Global

The IMF crisis and how to solve it

The IMF is approaching its 70th birthday and the Greek programme has been a candidate for one of the most credibility-sapping in its history. Here I trace the IMF's role in programme from its stormy launch; its misfiring implementation; the Fund's half-hearted apology; and its early (and ongoing) attempts to draw lessons and revise its sovereign debt restructuring framework, which appear destined to deliver insufficient meaningful change. A transparency revolution is both necessary and feasible. It worked for central banks in the 1990s. Why not the Fund?

1. Introduction

In this paper[1] I look at the IMF's role in the Greek crisis. Or put another way I look at Greece in the context of the IMF's crisis; the mistakes the Fund made; the immediate and deeply embedded institutional causes; and what can be done to start to put things right. In my opinion, nothing less than a transparency revolution is required. And one is feasible. Back in the early 1990s, there was an amazing global transformation in monetary policy frameworks. Many of the world's least credible banks – including those with reputations for overseeing unstable inflation and failed exchange rate regimes – overcame huge institutional obstacles to transform themselves. They adopted radically improved transparency and internal organisation, thereby bolstering credibility for delivering low inflation. The analogy with the IMF in 2014 is striking; here is an opportunity too good to be missed.

2. The euro crisis: where it went wrong for the Fund

Europe experienced twin crises, one in economy and the other in policymaking; the IMF shares responsibility for both. Its surveillance did not anticipate the crisis and its programmes did not contain it; layers of mistakes that culminated in some astonishing forecasting errors.

The Fund revised down its projections for the level of 2014 Greek GDP a mind-boggling 22% in just 18 months (yes, over 1 percent a month). In US terms, that is the equivalent of revising away the combined output of the whole of California, New York and Florida. With such errors, it was impossible to produce the medium-term budgeting adjustment central to stabilising Greece. Greece has endured the largest but by no means the only forecast errors (Table 1); errors which can be explained by the dismal algebra of credit crunch + austerity = output collapse.

Table 2: IMF's maximum forecasting revisions of nominal GDP across all forecast vintages April 2012 to April 2013

	2013	2014	2015	2016
Cyprus	-18%	-24%	-26%	-27%
France	-6%	-6%	-7%	-7%
Germany	-6%	-7%	-7%	-6%
Greece	-25%	-27%	-27%	-24%
Ireland	-10%	-10%	-11%	-4%
Italy	-9%	-10%	-11%	-11%
Portugal	-9%	-10%	-10%	-9%
Spain	-10%	-11%	-12%	-13%

Note: Maximum revisions are defined as the % change from the strongest to weakest projection between WEO vintages.

Source: IMF WEO, leaked Troika documents for Cyprus, Exotix calcs.

It's not just Greece, of course. The IMF's downward forecasting revisions in the three-year period from April 2010 are astounding for several Eurozone economies. In ascending order, the forecast errors by country were Germany, -7%; France, -7%, Portugal, -10%, Ireland, -11%, Italy, -11%, Spain, -13%, Greece, -27%, and Cyprus, -27%.

Where did it all go wrong for the Fund? Here I suggest the Fund made costly and avoidable errors; particularly arising from its inadequate pre-crisis surveillance; its

[1] This article reflects Gabriel Sterne's personal views and does not necessarily reflect the views of Oxford Economics

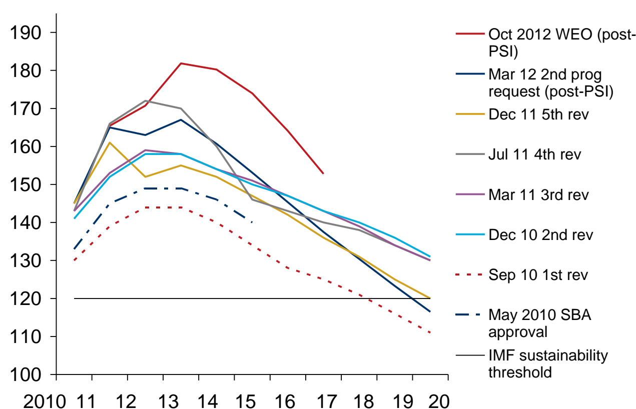
Economist: Gabriel Sterne, Head of Global Macro Investor Relations | tel: +44 207 6208773 | e-mail: GSterne@oxfordeconomics.com

willingness to break its own rules in lending to Greece; and its willingness to accommodate the Eurozone's politicians refusal to build a backstop to limit economic implosion in the south of Europe.

First, the Fund broke one of its most essential rules by supporting a programme in Greece from May 2010 which was inadequate to secure debt sustainability. The Fund simply is not allowed to do that. To break the rule is to throw good money after bad; it not only delays the inevitable, but makes it worse. With every passing IMF progress review, the Fund needed to make ever more fanciful policy and growth assumptions to continue the pretence that debt was sustainable so that the programme could continue.

Worse still, the pretence that Greek debt was sustainable took place when everything (including the IMF's own numbers, Chart 2) was pointing in the opposite direction. Even by their own arbitrary definitions of debt sustainability (120% of GDP by 2020), the Greek programme was unsustainable between the second review (December 2010) until the fifth review (December 2011), which incorporated PSI.

Chart 2: IMF projections for Debt to GDP ratio



Source : IMF

The only circumstance in which the IMF's rulebook would allow it to lend into an unsustainable debt burden is when there is a commitment to make it sustainable. Had there been greater realism at the start of the Greek programme there would have been a good case for going ahead. It would have run along the lines of "we expect the Greek authorities and Eurozone to make debt sustainable by first review, and implement by second review". That would have indicated that a restructuring was on the horizon; markets would have been warned; and the contagion once default occurred reduced.

