

CRISIS PREVENTION THROUGH GLOBAL SURVEILLANCE: A TASK BEYOND THE IMF

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In early 2008, the future of the International Monetary Fund was in doubt. The world was awash with dollars since the United States ran an enormous current account deficit, the mirror image of which was trade surpluses in most other countries. Hence, few countries had balance of payments problems, and the IMF had few borrowers. IMF income was insufficient to meet its costs, and so it retrenched hundreds of economists, and both its relevance and legitimacy were questioned.¹ But that episode now looks like a temporary historical blip. After the collapse of Lehman Brothers—and the global financial system—in September 2008, the IMF was suddenly in more demand by governments than ever before to help finance stricken countries across continents. The G20 agreed to triple IMF resources to \$750 billion, the four BRICs (Brazil, Russia, India, and China) agreed to subscribe to the IMF's first bond issue of \$80 billion, and India has bought 200 tons of IMF gold. So an IMF role seems assured in future crises.

Yet, in between crises, the role of the IMF may be more limited than ever before. Global capital movements—and even labor remittances from overseas—now dwarf the IMF's resources. For instance, India's biggest-ever loan from the IMF was \$4 billion in 1991. But net capital inflows were \$25.5 billion in 2005–06, \$45.2 billion in 2006–07, and \$107.9 billion in 2007–08. Labor remittances

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¹Even before 2008, the IMF's relevance was being questioned. See, for example, Kapur and Webb (2006).

alone fetched India \$46 billion in 2007–08 and \$44 billion in 2008–09.

Structural changes have also reduced the list of countries chronically dependent on the IMF. In the current crisis neither Brazil nor Argentina needed IMF money. Asian countries have built up their own foreign exchange reserves in order to avoid going to the IMF. And after the current crisis, eastern Europe will be tempted to go the Asian way. So, the IMF may in the future have longish periods of minimal business, though it will still be in demand in major crises.

Ending Reserve Anxiety

IMF Managing Director Dominique Strauss-Kahn visualizes a new and much bigger role for the IMF (see *The Economist* 2009). He wants to increase IMF resources massively to \$2 trillion, making it big enough to offer crisis insurance—unconditional lines of credit to developing countries in a crisis. He believes this will check “reserve anxiety”—the tendency of developing countries to accumulate huge foreign exchange reserves as insurance against a future crisis, something that contributes to global imbalances. In Strauss-Kahn’s scheme, countries would regard credit lines from the IMF as being as good as owned reserves, and hence refrain from excessive reserve creation.

The chances of this happening are zero. Developing countries simply do not trust the IMF. This is partly because the IMF is dominated by the West, and partly because of the IMF’s track record in imposing politically humiliating and economically questionable loan conditions, especially in the Asian financial crisis. After that traumatic event, many Asian countries decided to deliberately build large reserves so that they would not have to depend on the IMF again. They launched the Chiang Mai initiative as an Asian swap arrangement to reduce reliance on the IMF. This facility was upgraded in early 2009 into the Chiang Mai Initiative Multilateralization (CMIM), aimed at turning bilateral swaps and credits into a regional reserve pool. The ASEAN countries plus Japan, China, and Korea specified contributions to their \$120 billion pool, set down borrowing entitlements, and allocated voting shares. In October 2008, the Federal Reserve provided swap facilities of \$30 billion to Brazil, Mexico, Singapore, and South Korea. More recently China offered

swap lines to Argentina and other selected developing countries. All these efforts were driven by lack of faith in the IMF's capacity or trustworthiness to check the crisis.

During the crisis, Strauss-Kahn created a flexible credit line enabling pre-qualified countries to get unconditional access to IMF funds. But only three countries—Mexico, Poland, and Colombia—drew upon the facility. One reason is that the public and politicians in most developing countries view IMF loans as humiliating. Strauss Kahn would like to expand the flexible credit line to become a global insurance facility, but there is little or no political support for this scheme either in rich or poor countries.

To improve the credibility of the IMF and make it look less Western-dominated, the G20 has agreed to shift 5 percent of voting power from overrepresented to underrepresented countries. In practice the U.S. share will not be affected at all, but the European share will fall and China will be the principal gainer. While this minor reform may be politically desirable, it will not change the fact of Western domination. In these circumstances, it is a fantasy to think that developing countries will cease to build up their own foreign exchange reserves and depend instead on a bigger and supposedly trustworthy IMF.

