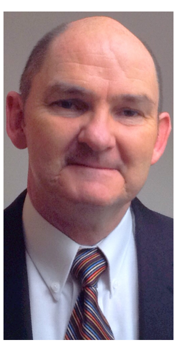
Global Early-Warning and the IMF

The global economy continues to grow strongly

"The strong global expansion is continuing ...

... risks ... remain modestly tilted to the downside"

IMF, July 2007



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The IMF failed to provide warnings of the long-latent global vulnerabilities which resulted in the global financial and Euro Area crises. This reflected systematic shortcomings in its early-warning work, requiring specific fixes. If those fixes are not made, a new institution is proposed to provide global early-warnings.

Anniversary

Advanced anniversaries are customarily occasions for much varnished story-telling. The International Monetary Fund's 70th this year has followed form.[2]

But that milestone occurs in the shadows of Lehman's and the Euro Area crises. Prior IMF analysis of the world economy—known as "surveillance"—not only failed to contemplate either possibility, but celebrated the circumstances which led to both, right up to the eve of eruption.

Despite some recovery and challenges from other sources, these crises continue to wreck havoc with the lives of millions across the world:

- many in the advanced world face unemployment, especially the young;
- many more face ongoing real wage cuts, unbearable mortgages, long-delayed retirement, and contingent obligations to backstop banks;
- Euro Area countries have fared worse than in the Great Depression with no end in sight, stoking political extremism in a further echo of that earlier era;
- in the advanced world, government help for citizens will be constrained for a generation by repayment of the crisis-necessitated jumps in government debt;
- in the developing world, prospects have also been impaired as they depend heavily on advanced economies for investment and to buy their exports;
- and the whole world faces further risk of aftershocks from the two crises.

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[1] With many thanks to Gabriel, Chris, Peter, Masami, Edward, Tony, Sam, Chip, and Byron.

[2] Text in blue is hyperlinked to support notes that I prepared for this piece, and in green to work by others.

Given these global and generational catastrophes, something closer to truth—rather than varnished-story—telling seems appropriate on the anniversary of the institution, the IMF, which was summoned into existence 70 years ago, in the wake of the Great Depression, precisely to prevent recurrence of such disasters.

My vantage point on this is almost unique: a Fund[3] staff member for 20 years, the latter half as senior staff, working in its European Department from 1998 onwards i.e, from near the genesis of securitization and the Euro right through to OMT and beyond, in the engine room where IMF analysis of these matters went awry. Many others passed through that room over that time, but few saw it all the way through.

I did not see the disasters coming, and I have learned much from that fact.

But there is much more to be learned from the failure of the Fund to see them coming than has been recognized. And those lessons need to be learned if the IMF's surveillance mandate is to be better realized in future.

The starting point is that the world and economics have changed greatly since that surveillance mandate was established. Thus, the Great Depression-inspired judgement that policies inconsistent with exchange rate pegs and open trade were *the* enduring threats to global stability—and hence the appropriate focus for IMF early-warning surveillance—has long gone. But even if those indicators of danger have been discredited, the IMF mandate to spot and head-off global threats through surveillance remains, as reflected in its founding Articles I & IV(3), its inspiration, and its resourcing.

But that mandate was not fulfilled in respect of the Lehman's and Euro disasters.

In their wake, the IMF has issued a string of apologies of sorts—for groupthink, for "overly optimistic" Greek and "overly pessimistic" British projections, and for wholesale miscalculation of fiscal multipliers.

[3] The terms "IMF" and "the Fund" are one and the same—they are used interchangeably.

But these apologies dissemble and distract; there are much bigger issues at stake.

Because neither Lehman's nor Euro travails were once-in-a-millenium "black swan" events. Instead, both were accidents long waiting to happen. And both had been predicted, not by Chicken Little or Cry Wolf types, but by people who had correctly understood the dangers.

Key figures, such as Brooksley Born, William R. White, Ragu Rajan and others raised precise alarms about global financial fragilities well before Lehman's. And Peter B. Kenen, the Bundesbank, Milton Friedman, and Martin Wolf—Eurosceptics none—were among many who pointed to Euro misconstruction at its birth.

And their warnings reflected the most introductory of economic ideas: that nothing good comes of systematically underpricing risk; and that while currency areas do not have to be optimal, they should not be grossly suboptimal.