The IMF chose over-optimism on debt sustainability rather than making a commitment to making Greek debt sustainable now or in the future; and this pushed Greece into a dire predicament. There is an old IMF mantra that concerns financing a programme, which recognises a simple trade-off between adjustment and financing. The more finance is available, the less adjustment needs to be undertaken. It is sometimes hard to strike a balance. If adjustment kills the economy then there may be no equilibrium; things just get worse and worse until the outcome is catastrophic. The traditional way to escape the vicious circle – through devaluation and private sector debt relief – is much harder in a currency union. Ultimately the IMF's Greek procrastination was fruitless: Private lenders to Greece suffered a scalping, Greece did not have a bank that lent between mid-2011 and mid-2013, youth unemployment reached 60%, and the ECB had to intervene massively to keep swathes of the European banking system afloat.

Second, the IMF treated the Eurozone as a partner to be accommodated wherever possible, not as a patient to be cured. As a consequence of this mind-set the IMF enforced voluminous but asymmetric conditionality, pertaining only to the crisis countries and never to the broken central institutions. Late in the day, the IMF has made softly-spoken requests for progress on the Eurozone's crisis resolution institutions – banking union, fiscal coordination, and OMT – and on the Eurozone-wide policy settings, including the aggregate EZ-wide fiscal and monetary stances.

Symmetrical conditionality would have meant "no IMF programme for Greece, Ireland or Portugal without ... " Absent these essential complements to country conditionality, progress on crisis resolution has been half-baked, and country programmes have staggered along with ever-postponed policy targets and underperforming macro outturns.

Part of the problem for the Troika arrangements was that the Fund has always been a junior lending partner. The Eurozone never needed Fund financing. They would have benefited more from the Fund's coherence to secure simultaneous adjustment between crisis country and the centre of Europe. But relationships were skewed by the arithmetic. From the Fund's perspective "our programme, your money" deterred appropriate relations. It should have been the Fund on one side of the table,

and the stricken country and representatives of Europe on the other.

Third, Fund actions were hampered throughout the euro-crisis by fundamental diagnostic errors. First, its highly-resourced pre-crisis surveillance appears to have been weak. For example:

- Efforts to encourage bank-recapitalisation in the Eurozone were too timid and too late; the IMF finally published its blueprint for euro-wide banking supervision in February 2013; some might say too late by a couple of years; but given its centrality to the success of the Euro I would say well over 15..
- At the height of the crisis, the Fund's back and forth on fiscal multipliers and fiscal policy requirements was incoherent; reflecting a long-standing internal confusion about the circumstances in which austerity works..
- The Fund has consistently and unequivocally praised German supply-side reforms, even though – absent matching reforms elsewhere – they are a key cause of the euro-imbalances.

The role of IMF procrastination

Official sector lending in 2010 and 2011 probably made the Greek crisis worse. There is a strong case to be made that the bail-out, by prolonging the crisis without taking firm action, did more harm than good, and an equally strong case that this was to be expected.

The creditor composition of Greek government debt also changed markedly over the period. Prior to the first IMF disbursement in May 2010, Greek debt was owned 100% (or thereabouts) by the private sector. In order to achieve the same haircut as now in NPV terms, it may have been possible to have at most a 48% NPV haircut on private sector debt, rather than the approximately 70% NPV haircut that was inflicted in February 2012.

Even this basic "early action premium foregone" is likely to be a considerable understatement of the true "early action haircut reduction premium." An earlier restructuring would also have meant an earlier reduction in debt service payments, a lower fiscal deficit, a milder and shorter recession, less funds required to recapitalise banks, and a range of other indirect benefits. So I think it is realistic that the same impact could have been achieved with a haircut of around 25-50%.

In that context, I find burden shifting (public sector mistakes, private sector losses) indefensible. In terms of redistributing losses, delays in reducing Greece's debt burden merely achieved a transfer of resource within private sector creditors. The biggest gainers amongst creditors were those in the private sector whose bonds matured between mid-2011 and January 2012. The official sector funding helped pay these out. Those creditors that sold on the secondary market during the period also benefited relative to the ultimately disastrous end game. The biggest losers were those in the private sector who continued to hold GGBs; their eventual haircut was much bigger because of official sector procrastination and burden shifting that reduced the proportion of debt available for haircuts.

3. Regrets, IMF have a few

In mid-2013 the IMF published an historic staff report that raised concerns about the quality of the Fund's work on the Greek bailouts, which began in 2010. Most significantly, the report appeared to acknowledge[2] that the IMF broke one of its most essential rules by supporting a lending programme to Greece from May 2010 that was inadequate to secure debt sustainability.

But then again...

The IMF's rejection of its own staff's mild criticism is arguably the bigger and yet under-told part of the story. The official IMF response to the staff report was contained in a single paragraph[3] offered by its Executive Board on June 5:

Directors ... agreed that [the report] provides a good basis for all parties to draw valuable lessons ... noted ... overly optimistic assumptions, including about growth ... [and] noted the benefits of a timely restructuring of sovereign debt with the necessary safeguards to contain spillover risks and moral hazard.

Is that it? The official response read like a side-step. It did not address the main points of the staff report. It said

---

[2] 'Ignored Many Flaws — the report', FT Alphaville, 5 June 2013, http://ftalphaville.ft.com/2013/06/05/1526142/ignored-many-flaws-the-report/

[3] 'IMF Executive Board Concludes 2013 Article IV Consultation, Completes Third Review of the Extended Fund Facility (EFF), and Discusses Ex Post Evaluation of 2010 Stand-By Arrangement (SBA) with Greece', 5 June 2013, http://www.imf.org/external/np/sec/pn/2013/pn1364.htm

nothing about how to prevent recurrences of over-optimism; or about what constituted a "timely restructuring" (who could be against "timely" anything?); or about what the "valuable lessons" were; or about follow-up work on how to learn from them. To those of us familiar with IMF Board-speak, it sounded as though the report may had just been binned.