However, the IMF has been entrusted with one new task. The G20 has decided that greater surveillance and peer review of the global economy is necessary to nip future crises in the bud. It has given the IMF the main role in this crisis-prevention surveillance. This step may suggest that the IMF now has a much bigger global role to play. In fact, it has been given a thankless job that it will not be able to perform well.

Preventing Crises through Better Surveillance

The G20 has decided that the world needs an early warning system to thwart future crises, and so constant survey and peer review of major economies is necessary. The IMF will play a key role in this surveillance, since it already has a large, highly qualified staff that has long been in the business of economic surveillance using sophisticated forecasting models.

Yet, with all its expertise, the IMF's track record in predicting crises is rather poor—not because the IMF has third-rate economists or models, but because forecasting is a very uncertain business. No

model can satisfactorily account for the irrational exuberance and fear of real life. Besides, the IMF is subject to political pressures since its shareholders are governments, and so it often cannot say aloud what it really thinks. For instance, it told east European countries in private that they were dangerously over-borrowed but did not think fit to say so in public.

Despite its formidable array of models and economists, the IMF failed totally to anticipate, let alone check, the current financial crisis. On September 2, 2008, just days before Lehman Brothers went bust, IMF Survey Online carried an interview with the new IMF chief economist, Olivier Blanchard. The headline declared: “Blanchard Sees Global Economy Weathering Financial Storm.” In the interview, Blanchard (2008) said:

If the price of oil stabilizes, I believe we can weather the financial crisis at limited cost in terms of real activity. What makes the crisis so complex is the combination of these two shocks (oil and financial). I believe we have a good sense of how to handle each one separately. But the combination is tougher. The lower interest rates, which would help fight the financial crisis, run against the risk of inflation triggered by the oil shock. And one can think of many bad scenarios where low activity makes the financial crisis worse, and macroeconomic policy has little room for maneuver. At the same time, one can easily think of more optimistic scenarios, and I actually see them as more likely. If the price of oil stabilizes, I believe we can weather the financial crisis at limited cost in terms of real activity. And if, for example, the price of oil returned toward \$100—not a crazy scenario, as few of us understand how it got much above \$100 in the first place—then inflation pressure would rapidly subside, and I would be even more optimistic.

Within weeks of Blanchard’s optimism came the collapse of the world’s two biggest mortgage companies (Fannie Mae and Freddie Mac), the world’s biggest insurance company (AIG), and all four of the top investment banks (of which Lehman brothers was the only one not rescued). Money market funds were till then seen as completely safe, but panic burst when the Reserve Primary Fund confessed that the net asset value of its money market units had fallen below one dollar.

Global finance fell off a cliff, but nobody in the IMF had any inkling of the coming calamity. Instead, Blanchard argued that if oil fell below \$100 per barrel, “then inflation pressure would rapidly subside, and I would be even more optimistic.” In fact oil soon fell below \$40 per barrel, but the overall outcome was disaster, not reprieve.

Arvind Subramanian (2009) of the Peterson Institute of International Economics says bluntly:

The IMF’s cock-up was two-fold. First, it was weak and/or ineffective in addressing the problem of global imbalances that contributed to the crisis. It was ineffective in making countries that ran large current account surpluses, notably China, to adjust, and equally ineffective in influencing policies in the current account deficit countries, notably the United States. Second, and arguably the bigger failure, was to preside over large capital flows to Eastern Europe despite the lessons that it should have learned from the experience of the Asian financial crisis in the late 1990s. These flows to Eastern Europe were in some cases so large that it did not require hindsight to see the problems that they would lead to. Warnings about the unsustainability of these flows should have been loud and insistent. And they were not.

Subramanian gives the IMF a poor C grade for its surveillance.

The biggest fiasco occurred in Iceland, whose foreign debt by the second quarter of 2008 had reached 9.55 trillion krona, almost 800 percent its 2007 GDP of 1.29 trillion krona. Back in 2003, its foreign debt had been barely 100 percent of GDP. By the end of 2008, external debt had hit 13 trillion krona, of which over 11 trillion krona pertained to the banking sector. Banks borrowed short-term on global markets to fund a lending spree that created huge asset bubbles in Iceland. When Lehman Brothers collapsed and rolling over loans became impossible, Iceland’s banks went comprehensively bust.