Though none of these observers foresaw precisely how the two problems would interact, they spoke up in good time for the Fund to hear and respond and for alternative courses to be set. But they were dismissed—sometimes from their jobs—and caustically so. And both ships sailed onwards towards the disasters predicted.

So the question at *70* is not only why IMF surveillance failed to spot these problems itself when a number of others managed to do so, but why it paid no heed even when it was told of them and whether it will do any better next time.

Alibis

After ritual regret and self-exhortation to do better in future, the Fund's typical line on its failure to foresee risk of these crises—usually in passing or in sub-text, but omnipresent—is that "others didn't see them coming either" and that crises have the benefit of putting us "back in business". The implication is that others were at least equally at fault and crisis avoidance wasn't our *real* job anyway.

It is odd enough that the Fund thereby denies the main purpose for which it was created—prevention of global economic catastrophes—on its milestone anniversary. And to say that others failed equally falls well short of the whole truth. But even more than these, if the Pentagon was to explain its failure to deal with a nuclear missile attack on the U.S. by saying that "plane-spotters didn't see them coming either", the reaction would be disbelief. So with the IMF.

Indeed, these alibis are symptomatic of the cocktail of hubris, naivety, and power in the IMF and the broader economics profession which shunned the warnings.

Hubris

The standard pre-crisis dismissal of the early concerns raised by Born, White, Rajan and others about severe fragilities in global finance was that such people could not possibly know better than markets—which went from boom to boom. And the Euro-reservationists' early warnings were similarly dismissed. Rather than spotting fatal flaws, it was said that they had simply misunderstood the most elegant parts of the design of the Euro as it evolved to ever closer union.

But hubris ran much deeper than that. By the 1980s, not only had policies inconsistent with exchange rate pegs and open trade been abandoned as indicators of pending global crisis, but the presumption had become entrenched that global crises themselves were things of the past. So much so that the IMF, created specifically to head them off, had given up on the task. Seeking new roles, it had begun commenting on any remotely macroeconomic issue anywhere. And its work on advanced economies had degenerated into obsession with the minutiae of the day-to-day management of their business cycles, year-ahead forecasting, and steady-state growth issues—eye totally off the ball.

And that mindset was also reflected in the way that IMF surveillance treated the Euro after it was launched in the late-1990s. The Fund simply took as read that the Euro was fundamentally robust. So rather than even keeping just one eye out for the dangers that the Euro-reservationists had carefully pointed out, the most comprehensive review of pre-crisis IMF work on the Euro concluded that the IMF "failed to take into account the implications of [Euro countries] being in a currency area." Macroeconomic analytical and procedural failures simply do not come more fundamental and basic than that.

And that same hubris and consequent distraction is still evident in the Fund's post-crisis self reforms. Just as the immediate pre-crisis IMF was focussed on projection of a "kinder, more responsive" IMF—creating an alphabet soup of new IMF lending windows for each day of the week—rather than on preparation for global crisis, so its post-crisis focus has been similarly misdirected—creating a swathe of new surveillance products. So it now has spillover/spillback, regional, cluster, external, housing, consolidated surveillance and G-20 reports, early warning exercises, and staff blogs, videos and position notes to add to the pile of Article IVs, FSSAs, ROSCs, WEOs, GFSRs, Fiscal Monitors, REOs, working papers, and press statements that it already had.[4]

The view implicit in this focus of post-crisis IMF self reforms is that its prior problems were not of diagnosis but of messaging, requiring these new outlets. But this clutter of products aggravates the underlying impediments to diagnosis, adding further woods-from-trees, silo, and administrative-overload burdens to the hubris and distraction problems under which IMF global surveillance already labored.

And this swirl is the tip of the iceberg. New internal IMF staff turnover rules will reduce the average service time of the whole complement of staff in any department at any time to just 3 years. This added churning of staff heralds further non-learning, non-accountability, and non-ability to challenge advanced countries. Expect more mea-culpas and kowtowing from the IMF as a result.

This mis-focussed post-crises activity is symptomatic of an institution that has been caught out, not one that is purposefully making headway to fix its failings.

[4] Summary descriptions of each of these kinds of surveillance products can be found here.

Too harsh? Just think through one specific example. Ask yourself; if the recently-commissioned spillover reports—which assess a country's impact on others—had been prepared in 2005, would they have helped the IMF back then to heed those warnings of latent global fragilities? Unlikely:

- One would not have been written for Greece. Semi-Balkan, yes; but just 2 percent of EU output; recipient of stable capital inflows from well-supervised European banks; Euro member. The IMF judgement back then would have been that there was no impact of Greece on others worth writing about.