Senior IMF management and staff also rejected key parts of the criticism. In the Wall Street Journal article[4] that broke the story, Christine Lagarde argued that if the IMF had not tweaked its rules, "it probably would have meant no IMF support at that time." The head of her Greek team Poul Thomsen reflected "If we were in the same situation... we would have done the same thing again." And Olli Rehn, economics chief at the European Commission, bluntly rejected the report, noting in an interview with the WSJ that an earlier Greek public debt restructuring would have jeopardised the euro.

My interpretation therefore, was that while there are some in the Fund who sought to learn lessons, the prevailing mood in IMF management was one of "je ne regrette rien". And this in the face of those gigantic errors I highlighted earlier.

A further troubling issue was the brazen attempt to shift the rationale for the Greek programme. Here, even the staff report was too mild. In 2010 the programme proceeded on the premise that, on balance, Greek debt was sustainable. This was the clear position of IMF chief Dominique Strauss-Kahn, and of the head of the Fiscal Affairs Department in September 2010, as expressed in a Staff Position Note with the preposterous title of "Default in Today's Advanced Economies: Unnecessary, Undesirable, and Unlikely."[5]

It was straightforward at the time to write down a huge but standard-looking fiscal and structural adjustment that was big enough to secure sustainability without a restructuring. Good on paper, bad in Greece. Fewer than 18 months after that publication of that position note, the IMF was insisting on a 70 per cent haircut on Greek government debt as a condition for further financial support.

In contrast, the IMF's rationale now appears to be the (justifiable) concern that restructuring in 2011 could have destroyed the euro for lack of Eurozone firewalls. French banks in particular were highly exposed to Greece.

This is not just a case of "well, which rationale was it?" Much more significantly, if the IMF – as they now say – judged the necessary conditions for stability in Europe to have been absent, why did they not demand that the European authorities take steps to put those conditions in place, as formal criteria for the original loan to Greece? The IMF is simply not authorised to lend on a huge scale when it regards conditionality as inadequate to secure success.

Much more is at stake here than the extent of IMF regrets. An underlying concern is that all the factors that led to these errors remain firmly in place and that there has been little transparency with regard to learning lessons. We return to this issue in Section 6. To give just one example, at a conference in 2013, the Fund was asked to defend its support of measures to seize 10 per cent of all Cypriot bank deposits, a decision that came close to reigniting the euro crisis[6], until it was shamefacedly withdrawn. The IMF refused to answer[7].

4. The IMF's response so far

In April 2013, the IMF published its first major paper in a decade on sovereign debt restructuring. The Fund asked a simple question: how to prevent them from being "too little, too late" to resolve debt crises?

The Fund's ongoing review journeyed from staff to its executive board to a consultative paper[8] and global outreach[9]; it prompted industry bodies to join the debate and has spawned much media coverage. Staff will return to the board at some point this year.

[4] 'IMF Concedes It Made Mistakes on Greece', Wall Street Journal, 5 June 2013, http://online.wsj.com/article/SB10001424127887324299104578527202781667088.html

[5] http://www.imf.org/external/pubs/ft/spn/2010/spn1012.pdf

[6] See http://ftalphaville.ft.com/tag/a-cypriot-precedent/

[7] See http://www.tubechop.com/watch/1131444

[8] 'Sovereign debt restructuring – recent developments and implications for the Fund's legal and policy framework', IMF, 26 April 2013, http://www.imf.org/external/np/pp/eng/2013/042613.pdf

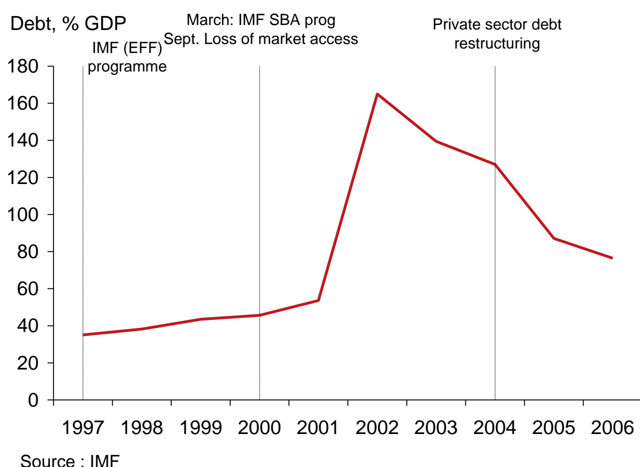
[9] 'Sovereign Debt Restructuring: Lessons from Recent Experience', IMF videos, 12 October 2013, http://www.imf.org/external/mmedia/view.aspx?vid=2740132574001

Although the IMF has focused on the general issue of too little debt relief being provided too late in the day, I would argue that there is a specific issue which policy could better to address. Why has the Fund pulled the plug on some countries with clearly unsustainable debts (e.g. Ecuador, Russia and Uruguay), yet delayed pulling the plug on others (notably Argentina and Greece)?

Argentina's descent into calamitous default took place after it had been in an IMF programme for more than a decade. In Greece, it took nearly two disastrous years under the auspices of a malfunctioning IMF programme before private sector debt restructuring (PSI) was implemented in March 2012.

