism to ensure greater efforts to "connect the dots".

– To address **analytical weaknesses,** the IMF should establish operational and research partnerships with other international organizations and with central banks and government researchers. This would help the IMF overcome its insular culture and to become more aware of alternative views. Such partnerships could also enable the IMF to identify much earlier problems such as asset bubbles, and come up with better approaches for how to address them.

Most of these conclusions and recommendations had been raised in earlier IEO evaluations and in self-evaluation studies prepared by the IMF. While cognitive biases were not raised as such, some of the same concerns have been mentioned in the past. For example, the 1999 External Evaluation of IMF Surveillance called for "more outside experience in general to mitigate against insularity and conformity." The 2008 Triennial Surveillance Review pointed to the need to strengthen risk assessment and guard against tail risks, highlight "unknowns", and "think the unthinkable."

Governance and organizational issues have been repeatedly mentioned as detracting from IMF surveillance and its ability to respond to crises. The 1995 Whittome Report on Fund Surveillance urged that staff's analysis should be pertinent and pointed, leaving political considerations to the Managing Director. The 1999 External Evaluation of IMF Surveillance called for the Board and Management to make clear that they would, if necessary, back up staff that give frank advice. The 2006 IEO Evaluation of Multilateral Surveillance called for enhancing the roles of the Board and the IMFC in multilateral surveillance, a move that was believed would free Management and staff even further from political considerations. And the 2006 IEO Evaluation on the Financial Sector Assessment Program pointed to the importance of the IMF conducting FSAPs in any country where Management considered it necessary irrespective of whether these countries had volunteered. While not calling for the FSAP to be mandatory, the IEO recommended that Management signal to the Executive Board which countries it believed were the highest priorities for conducting a financial sector assessment. Had this initiative (which was effectively implemented after the crisis) been in place at the time, at a minimum it may have created a stronger sense of evenhandedness among the membership and perhaps helped to mitigate the crisis.

The concern with "silo behavior", the need to better "connect the dots", and insufficient cooperation within the IMF had been discussed in several previous reviews. The 2005 McDonough Report, for example, explained that "what is needed is an environment that fosters and provides incentives for close collaboration and cooperation between departments, to increase cross-fertilization between the IMF's traditional macroeconomic work and its work on financial and capital market issues, and to overcome the silo mentality that is lessening the overall effectiveness and influence of the institution as a whole." The 2006 IEO Evaluation on the Financial Sector Assessment Program suggested that strengthening the internal review process was needed to ensure that key messages on macro-financial stability were fully reflected in Article IV assessments.

The need to strengthen analytical work on financial sector issues and its integration with macroeconomic analysis has been a long-standing issue at the IMF. The 1999 External Evaluation of IMF Surveillance, the 2001 Lipsky Report, and the 2005 McDonough Report each recommended that the Fund should place greater emphasis on surveillance of financial sector and capital markets issues and that it should strengthen the linkage between bilateral and multilateral surveillance. The McDonough Report called for a fundamental change in how the Fund thinks about financial issues, including in particular that area departments should elevate financial issues to a central role in their work. In the 2008 Triennial Surveillance Review, IMF staff agreed that it needed to do a better job at integrating macroeconomic and financial sector surveillance.

4 The IMF's Role in the Response to the Great Recession

This section describes the roles that the IMF has played thus far in the global response to the Great Recession. It also considers the extent to which lessons from past experience were taken into account in this response, and points to current challenges.

The IMF has been involved in numerous aspects of the response to the crisis, including three main types of activities: coordinating global and regional responses, channeling surveillance into the recovery effort in order to prevent another global crisis, and providing financial support to impacted countries.