- Such a report for Germany would have had similar presumptions, but would have lauded Germany's anchor role in the Euro and EU rather than seeing its increasing competitiveness vis-a-vis the peripheries as any sort of threat.

- In the unlikely event (because it is not a country) that one might have been written for the Euro Area, the no bailout clause would have been seen as securing sound fiscal policy in a devolved system, rather than as denying Euro sovereigns a lender of last resort—hence comprising a major global fault-line.

- A spillover report for the U.S. back then would have fared no better. Given the IMF view as late as August 2007 that "systemic risks appear low" in the U.S. financial system, such a report might have noted that *if* something went wrong in the U.S., its global role would imply great consequences for others. But that would not only have been stating the blindingly obvious, it would also have been dismissed as fanciful—because nothing *was* going to go wrong in the U.S. Such a report would have made even less headway than Rajan's work.

Spillover reports, as others, will reflect priors; they will not be means of awakening.

Naivety

But important as hubris has been in producing IMF global misdiagnosis, don't underestimate IMF naivety, notably the urge to be an appreciated global citizen.

For example, every IMF country report notes up and downside risks, often (as in the quote on the title page of this piece) "tilted", and now formulated in grand-sounding risk assessment "matrices". Risk is always present, so by definition such routine cautions add little value. But they are far from harmless. Because the IMF in its naivety is so concerned to be "helpful" that its cautions about risks are always expressed, however implicitly, with a time dimension—in the next six months, or year or two, because that is the attention horizon of its main audience, the IMF Executive Board, and financial markets.

That time reference is fatal. The nature of macroeconomic fault-lines, such as those which eventually resulted in the global and Euro Area crises, is that the economics profession has no idea when they will crack; it can only claim to have some grasp what constitutes a fault-line. So if such an identified tectonic danger fails to materialize within its appointed time slot, the IMF is predisposed to cower and withdraw its alarms lest it be "proven" alarmist and wrong "again". And in the wake of such "failed" predictions, rather than reiterate concern with the ongoing—if not still accumulating—dangers, the IMF seeks desperately to *say something new*, lest repetition corrodes its credibility and irritates. This behavior can be seen in stark relief in pre-crisis IMF surveillance on Iceland.

Alongside, the IMF yearns to be *taken seriously*. Since standing alone inevitably runs the risk of being mocked, the Fund inclines, de facto, to being wrong with the crowd than right with the minority. This can be seen in how extraordinarily high it sets the bar before making crisis calls, as in Iceland. But this behavior completely undermines its early-warning role. Effective crisis prediction requires willingness to stand alone or crisis calls will inevitably be too late—by the time that consensus says a crisis is coming, everyone has already panicked and so precipitated it.

These urges to be appreciated and taken seriously thus set IMF risk analysis up to keep quiet about the fact that a drunk is teetering on a cliff-edge—because she hasn't toppled in the last half an hour and no-one else says she's drunk or anywhere near a cliff—and instead to emphasize banalities; that she is unlikely to remain on the spot and that her next totter is likely to be "tilted" this way or that.

Beyond these time-dimension and mock-aversion traps into which IMF risk analysis has fallen, further kinds of good global-citizen naivety undermine the construction and value of its flagship output, the global forecast, the WEO.

Despite the fanfare, the WEO is little more than a clunky adding-up exercise. All country teams make projections; other staff note oddities in the sum of them and since last time; adjustments are forced; gears grind; the gap between global exports and global imports lets out some steam; and hey presto, WEO.

One issue is that the staff are instructed to show that by 5 years time, balanced moderate inflation potential has been achieved. So by dictate rather than derivation, the WEO cannot predict a crisis or the risk thereof, and even has trouble projecting a sustained global fallout from one once it has actually happened. Here is the presumption that global crises are things of the past set in IMF stone.

But there is more. The basic building block for IMF analysis of advanced economies is the individual countries, even though many are so tied to each other that their outlook is more determined by what is going on around them than by their idiosyncratic features. The issue is not spillovers; it is integration. No-one would analyze the U.S. by studying each of the 50 states and adding them up because, thanks to economic integration, the process would be overwhelmed by noise drowning the signals. But that is what the IMF does for the Euro Area, the EU, and elsewhere in the advanced world. By starting analysis for such economies at country level rather than at determinant higher levels of aggregation, IMF assessments of advanced economies are set up to drown.