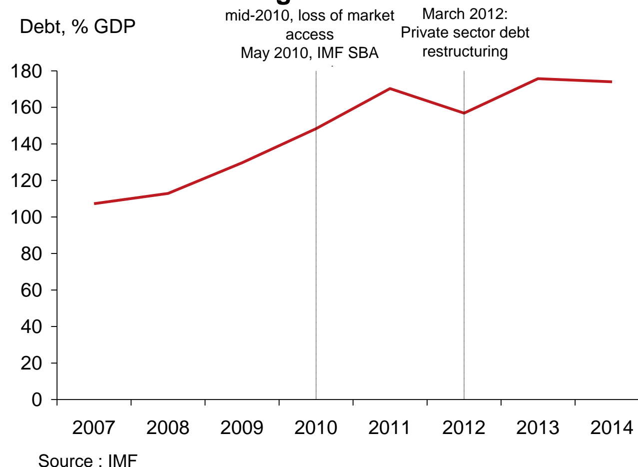
The Fund itself points out that "allowing an unsustainable debt situation to fester is costly to the debtor, creditors and the international monetary system." In both Greece and Argentina, the official sector poured in money that ended up bailing out holders of short-term debt. Procrastination not only delayed the inevitable, it made matters worse for private creditors as a group; and, more importantly, for the countries' economic and financial systems.

Chart 3: Too late: Greece



Source : IMF

Chart 4: Too late: Argentina



Source : IMF

The view from Paragraph 32

The IMF's initial proposals — encapsulated in the thirty-second paragraph of the April 2013 paper — aimed to incentivise more timely restructurings, partly by attempting to make them less of a big deal. Specifically, if the IMF determines that debt is in an uncertain "grey" area of sustainability, which is the norm in such cases, the Fund would lend. But in order not to "waste" official money bailing out private creditors, the sovereign would have to bail in the latter by "reprofiling" debt: extending maturities on all private sector bonds and loans falling due within the life of the programme. If the programme works, bondholders are paid out (albeit around three years late). If it does not work, a full-scale restructuring would need to be undertaken.

The potential benefits of the approach are clear, but are offset by potential costs. The rating agencies would spell "reprofiling" D-E-F-A-U-L-T, and I doubt there will ever be a default without serious consequences. Reprofiling bonds would in general trigger CDS. In advance of a possible reprofiling, fears of one would be likely to accelerate and deepen the loss of market access, adding to sustainability concerns.

Countries, or more specifically political leaders, are also inclined to resist default to the extent it tarnishes their own and their country's reputations. The country may therefore strive to disintermediate the IMF and seek alternative sources of crisis lending, a trend already seen recently in countries ranging from Egypt to Ukraine, Belarus to Spain.

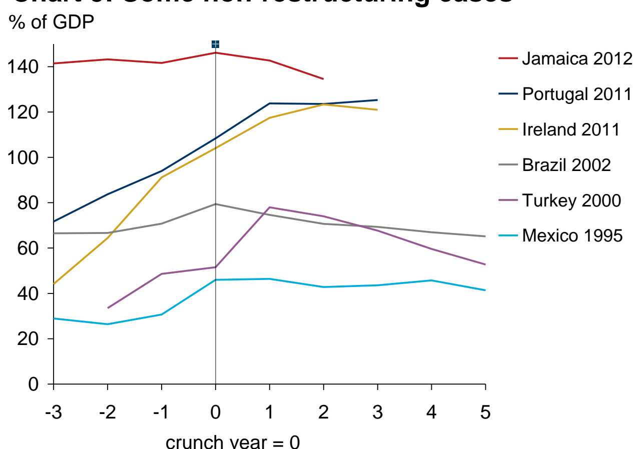
A case-by-case approach

The case for any early reprofiling of sovereign debt should be based on a cost-benefit analysis of the particular circumstances. Such a "case-by-case" approach is indeed the decades-old first key principle underpinning the approach to sovereign debt restructurings, as spelt out by the Paris Club[10] of official sector creditors, as well as by the IMF under current policy. If, for example, a country had an acute financing need on account of a big current account deficit, but little debt maturing over the next couple of years, then the case for reprofiling would be particularly weak. Similarly, the case would be weak if there was a strong possibility of regaining market access during the programme.

The cost-benefit analysis of reprofiling versus the alternatives needs to be a two-way exercise. The first is to compare reprofiling against using IMF money to bail-out creditors. The second exercise involves a reprofiling of only short-term debt versus a more comprehensive restructuring.

Past IMF programmes that covered the financing costs of maturing near-term debt actually have quite a good track record, leaving Argentina and Greece aside. There are numerous famous IMF programmes in which sovereigns avoided default; re-accessed bond markets, found a road towards recovery, and repaid the IMF. For example, reprofiling default would have made matters worse in the cases of Mexico (1995), Turkey (2000), Brazil (2002), Ireland (2011) and Portugal (2011).

Chart 5: Some non-restructuring cases



Source : IMF

"One and done"

The other alternative to reprofiling short-term debt is a more comprehensive debt treatment, which I think offers considerable advantages in cases where the uncertainties lean heavily towards unsustainability. In previous decades sovereign debt was concentrated in the hands of banks, while nowadays it is held primarily by asset managers. In this context I think that a "one and done" approach when debt has become unsustainable provides a cleaner and more efficient treatment than potentially two defaults; one at the start of the programme and – if it fails – possibly another at its end. Better to negotiate once and for all a level of future debt service consistent with ability to pay and appropriate adjustment policies. It is also better to seek relief from all creditors in a reasonably equitable fashion, rather than pick only on the short-end guys and official creditors, while those owning long-term bonds relax for a while on the sidelines.

In the face of very strong evidence in support of the case-by-case approach, I think the IMF review got off to a false start. The centrepiece of the Fund's 2013 proposals – to virtually automatically link Fund lending to a partial creditor-bail in – was radical, misguided, and a distraction from the main issues.

A key question is how much of "too little and/or too late" has been down to the Fund itself, and what were the institutional causes? Was it poor analytics? Or a lack of understanding of some of the key institutional features of sovereign bond markets? What role have internal governance issues played?