Leadership and Coordination

Early in the crisis the IMF took a leadership and coordination role that led many observers to argue that the institution had had a comeback after several years of being on the sidelines of global economic governance. At the October 2008 Annual Meetings of the IMF and the World Bank, the IMFC asked the IMF to work with other organizations and country groupings on a coordinated response to the crisis. In November 2008, the IMF Managing Director called for a coordinated global fiscal stimulus of 2% of global GDP at the G20 Leaders' Summit in Washington. In response to a request from the G20, the IMF became the de facto secretariat of the Mutual Assessment Process (MAP) tasked with providing forward-looking analyses of whether policies pursued by these countries are collectively consistent with sustainable and balanced trajectories for the global economy. The IMF joined the newly created Financial Sector Board (FSB) where it assumed the lead responsibility for integrating macroeconomic and financial sector analysis. It helped launch the Vienna Initiative in January 2009 to preserve commercial and other lines of credit in central and eastern European countries following the sudden-stop in capital inflows. Beyond its coordinating role, the IMF brought to the Vienna initiative its experience with a similar exercise in the late 1990s in confronting the East Asian crisis. In this and other initiatives, the IMF partnered with other international organizations.

The close association, and in some instances integration into country groupings and other organizations, is seen as having led to greater traction of the IMF's surveillance and program work. However, there seems to be a trade-off between this greater traction, on one hand, and the IMF's independence and equal treatment of the entire membership, on the other hand. Some member countries are not convinced that the IMF is appropriately placed in regard to its work with the G20, and there is even greater concern in regard to its engagement with the Troika. Given the benefits and drawbacks of these modalities, it will be critical that over the medium term the IMF membership agree on the type of engagement with such groups, that is, determine the appropriate balance between enhancing its traction and ensuring its independence.

Surveillance

Three aspects of IMF surveillance since 2008 deserve special attention: analysis and advice on fiscal and monetary policies, IMF engagement on financial stability issues and financial sector policies, and efforts to strengthen risk analysis.

Fiscal and Monetary Policies

Shortly after its initial call for global fiscal stimulus, the IMF noted that these recommended policies were contingent on the fiscal space in each member country. Still, some analysts are concerned that this policy advice did not sufficiently distinguish between countries with different initial fiscal positions and debt ratios.[2] In any case, in 2010 the IMF modified its advice and recommended that advanced economies shift to fiscal consolidation once their recoveries were on a sustainable path. At the same time, the IMF advised relying on accommodative monetary policies, including quantitative easing, to stimulate demand in the face of fiscal restraint. Some policy makers and analysts have argued that this advice may have

[2] Some have argued that the IMF should have focused more on pushing back countries that could not afford to expand (or that at the least it should have made sure that it was not providing a justification for an unsustainable expansion).

been premature; they also have argued that the resulting policy mix may not have been the most appropriate, as monetary policy is considered to be relatively ineffective in expanding private demand following a financial crisis, especially in an environment of near-zero interest rates. Additionally, authorities in many emerging market economies were concerned that IMF advice had not paid sufficient attention to the destabilizing spillover effects that quantitative easing had on their countries, thereby exacerbating capital inflows and the appreciation of their currencies.

Financial Stability and Financial Sector Policies

As the crisis erupted, the IMF began paying much more attention to financial stability and other financial sector issues. As a member of the FSB, the IMF analyzed shortcomings in financial sector policies and regulatory frameworks, and independently it urged authorities to deal with "too-big-to-fail" systemically important financial institutions (SIFIs) and limit cross-border spillovers. The IMF also made financial stability assessments (FSSAs) mandatory for systemically important financial centers. These assessments are supposed to be done no later than every five years as part of the Article IV bilateral surveillance process. The IMF scaled up research on macrofinancial linkages and increased financial sector technical assistance, especially in impacted countries. Still, questions remain on the extent of the integration of macro and financial analysis in surveillance, both at the bilateral (FSAP and Article IV) and multilateral (GFSR and WEO) levels. It also remains to be seen whether FSSAs will consistently offer candid diagnosis and advice, especially for large advance countries.