So why does the Fund persist with all of this? Look to its global citizen naivety: because it is composed of country members; because it feels obliged to subject all members to the same procedures regardless; because it has to end up with forecasts for countries, so it thinks it has to start with them; because it wants to give the press the individual country forecasts that the press wants; because it has always done these things; and because all of this is appreciated, even if it always fails the only time when failure matters—in global crisis.

The WEO is substantially redundant for early-warning purposes. It has its fans; it is provided free of charge, and pundits like to cite it as authoritative if it happens to echo their own views. But every major outside review has found that it has never deviated significantly from the conseusus of private forecasters, and that it has an unblemished record of failure to anticipate the risk or timing of global turning points, including—as late as the July 2007 WEO update—the crises from 2008 on.

This can come as no surprise given that its construction *presumes* stability, ignores where the fate of advanced economies is actually and increasingly determined, and embodies the Fund's instinct to follow the crowd. Everything in the WEO that others need by way of global outlook (including for IMF program projections and low income country work) could be taken from private consensus global forecasts.

But its redundancy is far from harmless. It is resource intensive, it distracts, and it hardwires in the institution the presumption that global fault-lines, such as those that erupted into the financial and Euro Area crises, do not exist.

Power

And after hubris and naivety, there is power. A feature of such global fault-lines is that they typically have huge amounts of political and actual capital invested in them. Those so invested—notably the governments of the major world powers which are the IMFs controlling shareholders, its "masters"—have no interest in one of their own little creatures, the IMF, drawing attention to the dangers.

Rajan, while at the IMF, crossed this line in 2005 with his prescient warnings of seismic worldwide financial risks. With those, he ran smack into the core free-finance faith of global policymakers, personified at the time by Alan Greenspan, then outgoing Chair of the Board of Governors of the US Federal Reserve System. For his troubles, he also earned the damning disparagement "slightly Luddite" from Laurence Summers, then former U.S. Treasury Secretary. Neither Rajan nor his ideas were long for the Fund after all that. Everyone there duly took note.

And though the Euro problems were even more conventional and longer-brewing than those corroding global finance from the 1990s, no-one in the Fund dared to challenge the Europeans. Their elite yearned for union so as to rival the U.S. and rising China. They cloaked this ambition and the attendant internal power struggle with talk of securing European peace, and were happy to proceed against the grain of their own voters who would eventually learn what was good for them. So there was no question of hearing of suboptimal currency unions from the upstart IMF. The all-European Managing Directors (MDs) and overweighted European IMF shareholders, using their status as majors, saw to that. Not even Rajan took on the Euro. There was only IMF applause and tinkering, right up to bust.

And the record on published IMF surveillance on both matters matches that on what took place in private. The key ex-post studies of pre-global crisis and pre-Euro crisis surveillance both enquired of many who knew first-hand and had every incentive to say if prior IMF *sotto voce* messaging had been any better. Sadly, not so.

In sum, though the early warnings of risks in global finance and the Euro made by others adhered to all IMF advice on how best to make early warnings, the cocktail of hubris, naivety, and power stacked the odds overwhelmingly against the Fund ever paying heed or passing the messages on to its masters or to the global public.

And bear in mind that none of those who correctly identified the global threats inherent in free-finance and the Euro needed any of the IMF surveillance paraphernalia, old or new, to do so. Instead, not only were they largely free of the distraction of producing or consuming it, but they were at liberty to ask and keep asking the right questions, and to follow wherever the answers led.

Unchastened and Unloved

The shortcomings of IMF global early-warnings as reflected in these surveillance failures were (and are) not to do with messaging—motivating the yet further expanded range of publications—but to do with focus and diagnosis.

At one level, those problems originate in the job specification for IMF work on advanced economies—business cycles, year-ahead forecasts, time-framed risks, steady-state growth issues, rather than identification and avoidance of global fault-lines.

But that, in turn, originates in the fact that at 70, the cocktail of hubris, naivety, and power—the lens through which all IMF surveillance, old and new, is written and read—is astonishingly unchastened. Not even the two recent global disasters have yet managed to accomplish that, apologies notwithstanding.

Some of the evidence of that continued unchastening is visible in details:

- Despite the others, there has been no apology to Rajan, rather criticism that he did not reflect his warnings in the WEO—as if that would have been an appropriate place for them and as if he had been free to do so.