The IMF holds annual consultations—called Article IV consultations—with every member state and should have been able to flag Iceland’s follies. Shockingly, it failed to do so. IMF staff

reports on Iceland's Article IV consultations for 2007 and 2008 make stunning reading.

The 2007 report was submitted to the IMF Executive Directors for discussion in August 2007. By then the subprime mortgage crisis was already at an advanced stage in the United States. As Fed Chairman Ben Bernanke put it in a speech at the Economic Club of New York on October 15, 2007, "The rate of serious delinquencies had risen, notably for subprime mortgages with adjustable rates, reaching nearly 16 percent in August, roughly triple the low in mid-2005." The writing was on the wall for other imprudent countries too, but the IMF report on Iceland could not see it. Its executive summary sums up IMF views as follows.

Given the risks in private consumption and absence of slack, additional restraint is necessary to re-anchor inflation at the target and ensure restoration of external balance. Fiscal policy will need to make a contribution and the HFF [the publicly owned Housing Financing Fund] must be reformed quickly to increase the effectiveness of monetary policy. Along with other measures to ensure fiscal policy provides greater macroeconomic stabilization, spending ceilings need to be binding. The banking sector appears well placed to withstand significant credit and market shocks. However given the rapid expansion and increasing complexity of banks' business, continued vigilance and further development of stress testing and risk management techniques is crucial. Following the mission, initial steps were taken regarding the HFF and the central bank announced that policy would need to be tight for longer to achieve the inflation target [IMF 2007; emphasis added].

Incredibly, the IMF's analysis of Iceland's financial sector ended with a good chit. Here is the relevant section in its report:

Although *stress tests suggest that banks have adequate capital to withstand large shocks*, there was agreement that continued development of stress testing techniques would be important. The stress tests performed by FME incorporate shocks that are quite large and the bank-by-bank impact on capital adequacy is published quarterly on the FME's website. When discussing whether the magnitudes of the shocks were appropriate, the FME noted that while the imbalances in Iceland have grown,

the shocks are always performed relative to the latest data outturns. *Consequently once markets begin to move, the tests track the evolution of capital adequacy quarterly, providing ample lead time to restore capital buffers if necessary* [IMF 2007: 15; emphasis added].

So, the IMF really could not see any short-term problem, and suggested moving on to medium-term issues:

Focus has shifted from short-term issues on the banks' liabilities to medium-term issue of credit quality. Despite low default rates, the rapid pace of credit growth and the extent of household and firm leverage means credit quality could become an issue. The majority of household debt, however, is long-term and so interest rate risk is low. Although the bulk of the banks' foreign currency lending is to firms with natural hedges, the increase in foreign currency lending to the generally unhedged retail, construction, and household sectors poses a growing concern. *The magnitude of these exposures remains small*, but the growth should be monitored closely [IMF 2007: 15–16; emphasis added].

Here, the IMF showed a dim awareness of some risks, but none of the imminent avalanche. Indeed, the overall tone of the report was very favorable to Iceland:

Unlike during a similar period last year, the króna has remained strong and confidence in Icelandic banks stayed high as indicated by their equity prices and credit default spreads. In addition to reflecting the banks' improved risk profile, this may also be due to a greater understanding in international capital markets of Iceland's unique circumstances. The banks have done a better job of explaining their business model and emphasizing that the size of the domestic economy can distort the picture suggested by standard ratios to GDP [IMF 2007: 7].

It would seem that Iceland's banks managed to fool the IMF as comprehensively as they fooled the markets. The overall assessment

of the IMF report was, “Iceland’s medium-term prospects remain enviable. Open and flexible markets, sound institutions, and skilful management of natural endowments have enabled Iceland to benefit from the opportunities afforded by globalization” (IMF 2007: 17). Famous last words!

One year later, Iceland was sliding toward disaster. So, let us take a look at the IMF staff report of the Article IV consultations for 2008, discussed by the Executive Directors in September 2008. The tone of the executive summary finally shows much greater appreciation of the difficulties. “The long expansion is coming to an end, and the economy’s overstretched private sector balance sheets, large macroeconomic imbalances and high dependence on foreign financing” (IMF 2008a). The executive summary provides the following staff view:

The main challenge is to facilitate an orderly rebalancing process, while mitigating risks. A key concern is external liquidity risks, which could also trigger an unwinding of domestic vulnerabilities. Monetary policy should continue to be tight, to return inflation to target and shore up confidence in the krona, given prevailing inflationary pressures and external vulnerabilities. The highly expansionary fiscal policy should be restrained to help support the central bank’s efforts to combat inflation and maintain confidence. Further actions to mitigate financial sector vulnerabilities should be pursued with vigor as concerns about bank’s funding are at the core of the external liquidity risks. Contingency planning needs to continue in full force [IMF 2008a].