The Fund's report made only tentative conclusions about its own role, confessing that "In hindsight, the Fund's assessments of debt sustainability and market access may sometimes have been too sanguine." I make that three qualifications spoken through seventeen words of gritted teeth!

The Fund published a revised paper[11] on Sovereign Debt proposals in June 2014, which responded to many of the criticisms of its earlier proposals. The Fund has ditched automatic reprofiling, but retained the emphasis on the

[10] http://archive.is/l1r0J

[11] 'The Fund's lending framework and sovereign debt – preliminary considerations' IMF, June 2014, http://www.imf.org/external/np/pp/eng/2014/052214.pdf

reprofiling option. The report merits a detailed reflection beyond the scope of this paper. My initial take, however, is that this will probably not add much to the sovereign debt restructuring tool kit. There is an element of staff and the Board being unable, for political reasons, to address the issue that really matters… themselves! I develop the arguments in the remainder of this article.

5. Causes of policy mistakes

What are the causes of IMF policy mistakes? First I will touch briefly on reasons pertaining immediately to the euro crisis; and then devote more consideration to more deeply embedded institutional design faults. There are some immediate explanations:

Poor leadership

Dominique Strauss Kahn's (DSK) Presidential ambitions impacted the Fund's staff's scope and drive to produce and convey analysis that was disturbing to Europe. There have been well-publicised spats between the Fund and the Eurozone authorities, that have led some commentators to presume the Fund has taken a detached view; fiscal multipliers being one example. But even if such issues put the Fund ahead of the Eurozone in terms of forward thinking; they typically relate to issues long-fretted over by markets and it is difficult to think of an issue where DSK's Fund was ahead of the game.

Analytical conservatism and under-preparedness

The IMF's European Department struggled to adjust from its longstanding light-touch surveillance mode. Once the crisis began, groupthink quickly took hold within the IMF and intra-Troika (a conclusion supported by the triennial surveillance exercise[12]). The Troika forecasting process requires consensus between IMF, EU, and to some extent domestic authorities; it is hard to imagine such a process could ever react boldly to a poisonous forced marriage of a shrinking public sector and a credit-choked private sector. In spite of all its analysts and spreadsheets, the Fund does not have models or frameworks for dealing adequately with credit channels and deleveraging. It was always easier to revise a projection down a bit while maintaining the view that things will come back eventually than it was to overwrite forecasts in bold red ink; re-diagnose and get the macro frameworks right.

Gamble for redemption bias

…. or use other metaphors such as can-kicking and fear of plug-pulling). The IMF has an institutional fear of being blamed for being the crisis-catalyst. Even the highly respected Stanley Fischer was prone (in the case of Argentina) to extend-and-pretend-itis. Under this view, the benefits if the gamble works are so big they are worth the risk. The counterargument that can-kicking makes the crisis worse is given insufficient air time within the Fund. The Fund has over decades demonstrated an institutional bias in favour of one last effort, and then another, and then ... when making these calls.

Deeper causes of policy mistakes: the absence of checks and balances

I have long been struck by how – in spite of the torrent of published documents – the IMF barely needs to provide any justification of absolutely crucial analytical and policy decisions. These key matters are conveyed, if at all, with a few obscure sentences in a report discernible only to the most 'insidery' of insiders, or with a stock answer to a journalist's question.

There are numerous examples of inadequate explanations, including: (1) the decisions to go ahead with the Greek programme in 2010 and deny the possibility of restructuring; (2) the decision 28 months later to back changing Greek bond law to facilitate the scalping of bondholders amounting to around 70% of initial value; (3) implicitly supporting the view that the Greek debt buyback would make debt sustainable when all it entailed was shuffling debt between the state and state-owned banks; (4) the analysis and decision to recommend 30-40% haircuts on uninsured depositors in Cypriot banks only to nearly double estimates two weeks later.

Under the current opaque regime, some version of the details will probably leak out at some point. They already began to do so on Cyprus in January 2013 when the preference of some in the Fund for haircuts became known; then, that the Fund publicly backed a tax on all deposits (including insured deposits, link); and then that the Troika appeared to be briefing successfully against

[12] 'The IMF's financial surveillance strategy', IMF, 28 August 2012, http://www.imf.org/external/np/pp/eng/2012/082812.pdf

the deal it had signed in order push blame on to the Cypriots. Intra-Troika spats also became elevated.

And even after the passage of time when the dust has settled and there is opportunity for reflection and lesson-learning, such efforts are shabby. Shockingly, by far the best and most detailed account of individual roles in the Fund's previous major failed gamble for redemption – prior to the 2000-01 Argentine crisis – is contained not in any official minute, or post-mortem, but in Paul Blumstein's policy thriller "And the money came rolling in..." Senior IMF staff speak candidly in the book, as if letting off steam after the event. But, and partly as a result, the chaos of IMF policy in the euro crisis would appear to suggest that few if any lessons have been learned.

The IMF Board

Any assessment of IMF has to include its Board, the place where staff analytics and international politics meet and mould policies, sometimes with poor results.

Paulo Nogueira Batista's busy week at the end of July 2013 is a good place to start. He was recalled to Brasilia to account for his abstention, as Brazil's representative on the IMF board, on the Fourth Review of the Greek programme[13]; a reminder of the seemingly intractable issue of politicisation of the IMF Executive Board. Batista has been a frequent abstainer on the Greek programme, and it was clear he was making his own call. As the FT reported[14], his abstention last week was a step too far, even for Brasilia.

The review nevertheless appeared to go through 23-0 (call it near-consensus if you will). None of the 24 members of the IMF Executive Board has ever voted against a euro crisis programme, not even when the Greek reviews visited fantasy land.