- The IMF Department Heads most tied to the pre-crises IMF misjudgments were promoted. They work on renewable fixed-term contracts at the MD's behest, so reticence to speak truth to the MD's power is duly rewarded.

- The Europeans' lock on the MD's appointment has tightened.

- WEO processes go on as is, as do the regular 3-year IMF assessments of its own surveillance, every vintage of which has failed to confront the cocktail undermining surveillance because it asks "do we endorse?" not "were we warned?"

- The basic legal rubric underpinning IMF surveillance adopted in 2012, the Integrated Surveillance Decision, also overlooked that corrupting cocktail, just like its mis-focussed and short-lived 2007 predecessor.

- Senior IMF staff, oblivious to their collective record consequent on all this, still opine in the name of the Fund on almost anything on any grounds, and still preen and tut-tut when their blandishments are ignored.

- The annual IMF research conference last Fall, on the global crisis, made not one mention of IMF disregard of early warnings. And the topic for the annual IMF research conference this Fall is—wait for it—spillovers.

All this follows the British World War II exhortation: Keep Calm and Carry On. But that unchastened attitude in this context heralds the prospect that the IMF will again fail to issue timely warnings of major latent global vulnerabilities.

And two key mid-crisis decisions of the IMF's masters compound that prospect: to assign the lead for re-regulation of global finance to the Financial Stability Board (FSB), not the IMF; and to shift from the G8 to the half-way house of the G-20 rather than to the global IMF for policy coordination. These decisions reflect the masters' doubts with the quality of its work, exemplified by its early-warning failures, and their preference to settle matters in restricted groups of insiders.

But, thus unloved, the second-fiddle role left to the IMF on these matters further handicaps its early-warning mandate by dismissing two key lessons of both recent crises. First, that fault lines do not lie in individual parts of macro frameworks—fiscal, monetary, regulatory—but in the interactions between them and across countries. So these parts cannot be well-determined in isolation from each other, by separate global bodies. And second, that the only counterweight to policy capture and the tendency of strategic goals to determine official assessments of risk, rather than the other way around, is to bring less directly self-interested outsiders into the heart of risk and policy assessment processes. Though the calibre of its pre-crises work has not earned the IMF this including role on re-regulating finance or global policy coordination, the assignment of these two jobs elsewhere ignores key lessons and underscores the Fund's status as rubber stamp for its masters' views. No amount of reassurance about IMF-FSB-G-20 coordination can mask or compensate for that.

The unchastened and unloved IMF is a reflection, rightly lamented by Martin Wolf, of the failure of global policy elites to restore their effectiveness and legitimacy after the two crises. This sets the stage for further IMF global early-warning failures, the costs of which will, again, be borne by the most ordinary of people, worldwide.

Fixes

The world needs an effective and encompassing institution for co-ordination of global economic policies, including to implement lending for stabilization and provide technical assistance for macroeconomic institution-building.

And much IMF work on these matters—including its leading roles in early calls for debt restructuring in the 1980s international debt crisis and in the stabilization of Eastern Europe after the Berlin Wall fell—has been highly productive.

Further, though the Fund has badly fallen short on global early-warning, that work cannot just be left to individuals to raise alarms, no matter how inspired, public-spirited, stubborn, and well-resourced they may be; this work needs routine organization. And nor can the tasks be effectively subdivided, as with the FSB.

So the case some make for outright abolition of the Fund—either because they see moral-hazard-infested-bailouts or, conversely, capitalist pig-dog diktat in every breath that it takes—is unpersuasive, though, due in part to failed prior surveillance, the recent four IMF programs in the Euro Area periphery come awfully close to being both of those caricatures in respect of the external creditor banks.

But the world does not need IMF global surveillance as is. Instead, this primary work of the Fund requires fundamental concrete fixes to become productive:

- Refocus surveillance on the Fund's original purpose—preventing instability at the core of the global economy. This would radically recast its substance and require a root-and branch clear-out of the morass of its products.

- To effect that refocus, apply a "Three No's" rule for the appointment of future MDs: "No Politicians; No Amateurs; No Majors." This would anchor IMF global early-warning in the voice of disinterested, competent, outsiders. Though he was from a major IMF shareholder, not since Michel Camdessus has one come close to satisfying that rule so, not surprisingly, he is the last great IMF MD.