So, the IMF recognized that serious problems existed. Yet even at this late stage its report shows no awareness that the economy was about to implode. The Financial System Stability Assessment 2008 (IMF 2008b) went into the issue in more detail, and its summary made the following points:

- The banking system’s reported financial indicators are above minimum regulatory requirements.
- Notwithstanding current strengths, vulnerabilities are high and increasing, arising from funding and credit risks and limited access to wholesale credit markets.

- The banks are adopting steps to address these vulnerabilities, including diversification of funding and selected asset sales, but it remains uncertain if these adjustments are sufficient in today's financial environment.
- In light of concerns about market access, stronger capital and liquidity buffers appear appropriate.
- The supervisory framework has been improved and the supervisor's capacity to supervise banks has been enhanced, but the bank resolution framework should be strengthened.
- Given the significant size of cross-border activities, continued and strengthened cooperation with host supervisors is warranted.

This still showed no awareness or apprehension of the imminent debacle. In the Article IV consultation report of 2008, one section on the condition of the financial sector ran as follows: "Liquidity and funding risks, associated with banks' reliance on market finding and sizable funding needs due to a significant amount of debt maturing over the next two years. Given the difficult market situation, challenges in securing adequate liquidity coverage at acceptable price could also reduce bank profitability" (IMF 2008a). Even at this stage in the crisis, the IMF merely envisaged an erosion of profitability. It had no clue that the top banks were about to go spectacularly bust.

On September 29, the government took over Glitnir Bank. The following week Glitnir Bank along with the bigger Landsbanki were handed over to receivers. Soon after, Iceland's largest bank, Kaupthing, also went into receivership. The scale of the financial sector's debt was so huge that Iceland's own sovereign rating crashed. Until this point Iceland was a fiercely nationalistic country that steadfastly refused to join the European Union. But so massive was the financial crisis that Iceland was obliged to apply posthaste for EU membership to give its currency and economy some credibility.

During the banking boom, thousands of Iceland's traditional fishermen became bankers. When the banks collapsed, they returned to fishing. This inspired a local joke that was variation of the old Chinese saying, "Give a man a fish and he eats for a day; teach a man fishing and he will eat the rest of his life." The Icelandic variation ran as follows. "Teach a man finance, and he will fish the rest of his life."

Why Crises Defy Prediction and Prevention

The Iceland example shows that, notwithstanding its expertise, the IMF is capable of whopping blunders. Yet in this episode, as in the overall financial crisis, economists in investment banks and central banks proved as unsatisfactory as those in the IMF. The problem was not just lack of competence in the IMF, but the difficulty of predicting how well-known problems could suddenly escalate into disaster.

Queen Elizabeth II of England once asked why nobody foresaw the crisis. In fact many economists had highlighted problems such as asset bubbles, the carry trade, excessive leverage, vanishing household savings in the United States, and global imbalances. Robert Shiller's book, *Irrational Exuberance*, predicted in 2000 the coming dot-com collapse, and the 2005 edition of the book predicted the housing collapse. Alan Greenspan and Ben Bernanke both knew of the housing bubble, and indeed knew that their low interest rates were inflating the bubble. But rather than try to prick asset bubbles in advance, they felt it was better to let bubbles burst and then clean up the mess. Martin Wolf and many other economists (including those in the IMF) repeatedly highlighted the problem of huge global imbalances (principally unsustainable deficits in the United States and surpluses in China). U.S. household savings had fallen from 9 percent of disposable income in the 1960s to zero in 2007, and it was plain to many economists that a return to normal thriftiness could cause a deep recession.

But while many economists could see unsustainable bubbles inflating, none knew when exactly each bubble would burst, or if all would burst together. At the British Academy Forum of June 17, 2009, "The Global Financial Crisis: Why Didn't Anybody Notice?" (the question posed by Queen Elizabeth), the summary view was that the crisis was "a failure of the collective imagination of many bright people," arising from "a psychology of denial" (Besley and Hennessy 2009). But not all economists were in denial. Some like Nouriel Roubini and Stephen Roach had for years been predicting disaster. But when the months passed and disaster did not strike, they were dismissed like the boy who cried wolf.

