IMF diagnosis simple: prescription, less so
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The International Monetary Fund's watchdog, the Independent Evaluation Office, has produced a comprehensive report on why the IMF did such a poor job of anticipating the global financial crisis. But it hasn't much to offer on ways to improve IMF performance.

The IMF has the comparative advantage, resources and access to identify potential problems. In theory it could map, more clearly than national authorities, the international financial links that proved so damaging.

But the IMF focused on the wrong issues - international imbalances and exchange rates - rather than overleverage and unsustainable asset prices. It was subject to group think and intellectual capture, not only championing conventional efficient-market thinking but also allowing itself to be intimidated by national authorities. It suffered from confirmation bias - seeing only those facts that confirmed its existing analysis.

The fund's analytical framework was inadequate, with insufficiently rigorous stress testing of financial systems. Where it did identify problems, they were on a laundry list of possible disasters, most of which didn't happen. Its governance structure discouraged it from reporting frankly and fearlessly - the "ruthless truth telling" Keynes, an IMF founder, advocated.

Part of the defence is no one did much better. Mainstream academics were, in Paul Krugman's view, interested in "beauty rather than truth" in their formal analyses. Clearly national regulators didn't see the problems coming. When individuals did warn (such as the Bank for International Settlements' Bill White) they were shouted down by authorities. Even when the IMF's own economic counsellor identified potential problems in 2005, he was ignored.

Many of these deficiencies are well known to national prudential supervisors, who grapple with them routinely. Lots of things might go wrong, so how do you identify the things that will go wrong? The financial sector is full of known unknowns and unknown unknowns. Further, many of them are "black swans" - things never experienced before or so rare that they are not recognised.

Warnings must not only predict what will go wrong, but when: the GFC's favourite scapegoat, Alan Greenspan, did warn about "irrational exuberance" in asset prices, but he was a decade too early, and well before the disaster came to pass he changed his mind.

The action needed to address dangers is inevitably unpopular with powerful vested interests. Regulators are always asking financiers to take less risk, exercise more care and hold more capital. This is bad for the bottom line, so financiers resist.

On top of this the fund has its own problems. It is a big, unwieldy international organisation with diffuse governance by its diverse 187-strong membership. Opinion gravitates to the mean, and strong dissent and thinking outside the box are inevitably discouraged.

Then there are political-economy problems. Even if IMF staff are prescient and know the details of what will go wrong, are they brave enough to take a powerfully argued case to the country's authorities? The message will be unpalatable and member countries have abundant expert resources to argue for a sanguine view.

The IEO urges the IMF to "talk truth to power". But power usually doesn't want to listen and you lose credibility if you warn against crises that don't happen. The IMF failed to spot the US subprime housing problem but warned Australia of a house-price bubble.

If you jump all these hurdles, you face the final barrier: how can you insistently warn of an impending crisis without precipitating it? Even if you were a mere trigger rather than a cause, you will be blamed. When the bubble bursts, never be left holding the pin.

So much for the diagnosis: what about the prescription?

The IEO recommendations are along the lines of "should try harder". It acknowledges the IMF can't predict crises, it can only identify risks. But it calls on the IMF to be "proactive in crisis prevention rather than primarily reactive in crisis response and management". Very true, but how?

The IMF needs to "clarify the roles and responsibilities of the board, management, and senior staff in providing incentives for staff to deliver candid assessments, in overcoming the obstacles of silos and 'fiefdoms', and in confronting political constraints". Amen to that, but such problems have been around forever. The fund needs to "create an environment which encourages candour and diverse/dissenting views". Good luck! It should "better integrate financial-sector issues into macro-economic management" and "deliver a clear and consistent message". Just so, but how?

The IEO must offer more. If these issues are "a recurrent theme in IEO evaluations", why haven't these reforms happened already? It may be that the IMF's feasible role is modest and that should be recognised.

Curiously, the IMF was largely a bystander during the global crisis, present at G20 meetings but not central to the action, which was largely with national authorities. It has similarly been a bit player in the reform effort, peripheral to the action as the Basel rules were revised.

The IEO report gives us a clue on why this happens, but no clear reform path.

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