- Further, do not restrict surveillance to IMF core competencies but to core motivations—global (as opposed to international) instability. Other motivations for surveillance, however worthy, should be left to others, notably the OECD.

- Free risk assessments on global fault-lines from time horizons.

- Scrap or completely recast the WEO and the 3-year surveillance reviews.

- End the MD's discretion over renewable fixed-term contracts as part of strengthened personal accountability of senior staff, and restabilize IMF staffing on large countries.

- With the primary causes of the IMF early-warning shortfalls thus fixed, give it the lead roles in the global surveillance of finance and on global policy coordination.

These proposals will inevitably elicit cautions about being *realistic* and *practical* about feasibility and time frames, and lobbies will press to retain their pet parts of the IMF surveillance paraphernalia. But this chain is only as strong as its weakest link. And just as aftershocks follow all quakes, so the world is in store for those after the two global crises, including as QE is unwound, and it remains at risk from whatever other unrelated, undetected, or unspoken global fault-lines may exist. So there is no time or substance to lose on these matters. And without the sharpening of concept and focus that they represent, neither the plans to strengthen internal administration by assigning them to one member of the Fund management team nor the efforts to adjust voting shares on the Executive Board will prove substantive.

The fixes will also help to strengthen global crisis management. Like the "fog of war", there is inevitably a "fog of crisis". But this is compounded if, for lack of looking for them, they explode out of the blue. So the fixes will also do what can be done to prevent IMF misjudgments when those matter—when the global economy is on the brink, such as the IMF calls for budget deficit reductions early in the Asian crisis, for fiscal expansion in Spain in 2009, for rapid resumption of growth in the 2010 Greek program, and for policy tightening throughout the Euro area in 2011.

The fixes could do more still. By focussing surveillance on global crisis prevention, the IMF could also encourage a reset of the norms which define appropriate fiscal, monetary, and financial frameworks. Thus, rather than design each of them assuming that the others work, a global-crisis-focus could call for each to be set so as—at least—to be robust to the failure of one of the others. This approach includes but goes well beyond calls to curtail "too big to fail" banks and proposals of the sort made by Anat Admati and others for bank capitalization an order of magnitude higher than now. And it would do much to head off mid-crisis policy choices between moral hazard and total collapse—reining in Wall Street by hammering Main Street. It will be developed in my book due in 2015: "Two Routes."

Expectations

But there is need to clarify expectations for early warning if any of this is to work.

The wisest of voices in economics rightly warn against excessive expectations about what is feasible. At that IMF research conference last year, Jeff Sachs noted that "crises are all different"; Greg Mankiw said that "those who don't study history are condemned to repeat it, as are those who do"; Paul Krugman debunked claims that the next U.S crisis will be Greece II; while Stan Fischer thought we would only know if the new global financial firewalls worked "once they'd been tested by fire".

All these observations are true. But collectively they go too far in making it sound as if prospects for global early-warning systems are utterly hopeless, as if, at best, the economics profession can only hazard a guess at what the next global crises might not be. Not so. All those points were also true ahead of the Lehman's and Euro Area crises. And so they overlook two further key points: that while one certainly cannot hope to catch everything, some global accidents waiting to happen—such as systematic under-pricing of risk and grossly sub-optimal currency unions (drunks on cliff edges)—are not all that complicated; and that the procedural failures to identify them in real time can be extraordinarily basic.

So just as expectations of global early-warning should not be set to high, nor should they be set too low. Straightforward economic global fault lines, just like their harder-to-spot economic and geological counterparts, may quietly accumulate massive pressures for years. And the longer the delay before the alarm is raised, the greater the risk that warnings thereof might set off the shocks they are intended to avert. So surveillance should at least be held to the standard of catching such straightforward accidents-waiting-to-happen early, with the content of surveillance of the globe refashioned alongside, perhaps as suggested in "Two Routes."

And alongside, it should be particularly censured when it not only fails to catch these, but when it backs ideas, passively or expressly, which are liable to *aggravate* risk of global crisis and *worsen* the set of choices then available.

Such IMF passivity was again evident when a Greek subsidiary of a Cypriot bank was converted into a branch in 2011. That shifted a sizable part of Greek sovereign debt to the island, thus significantly compounding the Euro Area maelstrom and Cyprus' own problems, subsequently requiring its IMF program.