As early as the first IMF annual meeting in 1946, Keynes argued that if the IMF and World Bank were ever to become politicised, then it would be best for those twins – his own cherished offspring – "to fall into an eternal slumber, never to waken or be heard of again in the courts and markets of Mankind" ... because ..."everything you determine shall not be for its own sake or on its own merits but because of something else".

His thinking is echoed in the modern-day aspirations for the IMF Board; Board Directors are to play a dual role – explaining to other Board members the views of their individual governments, but acting (and voting) independently of those governments when the interests of the Fund require it.

In reality the Board is certainly not Keynes' envisaged "Board of Representatives" – composed of senior individuals able and willing to vote their minds, independently of the governments who appointed them, in a manner akin to the best behaviour of non-executive directors in corporations. Instead, I have something closer to Keynes' nightmare of a "Board of delegates" who are mandated by the governments who send them what to say and how to vote case-by-case. In this context, Batista has been an outlier.

The politicisation is stark in matters concerning Europe. The sum of votes of seats where a western European country is the biggest shareholder is nearly 40 per cent of the total Board votes, by far the largest single bloc. That goes alongside western Europe's lock on appointments to Managing Director. And with the advent of the euro, Eurozone members decided to speak with one voice at the IMF Board on virtually all matters. This turned out not to help with seeing the Eurozone crisis in advance, nor with providing a coherent response to it.

The leaked Cyprus Board discussion[15] provides a rare insight into how the Board actually works. As expected, the fieriest comments came from Brazil's Batista, carving out the memorable phrase:

"Every program needs a pinch of optimism but in this one the required dose of goodwill– or suspension of disbelief, if you will – goes way beyond the average."

Just as striking as Batista's fire is the impression left by certain Board members of a determination to avoid

[13] 'Greece: Fourth Review Under the Extended Arrangement Under the Extended Fund Facility', IMF, July 2013, http://www.imf.org/external/pubs/ft/scr/2013/cr13241.pdf

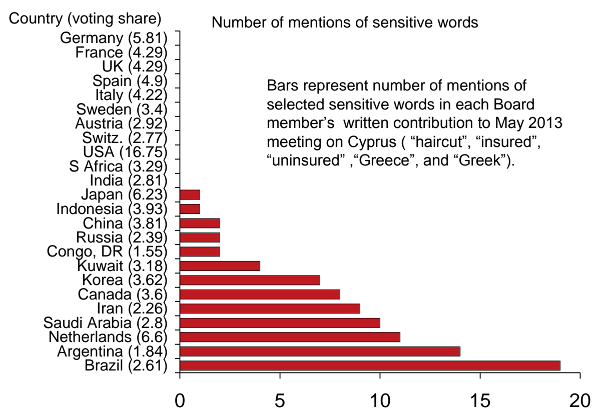
[14] 'Brazil backs IMF aid for Greece and recalls representative', Financial Times, 1 August 2013, http://www.ft.com/cms/s/0/2e6f031a-facf-11e2-a7aa-00144feabdc0.html

[15] 'Statement by Mr. Snel and Mr. Kanaris on Cyprus Executive Board Meeting', 15 May 2013, http://www.stockwatch.com.cy/media/announce_pdf/May15_2013_IMF.pdf

troubling IMF management and staff with important issues if they are too close to home or too near the bone. Not a single European Director sought explanations from IMF management for its public flip-flop between taxes on all depositors versus haircuts solely on uninsured deposits, or the program's insistence that no depositors in Greek branches of Cypriot banks be haircut, pushing even more of the burden on Cyprus.

A word-count experiment is revealing. None of the statements written by any European Director (other than Cyprus's representative), or the United States, contained the words "haircut", "insured", "uninsured" or "Greece", symptoms of the most sensitive issues. In contrast those most inclined to mention them were seats where the largest countries (by voting shares) were Brazil, Argentina, Saudi Arabia and Iran.

Chart 6: A "willingness to raise sensitive issues" score for IMF board members



Source : IMF Board papers for Cyprus, May 2013, Author calculations

Note:. Zeros include Board members that did not prepare a written statement. The country given is the largest one (in terms of votes) in the constituency represented by the Board member; it is not necessarily the nationality of the Board member

Mild-mannered comments did not just come from the Eurozone. Suspicions that the UK Director's comments (p46-47) were toned down were given credence when the UK subsequently successfully lobbied[16] fellow Board members to reject IMF staff's call for the Treasury to offset the drag from planned near-term fiscal tightening.

A Board like this is, inevitably, reflected in the performance of management and senior staff of the institution. They have sheltered under the Board. For example, when the IMF's Head of European Department defended the IMF's actions in the euro crisis at the IMF spring meetings, he said:

> *[E]ach one of the programmes was approved at the Board unanimously…. And every review we have had since the beginning has been almost unanimously approved. So if there were concerns you would have seen it in that process, and we did see it in the previous crisis and we haven't seen it here.*

But if the support provided comfort and bolstered the programmes' legitimacy, it may also have led to a "united we fall" outcome in which the credibility of both was damaged.

In my opinion, the balance between a "Delegate Board" and "Representative Board" has clearly swung far too far in favour of the former. But the big countries are not going to give up power too easily. Perhaps it would take another deterioration in the euro crisis to persuade them. That, however, is a horrible thought.

If the mood for change became gripping, then they could aim to change the appointments processes for Directors and the "culture" of the Board to encourage "Representative" behaviour there. Why not consider some appointments akin to "non-executive directors" – who do not represent countries or groups of countries at all – and accompany that with the practice of publishing details of all Directors' objections to decisions, in the press releases which accompany IMF programme approvals. This would all help swing the balance back towards a "Representative Board".