Efforts to Strengthen Risk Analysis

Since the start of the crisis, the IMF has significantly increased its focus on risk assessment and revamped early warning mechanisms in order to address critical shortcomings that existed before the crisis. In addition to the vulnerability exercises for emerging market economies that were undertaken prior to the crisis, the IMF initiated vulnerability exercises for advanced economies and low-income countries. The IMF also introduced a semi-annual Early Warning Exercise, conducted in coordination with the FSB, to explore tail risks. New tools for multilateral surveillance introduced following the crisis, such as country Spillover Reports and the Consolidated Multilateral Surveillance Report have also contained discussions of systemic risks.[3] Finally, a high-level Surveillance Committee has met regularly to facilitate interdepartmental communication and facilitate "connecting the dots", a weakness that played a critical role in the run-up to the crisis.

Authorities in some member countries have indicated that the number of independent risk-related exercises has grown beyond their capacity to absorb the results, as well as that this proliferation may be a sign that the same silo culture prevalent in the IMF before the crisis still exists. It is also unclear whether the IMF has established a system or procedures to ensure that it is exposed to contrarian and alternative views on financial sector vulnerabilities and tail risks. The bottom line for all these efforts is the capacity to identify risks and vulnerabilities before they turn into a crisis; and on this, it may indeed be too early to know whether this is the case.

Financial Support to Impacted Countries

Early on in the crisis, the IMF launched several initiatives to afford member countries more and easier access to financial resources and thereby reduce the risk of contagion and spillovers. The three main elements of this multi-pronged strategy were to expand the resource envelope available to members, to revamp IMF lending facilities to better respond to member country needs, and to facilitate speedier processing of program lending.

Resource Mobilization

The crisis found the IMF with inadequate resources to effectively support its member countries. With hindsight, it is clear that the IMF and its members would have been better able to cope with the crisis if ahead of it the IMF would have already had significantly larger resources at its disposal. As soon as the crisis erupted, the IMF launched resource mobilization efforts to boost its lending resources and to secure agreement among the membership for a significant allocation of SDRs to member countries.[4] Through a combination of a series of bilateral borrowing arrangements from various member countries, the IMF was able to treble its lending capacity to about one trillion dollars. Participation in these arrangements was voluntary and did not affect a member's ownership "share" in the IMF, which is based on a separate allocation of contributions called quotas.

[3] In response to the IEO, 2011 evaluation, Management issued a Consolidated Multilateral Surveillance Report in September 2011 and April 2012. However, this report has not been issued since.

[4] A general allocation of SDRs, equal to about USD 250 billion, increased all members' international reserves broadly in line with their IMF quotas.

In keeping with a 2010 agreement on quota reform, a part of these member loans to the IMF was supposed to be converted into quota contributions. However, this quota increase (and reallocation of shares) has not come into effect because the USA has yet to ratify the agreement, and the scheduled discussions for the next round of quota reforms were pushed back. While there is a consensus that the increase in resources helped to calm financial markets at a critical moment, the large reliance on and expansion of borrowed resources has raised serious questions of legitimacy for an organization that is supposed to be quota-based. In view of the difficulties with quota reform, the IMF and its members could take the opportunity to consider a much larger quota increase to avoid such challenges in the future, especially in a time of crisis. One possibility would be to target a level of quotas that would match the current level of resources, including bilateral borrowing arrangements, which could then be phased out.

Revamping Lending Facilities

In March 2009, the IMF made significant reforms to its lending facilities, mainly by increasing access limits (the size of the loans allowed relative to a borrower's IMF quota) and streamlining conditionality. The increase indicated the willingness of the IMF to finance a larger share than in the past of the adjustment needed by a borrower, in view of the global crisis. In addition, it was in part a reflection of the expected doubling of quotas that has yet to take place. An important question for the IMF membership is whether these higher access limits should remain after the crisis has subsided.