But the IMF has also taken positions which directly aggravate risk of global crisis:

- its call in mid-2011 for all Euro Area fiscal and ECB policy tightening which "could even be positive in some program countries";

- its endorsement in 2013 of seizure of part of all small bank deposits in Cyprus;

- its support for swift and widespread revival of mildly-reformed securitization, the set of instruments which were at the heart of the global financial crisis;

- its recent sovereign debt restructuring proposals;

- And its recent call on Ukraine that with Crimea "seceded", Russian forces massing, debts to Moscow, a civil war, and more than a decade of program breaches, that "it is difficult to see that it [Ukraine's debt] would go on an unsustainable path."

All of these highlight the depth of the subversion of the Fund to political expediency —a core impediment to its early warning function—but the sovereign debt proposals astonish even me. The idea is that if a government has lost market access, has requested large new IMF loans, and has debts in the grey zone—neither clearly sustainable nor clearly unsustainable in the the IMF's view—a maturity extension by private creditors will be presumed, if most affected creditors agree.

That last condition is the key. It looks market-based. But creditors know that under the proposals they will face fierce arm-twisting, including by their regulators, to assent. So they will factor that into their prior decisions. Had those factors been in play in 2010 in the Euro area, peripheral exposures would have been shed even more precipitously. So the IMF, set up to avoid global crisis, is backing sovereign debt proposals which could have overwhelmed the Euro entirely, and which could yet do so. The search for better options, specifically for the Euro, should be a top priority.

But even if cured of hubris and shed of time-horizoned risk analysis, the politically subverted IMF would still fall short of reasonable expectations for global early warnings. Early in the process of development of plans which presage tectonic risks, before the dangers are self-evident, the Fund would remain congenitally inclined to give the benefit of the doubt rather than query its masters' strategic policies. Once those trains have left the station, the IMF's first instinct would still be to "help to make it all work", typically cheerleading, rather than to stand back to reassess the basic calculus in light of news. And later still in the process, with pressures mounting, the Fund's aversion to standing out from the crowd and worry that calling crises could precipitate them would keep the deck stacked against it issuing warnings, even late in the day. Thus, its early warning mandate is—and would remain—compromised by its political instincts and behavior at every turn.

Indeed, the IMF Executive Board itself spoke directly to these problems in its response to the internal evaluation of IMF surveillance ahead of the global financial crisis, when it said:

> "Directors agreed that incentives needed to be strengthened to ensure the Fund “speaks truth to power,” while noting that this was an exceedingly difficult issue for any international agency."

Coming from that source at that time, this summary is simultaneously: good PR; absolution for all; indefinite deferral of the substantive issue; and a sharp warning to staff to speak truth to power at their peril. Concise drafting if ever there was!

But by it, the Fund, effectively by its own admission, is set up to be behind the curve, to raise concerns about tectonic dangers set in motion by its masters only once doing so risks precipitating disaster.

And if, last time around, these deep-rooted inclinations even prevented the IMF from heeding thoroughly grounded warnings from outsiders, and have gone on to produce the smokescreen of new surveillance products and the recent incendiary endorsements, then we have to conclude, apologies notwithstanding, that the impediments to effective global early-warning by the IMF have not been fixed.

New Broom

If the IMF cannot or will not fix itself, then it should simply be left to do what it will on surveillance, and instead an alternative body should be set up to focus narrowly on identifying global fault-lines in time—because that job is there to be done and the vacancy is unfilled. And at the end of the day, that is the only task in the surveillance of the world as a whole that offers any hope of averting global dangers and of facilitating fully effective crisis responses when they are realized.

This body would be a Global Macrofinancial Risk Council—a sort of global CBO or OBR. It would be funded so as to shield it from the heavy hand of political interference from the major powers, perhaps by one or more of the great private foundations, amongst other sources. It would have independent country-level financial supervisors and fiscal councils as members, learning from them and feeding its work via them directly into their regular work back home.

But unlike the CBO or OBR, its task would not be to make or comment on short-term global projections and policies, or even the WEO. Nor would it comment on every macro issue going, as do global think tanks and the unchastened IMF. Indeed, it would not concern itself with any matters, however vexing they might be, unless, in its judgement, they heralded not only international, but global blowouts.

Thus, its task would be to provide early-warning of global economic tectonic shifts—in whatever country or country grouping, exchange rate regime, strategic aspiration, asset class, trend, institution, law, innovation, interaction, good intention or malfeasance they may lie, and—however long it might take for them to erupt.

