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2014 Triennial Surveillance Review - External Study - Risks and Spillovers

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2014 TRIENNIAL SURVEILLANCE REVIEW—EXTERNAL STUDY—RISKS AND SPILLOVERS

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EXECUTIVE SUMMARY

The global financial crisis and the subsequent economic downturn, from which much of the industrialized world has not yet recovered, exposed serious fault lines in the international monetary and financial system. It also highlighted serious failings in surveillance of risks to stability. Acknowledging its share of responsibility, the International Monetary Fund has been upgrading its surveillance efforts over recent years. This Triennial Surveillance Review, the second since the height of the crisis in 2009, therefore provides a vital moment to capture lessons that have become clearer over the past three years and to seize opportunities provided by regulatory reforms already in train.

Our key messages revolve around the importance of stocks as well as flows; of 'boomerang' effects whereby outward spillovers from a country's policies or problems swing back to hit itself; of the illusion of relying almost entirely on models; and of the opportunity provided by the macro-prudential turn in national regimes to reset the scope of Fund analysis and recommendations. Throughout we underline the importance of the Fund being joined-up, one organization. A few words on each here do no more than scratch the surface.

The Fund needs to institutionalize a focus on national balance sheets in assessing vulnerabilities stemming from liquidity, currency and other risk mismatches in the structure of an economy's liabilities and assets. Grasping the importance of gross capital flows without undertaking balance sheet analysis is like failing to finish a thought. That was a lesson from the 1990s' Asian crises. It is a lesson from, especially, the euro area crisis. It would be a sin to neglect it for a second time.

National policymakers are, given their interests, typically more focused on inward than outward spillovers, but that can be myopic since problems can bounce back in today's increasingly interconnected world. Bilateral and multilateral surveillance and recommendations must be joined-up.

[1] Tsinghua University and Harvard University, respectively. This paper represents the views of the authors and does not necessarily represent IMF views or IMF policy. The views expressed herein should be attributed to the authors and not to the IMF, its Executive board or its management.

Models provide discipline and aid explanation but cannot be a crutch. The lack of mainstream macroeconomic models incorporating default risk and a banking sector did not, could not mean that those were not sources of macroeconomic vulnerability. Formal and informal analysis are complements, warranting mutual respect and deserving to be joined up.

Not all remedies will be macro-prudential, but many will be. Although tragically late, policymakers have recovered the old knowledge that the financial system is a system; that national systems are interconnected; that they matter to and are affected by broader economic conditions; and that regulatory policy simply cannot be 'micro', focusing on individual firms as though they floated independently of each other, of markets, of the economy. This provides the Fund with the structure to articulate recommendations for balance-sheet vulnerabilities alongside its fiscal and monetary prescriptions.

Our recommendations come under four headings: strategy, substance, research and data development, and communications. They are not offered on a pick & mix basis, and for that reason are not summarized here.

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