This is the problem the IMF will face in devising an early warning system. It will surely be less optimistic in forecasting than it was

before September 2008. Yet, if it decides to follow the Roubini approach and constantly sounds alarms, it will soon be dismissed as another boy crying wolf. Former IMF chief economist Raghuram Rajan had in lectures and articles after 2006 talked of growing financial sector risk, but in the euphoria of the boom nobody listened. The IMF and others frequently made the rather obvious observation that global macroeconomic imbalances could not continue forever. Nobody disagreed, but nobody acted to correct the imbalances either. Nobody likes to break up a happy party. Few people want to risk a small recession (by deliberately puncturing an asset bubble) to reduce the risk of a mega-recession.

The G20 now wants the IMF to use its expertise and models to create an early warning system that prevents future crises. Yet behavioral economics (and actual experience) have demonstrated how useless the best models can be.

Alan Greenspan, writing in the *Financial Times* on March 16, 2008, identified unpredictable changes in human behavior as one reason why the financial crisis was not spotted by risk-management or econometric forecasting models:

These models do not fully capture what I believe has been, to date, only a peripheral addendum to business-cycle and financial modeling—the innate human responses that result in swings between euphoria and fear, that repeat themselves generation after generation with little evidence of a learning curve. Asset-price bubbles build and burst today even as they have since the early 18th century, when modeling competitive markets evolved. To be sure, we tend to label such behavioral responses as non-rational. But forecasters' concerns should be not whether human response is rational or irrational, only that it is observable and systematic. This, it seems to me, is the largely missing explanatory variable in both risk-management and macroeconomic models [Greenspan 2008].

Daniel Kahneman won the 2002 Nobel Prize for his work on behavioral economics. Standard economic models assume that human beings act rationally, but behavioral economics demonstrates that people often act on the basis of emotions and intuition; markets are plagued by herd behavior and groupthink; and humans in general tend to underestimate risks and overestimate

chances of success. Kahneman refers to this human tendency as “delusional optimism.” Problem is, delusional optimism cannot easily be integrated into forecasting models (see Kahneman 2009).

Indeed, such optimism means that human beings—politicians, bankers, investors, householders—are reluctant to accept or act on the possibility of worst-case scenarios. This means that surveillance and early warning systems created by the IMF are unlikely to be particularly useful in preventing disasters, whatever the G20 may think. The technical issues in creating an early warning system are difficult enough. But the biggest issues are behavioral. Cass Sunstein (2007) says, “Officials have two unfortunate incentives: to give undue attention to worst-case scenarios or to pay no attention to them at all. Sometimes their electoral prospects, or their overall popularity, depend on one or the other.” This is why decisionmakers exacerbate rather than dampen swings from euphoria to panic and back.

Three IMF economists, Atish Ghosh, Jonathan Ostry, and Natalia Tamirisa (2009), make the following point:

A realistic yet still ambitious goal for an early warning system is to raise flags about worst-case scenarios and present policymakers with options for how best to respond. This requires rigorous, forward-looking analysis, sound judgment and sharp communication. But even a perfectly designed early warning system may not be able to predict and prevent all crises, and may give rise to too many false alarms. Will policymakers be ready to listen (to early warnings) when the global financial crisis passes?

Conclusion

The proposed new role of the IMF, for global surveillance and crisis prevention, looks perilous and possibly doomed from the start. It may appear to work for some time but will almost certainly fail when the next major crisis arrives. The IMF's shareholders are governments, and the IMF is often obliged to pull its punches with major shareholders. Governments struggling with problems keep assuring their public that all is well, and will wish to discourage IMF warnings that might cause panic. Large creditor countries ignore IMF lectures: only borrowers listen, out of compulsion. The United States

has formally accepted the need for peer review of its policies, but no one in Congress is really going to change his views—or congressional actions—because of peer review by China or Brazil on U.S. follies. This adds to the earlier problem—that prediction is anyway very difficult, and the IMF's forecasting record leaves much to be desired. In coming years, the IMF will no doubt provide the G20 with voluminous surveillance reports and sundry warnings on risks. But the hope that this will prevent future crises looks like one more example of what Kahneman calls “delusional optimism.”

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