But, critically, it should not just "warn". It should also specify *minimal* remedies that would be *sufficient to contain* the risks it sees:

- "minimal" remedies, because that forces precision and selection in the dangers noted; it avoids perception, as with the IMF, that calls reflect ulterior motives; and it will embolden the Council to make calls early—helping to ensure that warnings are issued before doing so risks setting off the eruptions which they are intended to avert—because the corrective steps proposed are always as modest as can be.

- "sufficient to contain" the risks because the alternative of "sufficient to improve" means that, as in Iceland, "remedies", if only "helping", could still leave the world on course for disaster, but less-so. "Improve" leaves too much too open.

And learning the lessons of the dismissal of warnings on the Euro, the Council should neither wait until its concerns are unquestionably apparent, nor stop because "the train has left the station", nor fear repeating itself ad nauseam.

One set of messages to be issued early and often would be concern with the mis-assignment of roles between the IMF, the Financial Stability Board, and the G-20. And alongside that, it would do well to reiterate concerns with the quality of these bodies' global surveillance, stabilization programs, financial regulatory standard-setting, and policy coordination. The Council could regularly give testimony on these and other matters to the UN. But it would owe its primary loyalty to its mandate and the world public at large, not to their representatives in government or at the UN.

Its research program should build it into a major authority on the *origins* of global crises, including the Great Depression, the Gold Standard and Bretton Woods failures, the 1980s international debt and the Asian and the two more recent global crises. Equally importantly—though this will be tougher—it should also become an authority on how and why other global crises were avoided.

It will not always succeed. Its tasks will be to spot and raise concerns, on technical matters, directly with citizens in the great powers, about global threats consequent on their governments' plans (or lack thereof), perhaps alone, before the risks are obvious to all, and to propose minimal adjustments to shed the risks. No easy brief.

But given that, and that like fiscal councils, its only weapons would be competence, eloquence, selectivity, and integrity, it should be led by someone with form on these matters. Perhaps the ideal candidate, once he steps down from his present post, would be Rajan. Better this than him becoming the first "Three No's" MD of an otherwise unchastened and unloved IMF, in which he'd again be tied in knots. But if the Council sticks to the tasks specified, it would need only 10 or so such senior professional staff, with additional junior and support personnel.

There is irony in all this. An implication is that contrary to the received wisdom that pubic goods should be provided by government, this one—early warning of global economic fault-lines—it seems can only be supplied by non-government.

Who knows, perhaps the competition the IMF would feel from such a body is just the tonic that would finally induce it to turn the corner on its own global early-warning role. But I would not hold my breath on that. While the Fund can change the form of its surveillance on a dime, the essence is a distracted immovable object. Even now, its discussion of the Euro and global financial reform is only about "not remaining as is"; it has made no effort to say what the *minimum* is that might *suffice* not just to reduce but to *contain* residual risk of global blowouts. So much for taking on the hard questions that matter.

And what of the Fund's final defense of its conduct of surveillance, that it rightly called for higher global fiscal deficits in late 2008 to avert complete catastrophe? If the captain of the Titanic was similarly to attempt self-exculpation by saying that he'd been amongst the first to order everyone into the lifeboats, the response of the general public would once again—as with the defense that "others didn't see disaster coming either"—be utter disbelief. So with the IMF.

Perhaps after 70 years, it simply is time to give the main job for which IMF surveillance was originally created, global early-warning, to someone else.

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In all this, as in most matters, small things are telling. At that IMF research conference last Fall looking back at the global crisis, the master of ceremonies happily read aloud a blog from Paul Krugman to the whole assembly about the conference itself. Krugman, he said, wrote:

> "It's been a really nice, civilized day: talking about economic research and policy issues with smart, knowledgeable people, plus sharing some good memories of graduate school."

So everyone patted themselves on the back that the *Great Man* was so laudatory of them and of their nice conference.

But, notably, the master of ceremonies omitted to read out the rest of that post from Krugman:

> "I suppose I could have stayed in that life, which would have been really comfortable. But it's not the real world of economic policy, which is full of

> people who aren't smart, don't know what they're talking about, and/or are anything but honest. And someone has to take that real world on."

Indeed they do, because in respect of the global fault-lines produced by such real world policymaking, the IMF, at 70, has singularly failed to do so.

A list of the attachments may be found here.