A further big step forward would be to record individual voting and each Director's individual rationale in all Exceptional Access cases – i.e. the big programmes. The leak of the Cyprus Board papers demonstrated that such transparency is not harmful but does shed light on where the Board sees the risks of a programme. And it would be useful if minutes of such Board meetings were promptly published.

Sadly, the issues mentioned above have hardly featured in the decades-long debate on reform of the IMF Board. Instead, astonishing amounts of time and effort have, over decades, achieved snail-paced progress towards fairer geographical representation on the Board;

[16] 'Boost for George Osborne as IMF backs 'Plan A'', Financial Times, 17 July 2013, http://www.ft.com/cms/s/0/501b8d52-eeff-11e2-bb27-00144feabdc0.html#axzz2aQ5hgC73

important from the perspective of fair geographical representation; but it is not obvious that more EM representatives would do any better or worse in terms of holding programmes to account. My suspicion is that they would have done better in the euro crisis, and worse in an EM crisis, such is the political biases of the Board.

In short, the catalogue of IMF surveillance and programme failures over the past two decades signals systematic shortcomings in the institution. As Keynes foresaw, the structure and operation of the Board – spilling over into senior management and staff – is close to the centre of these failings. I am not of the view that Keynes' offspring be put to sleep forever. So the only alternative is to fix the problem.

6. Transparency revolution

Going beyond the need for reform of the Board, most of the IMF's failings derive from shortcomings in institutional design. I think it is important to go beyond attributing blame to one (or even a few) individuals. The Fund's role is too important to allow so much scope for a single individual so much scope to mess things up.

The Fund's performance at crucial moments can be improved via a revolution in transparency and accountability. Transparency works because it makes reputation more sensitive to actions. Accountability works if checks and balances provide a sufficient deterrent to policy biases including those mentioned above.

A decade ago, the literature on monetary policy frameworks was burgeoning with studies showing how transparency could help reduce inflation. It did so by reducing natural incentives of policymakers to indulge in inflationary policies. Transparency helped improve monetary policy formulation all over the world. The read-over from central banks is by no means perfect, but there are still important lessons the IMF can learn.

Decisions at the Fund have typically been the result of a complex cocktail of politics and analysis. The Managing Director, the IMF Board, and the staff all have responsibility. The best way for the Fund to restore its credibility that institutional biases are being tackled is to open up its kitchen to public scrutiny. In what follows I consider all the major players with responsibility for IMF decisions and suggest how accountability and transparency can be imposed on them to incentivise good analysis and de-politicise decision-making.

Fund staff and real time checks and balances

Under the current governance structure of the IMF, decisions are bound to reflect political motivations. What is more surprising is the silence of the technocrats responsible for global consistency of IMF advice. If there were published votes and minutes, as is now increasingly common practice in central banks, not only might we learn how an organisation packed full of crisis resolution experience could make such policy errors; we might also hopefully avoid future policy mistakes.

Probably over fifty highly experienced IMF staff professionals contributed to reviewing the average Greek programme document. This extends to hundreds by the time the document is circulated around the various constituencies of the IMF Board members. And in the case of euro-crisis economies we should not forget that there is a parallel European process going on at the same time. In our view the checks and balances do not work because none are sufficiently independent of an underlying political process, which has itself infected policy formulation with an opaque malaise. To misquote Churchill, "Never in the field of institutional accountability has so little been achieved by so many, for so many."

To overcome this bureaucratic quagmire of review and consequent obfuscation of accountability, an IMF Policy Committee should be formed. It should publish minutes and votes of key recommendations made to the Executive Board. This would make key staff individually accountable and help alleviate suspicion that staff and management policy advice to the IMF Executive Board is being driven by the political convenience of a European MD with ambitions of high office in one or other of the major euro economies.

The committee should be centred around the Managing Directors, but should provide a role for other key members of staff whose existing role is to provide checks and balances. These staff appear to have been unsuccessful in some recent programmes and I think should in future be made individually accountable for such failings. It should include the Director of the country Department of the afflicted country.

The Director of Strategic Policy Review Department (SPR) should be a key person on the Committee, not least to ensure his/her accountability. As the Fund's "internal police force", its most important role is to provide real time checks and balances.

If a controversial debt sustainability projection goes way off-track, the Director of SPR should be individually accountable. He, as much as any IMF staff member, should explain why he let the disastrously over-optimistic Greek programme get by him, and also the series of prior Eurozone surveillance failures noted above, which were in full flow on his watch in SPR and gathering in urgency.

I would also include three additional external members who are appointed for fixed terms, are not appointed from IMF staff, and have no role or prospects thereof in the IMF management structure. Externals have proven useful at providing independent checks and balances into Monetary Policy Committees around the world; sometimes presenting views that are off staff's radar, but turn out to be far-sighted, and running counter to groupthink.

In summary, our proposal is that the IMF Policy Committee (IMFPC) should be comprised of seven voting members, as follows:

- Two of the five managing directors on a rotating basis, with MD or first Deputy MD in the Chair.
- Director of country's regional department (or alternate)
- Director of SPR (or alternate)
- Three other "Externals."

According to this proposal, the balance of the voting power is skewed in favour of the "insiders" by four to three, but only if SPR, (the "check and balance" division) vote with the insiders. This, I think, strikes an appropriate balance.

The main point is to install a transparent process that would help instil a rigour and discipline into IMF staff decisions. The process would hold the IMF and its key individuals to account far more effectively than at present. And in so doing it would be of huge benefit to the Fund. Monetary policy committees all over the world have built credibility through transparency; the Fund could do the same.