The IMF created a new precautionary facility, the Flexible Credit Line (FCL), available to countries with strong policies and performance track records. The FCL has no conditionality, no pre-set access limits, and an insignificant commitment charge. This is appropriate given its intended goals and target clientele; and for many years, many members urged the IMF to create a facility along these lines. However, only three countries have availed themselves of this facility, raising the question of whether qualified member countries are concerned that use of the FCL may be seen as signaling that the borrower has serious economic problems, despite its acknowledged track record. In addition, many members believe that the FCL immobilizes too large a share of the IMF's lending resources given the very high levels of access that borrowers have requested and their indefinite length of engagement. In sum, while the creation of the FCL is an important new development that responds to the lessons of previous crises, it seems that some additional rethinking may be needed to increase its use among other borrowers and to include exit strategies in the arrangement design.

Financial Support to Members' Programs

After a number of years of declining lending at the IMF, in the face of the crisis, a surge of member countries came to the IMF for financial support. The IMF responded very quickly to these requests and lending commitments jumped from about USD 1 billion in 2007 to over USD 100 billion in 2009 and over USD 200 billion in 2010. The number of approved non-concessional IMF-supported programs rose from 3 in 2007 to 17 in 2009. In processing these program requests, the IMF showed greater flexibility than in the past in terms of speed and frontloading of resources. As part of the continued effort to streamline conditionality, it also eliminated structural performance criteria, which had proven to complicate the implementation of programs in the past. While it is too early to assess the design and impact of specific programs, it will be important to sustain these reforms after the current crisis is over.

5 Concluding Remarks

It is now clear that the Global Recession has been less deep, and maybe shorter than was feared at the time of the Lehman collapse when most analysts and policy makers thought that a repeat of the Great Depression was possible. In part, this was due to the institutional arrangements and automatic stabilizers that had been put in place since the 1930s. But the response of the international community and in particular of the IMF also played a role.

The IMF has undertaken many reforms since 2008, incorporating in its response to the crisis a number of lessons from past experience.[5] These include: it moved rapidly into crisis mode and called for coordinated global action; it took a lead in recommending expansionary fiscal and monetary measures; it raised resources to ensure that programs were adequately funded and to provide a safety net to mitigate contagion; it created precautionary facilities to assist countries with good macroeconomic frameworks to pre-empt impacts from the crisis, and it set conditionality that was more streamlined and better focused on macro-critical reforms.

These reforms have led to a widespread perception that the IMF's performance has improved; but, as can be expected, questions still remain on many aspects of this performance. Has the IMF given up too much of its independence in working in cooperation with other organizations and country groupings? How can the IMF return to being a quota-based organization that is representative of its membership? Did IMF advice to advanced economies move prematurely towards fiscal retrench-

[5] The 2003 IEO evaluation of Capital Account Crises called for the IMF to take a more proactive role as a crisis coordinator, to provide sufficient financing to generate confidence, and to focus conditionality on areas critical to crisis resolution.

ment? Did it pay sufficient attention to the impact on emerging markets of monetary expansion in advanced countries? How about the impact of monetary retrenchment on these economies? Has it put in place mechanisms and incentives to ensure even-handedness in its treatment of member countries?

These and other issues are likely to become the subject of much debate and learning for some time. While some of these issues have just now come to the fore, many others have been present for a long time and most of them had been mentioned in past IEO evaluations and IMF self-evaluations. In some cases, reforms had been undertaken at the time, but they stalled once the crisis that triggered them had subsided, or after it turned out that they did not achieve their intended goals. In other cases, there was pushback to reform, only to later result in the repeat of the same issues in subsequent crises. Therefore, it is critical that a system be put in place to detect problems as they arise, to overcome natural institutional inertia, and to allow corrective actions in real time.[6] Moreover, the IMF, as any other large organization, needs to find ways to allow external, alternative views to enter into the organization analysis and policy debates to prevent groupthink and other forms of cognitive biases.

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[6] The Lipsky Report (IMF, 2001) highlighted the need to overcome “natural institutional inertia”.

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