Communication with markets

Another benefit of inflation targeting was to help communication with markets, something the IMF has done with very little success in the case of various of its programmes. IMF programme announcements have done very little to placate markets. In May 2010, the IMF's mission chief for Greece said on CNBC following the announcement of the €110bn bailout, "I think, with the credibility of this program and support from the international community, I am confident that the problem will be contained to Greece and we will solve them here." A few days later, panic spread through other European countries and European policymakers had to cobble together the EFSF.

Post-event evaluation and IEO

The IEO is an internal auditing office that offers the potential for effective lesson-drawing and a medium-term deterrent to IMF mishandling. It was set up in the aftermath of the Argentine crisis with the stated role to support the Executive Board's institutional governance and oversight responsibilities "to conduct independent and objective evaluation of Fund policies and activities". The IEO has produced some high quality reports over the years. But their efforts are not always channelled to where they are most needed, and in a way that would deter glaring mistakes. But a revamp is crucial.

The IEO's work programme, as outlined in the Fund's 2012 Annual Report, reads like an instruction to stay away from the elephant in the room; there is no clue of the Fund's role in the euro crisis.

A recently published external evaluation[17] concurred, unfortunately, with the Fund establishment, stating "an evaluation of a current lending program would seriously complicate the Fund's ability to engage with that country, and could even jeopardize the success of the program." To us this reads like pandering to the Fund's desire to cover its back in the face of bad decisions

I put far greater weight on the counter-argument, which is that fear of high profile criticism of fantasy-fuelled projections might have a positive impact on the programme. A truly independent evaluation office (as opposed to the IEO) would have been screaming about this until it didn't happen, which would hopefully, because of the embarrassment, have been never.

The main criticism of the IEO is in the 'I'. It is insufficiently independent. Any evaluation office which is barred from

[17] External evaluation of the Independent Evaluation Office, Report of the Panel Convened by the IMF Executive Board, January 2013, http://www.ieo-imf.org/ieo/files/evaluationofieo/IEO_Second_External_Evaluation.pdf

offering thoughts on the Cypriot, Greek, Irish and Portuguese programmes until these programmes end does not, in our opinion, deserve to be called independent.

I would like to see the IEO given a dramatically increased mandate to cast immediate and high profile judgment on key Fund decisions, particularly where it comes to controversial programmes. Whenever there is a potentially controversial DSA, IEO staff should be called to make written comments and hold a press conference within two weeks of the programme document being published, at which point the IEO would question any dubious assumptions being made. The IEO response would be asked to cast a view on the Fund's forecasts, the risks; deficient areas of analysis (e.g credit channels) and whether the Exceptional Access Criteria were being breached.

The Managing Director

There is no defence to the current system for appointing the IMF's Managing Director. At best, it is just plain silly that the MD has been selected according to nationality for the last 67 years. Every MD has originated from Western Europe. Would it be going to far to call this racial discrimination for one of the world's most important economic roles. Probably not.

The policy has not produced the best qualified people for the job. Arguably, the Fund was led by three "inappropriates" in the 2000s. Each of Kohler, De Rato, and DSK has suffered some degree of tarnished reputation since their appointments. And even Lagarde has not escaped suspicion. Yet they were able to influence the choice of leader of the key European Department (see above) and to varying degrees cast the Fund in their image.

The Head of the Fund should be selected by a transparent open process, where the most qualified candidate gets the job. It is the top global economic policymaking job in the world. Nationality can only matter to constituents if they think they can influence decisions. Yet political interference with Fund staff is a bad thing, surely? So is there any possible defence for disqualifying most of the best candidates?

…or even an evolution

There are less revolutionary alternatives to our proposals. I prefer radical changes to the IMF, because I think these would be the best way of tackling policy deficiencies and the credibility problem.

There have been significant improvements in transparency of the Fund over recent years. Post-event evaluation in particular has improved. Almost all countries agree to have Article IVs (the annual country report) published. Other staff reports and Memoranda of Understanding are now generally published.

An evolutionary step towards greater real time transparency would entail publication of exceptional access cases before they go the Board. Before approving arrangements which go beyond normal quota limits, the Fund would need to publish materials that go to the Board for review. In euro crisis economies these have in any case generally leaked out of Brussels, so what has the Fund to lose?

A major step would be to have a gear shift in terms of dealing with market sensitivities. There is typically a Management Review Meeting around the time of publication. And there it is realistic to expect those minutes to be published. It is also realistic to expect the Fund to make new appointees to this meeting from outside the IMF's Management structure, and for these "Independent council members" to be free to send independent evaluation to the Board and to express these opinions in public.

In turn the Board's approach of taking all decisions by consensus or with a couple of abstentions at most needs to change. There is always scope for honest disagreement over difficult issues. What is the Board afraid of?

7. Conclusions

Inflation targeting regimes were set up when monetary policy credibility was at a low ebb; a strong analogy with the Fund.

The Fund was set up post-war, and its institutional framework has hardly progressed. It is time for radical change. Many dedicated and talented economists have worked at the Fund. There have been some great programmes in places as far apart as Bosnia and Seychelles, but it is an institution whose sum is less than the parts. It has historically performed badly when it most needs to perform well. Many staff have entered the Fund with high expectations, and left highly frustrated.

Now is the perfect time for the Fund to open up its kitchen and show the world the ingredients that go into forming key decisions. Many central banks turned an endowment of low credibility to an advantage from the 1990s by introducing radical reforms in transparency and accountability. Some central banks were transformed through government legislation. Others "just did it". IMF credibility is at low ebb; the current MD has an opportunity to leave a legacy well beyond the euro crisis.

Momentum for this sort of consistent improvement in Fund performance needs to come from outside and within. But in any case, without a transparency revolution on the IMF staff, I see little prospect that other reforms – to quotas and nationality of the MD, even if they are substantive – will secure a better IMF performance in the run-up to or the management of the next global crisis.