Office Memorandum

To: Reza Moghadam August 7, 2011

From: Chris Marsh

Subject: **Failure of IMF Macroeconomics and Substantial Risks to the Fund**

Significant risks to the IMF. This short memo underlines fundamental failings in IMF macroeconomics—failings that pose a significant risk to this institution, and present fundamental challenges for European programs in particular.

A concise statement. For brevity, this memo makes assertions without analytical "proof." I am on hand to provide additional material would this be useful. My concern is simple:

Failed financial programming. Today IMF staff seldom use financial programming. This problem can be seen in two ways, reflecting the general intellectual atrophy inside the Fund:

- ***Tables do not add up***. Staff routinely produce sector tables that are inconsistent. One can disagree about "behavioral" relations. But accounting constraints have to bind. That they do not raises questions about projections, policy advice, and program targets.
- ***Missing tables***. Moreover, surveillance cases often do not include the tables needed to reassure that our analysis is underpinned by full financial programming.

Latvia's example. In Latvia's December 2008 program, the sector tables were inconsistent by nearly 20 percent of GDP—not a simple rounding error! Four consequences followed:

- ***Projections were hugely over-optimistic***—staff should have seen the rapid current account reversal and grasped the depth of the coming recession. We didn't.
- ***Policy calibration***—policies were therefore not calibrated to macro-projections;
- ***Program targets***—the fiscal target could not possibly have been met. This created uncertainty about debt sustainability and possible devaluation;
- ***Currency crisis***—the result was a currency crisis for the first 6 months of the program. Nordic banks fled the currency—withdrawing about 1 billion euros; more than 5 percent of GDP. Contrary to staff claims that we "haven't seen large balance-of-payments outflows from these banks," the Nordic banks were the biggest program beneficiaries.

Lessons learnt? Most distressing, these mistakes are being repeated. Where verifiable, euro zone programs repeat these mistakes—the Greece 3rd Program Review being a particularly egregious case. If macro-projections turn out overoptimistic—which seems likely—and analysis of debt dynamics and required adjustment flawed, it will be difficult to explain why the clear failings are being overlooked and repeated. Progressive institutions learn from their mistakes; moribund institutions repeat them.

Does this matter? It is worth highlighting the substantial risks the current situation brings:

- ***Strategy for Europe***. Absent a framework understanding the implications of Europe's internal adjustment, we are sleepwalking towards disaster. Replacing sanguine guesswork with realistic macro scenarios is the first step to assess for ourselves (and our European friends) how the crisis in Europe can be resolved. Hoping for the best is not a strategy.

- ***Debt sustainability***. Basic calculus unveils an uncomfortable truth: GDP forecast errors have a larger impact on the dynamics of sustainability when the initial debt stock is high. Only by good fortune was Latvia's debt-to-GDP ratio relatively low when the crisis struck. The same is not true of peripheral Europe—even if smaller, forecast failings will be more damaging in these cases.

- ***IMF as program partner***. Having been invited to bring value-added to Europe owing to years of "program experience," it is remarkable that our analysis is based on phony financial programming and tables that don't add up. Are we really a good partner for future regional lending arrangements?

- ***Assignment of blame***. Worse still, given the high likelihood of failure in Europe, that our programs do not respect basic adding up constraints makes us a good scapegoat. Regardless of our public or private messages on Europe, absent macroeconomic due diligence we are open to blame once the dust settles.

- ***Financial risks***. It goes without saying that this situation brings substantial financial risks to the institution—we may not be made whole on a significant part of our lending book.

- ***Evenhandedness***. But perhaps the biggest risk is our loss of credibility outside Europe: Why have LICs and EMs been subject to the relentless logic of accounting constraints and careful programming, but Western Europe is given a free pass?

Governance and accountability. Of course, failings on this scale suggest deep problems within the institution: Why has there been no effort to learn from mistakes? Why is there no accountability of senior staff and management? Why, 18 months after Latvia, were staff sent to Greece to repeat the same mistakes (with devastating consequences, as we now discover)?

Real time warnings. Let me also note that this is not *ex post* posturing. In real time, in Latvia I provided clear, unambiguous warnings about our failings. They could have been acted on. And of course they equally apply to euro zone cases today. Of dozens of possible examples, some are worth repeating for their prescience or clarity (emphasis added):

- ***29 October 2008***. Two weeks before being called on mission, seven weeks before the Latvia Board meeting, I warned the Mission Chief and Desk we had no macro-framework: "…the current account and GDP is endogenous to some extent, though *this is not based on fully worked out macro frameworks* -- rather some guess work." No action.

- ***17 November 2008***. In constructing some further financing gap analysis for the Senior Mission Chief, we were repeating these earlier errors. I therefore insisted on including a health warning that "*These issues will need to be studied more completely in the context of a full macro-framework*." This warning was widely distributed. Nothing was done.

- ***21 November 2008***. On the various exchange rate options we were preparing for Latvia, I e-mailed SPR Front Office to warn that my concern: "based on a discussion this morning and this note, is that *the team might be discounting the future output costs of maintaining the peg* and the feedback on the housing market, banking system. This will likely be high, and *has to be programmed explicitly to really understand the needed fiscal adjustment and the cost benefits of maintaining the peg*." Bang on the bell. Ignored.

- ***1 December 2008***. Given weaknesses in the Briefing Paper and financial program, I warned SPR Front Office Reviewer that "*I strongly believe we should not leave without a stronger brief...*" The next day I warned: "*I don't think we ourselves are close enough to go back with a robust program* within a week ... I don't have much sway over the team, unfortunately." There would never be a robust program.

- ***9 February 2009.*** Regrettably, the team went on to produce a financial program riddled with mistakes and inconsistencies. As I continued to try and resolve these, I again e-mailed SPR Front Office Reviewer warning: "EUR are asleep at the wheel. *We have not had one single meeting to discuss the macro-framework (ever!) since joining the team…*"

Despite clear warnings on many occasions of the failings and likely consequences, and despite the catastrophic results—including the currency crisis and failed debt auction in Latvia in summer 2009—there has never been any accountability for these repeated and substantial failings. Instead the mistakes are being repeated—with greater consequences.

The irony in our intellectual atrophy. Moreover, it is not lost on me (at least) that at a time when the EU Commission acknowledge their pre-crisis "fiscal only" surveillance framework was woefully inadequate, we are regressing to "fiscal only" program monitoring. Our intellectual atrophy is complete.

Standards of professional integrity. In sum, it is difficult not to conclude that there are substantial failings within the IMF—incoherent programs, ignoring warnings, projecting blame, repeating mistakes. While it may be too late to undo all of the damage done, it is certainly worth trying. I am happy, as I always have been, to work towards solutions to these failings. But solutions can only be found once the failings are recognized. Until then, I can do no better than conclude with the words of Michael Mussa—reflecting on the IMF's role in the Argentina crisis:

> "… there is a critical difference between responsible, professional analysis that honestly attempts to assess central tendencies and reasonable bounds of uncertainty and advocacy analysis that endeavors to support a precooked conclusion favored by a country's authorities and Fund management. In the post-Enron era, when private auditors and analysts are—properly in my view—being held to reasonable standards of professional integrity, the Fund's executive Board should consider whether it should accept substantially less from Fund staff and management."

A decade on from Argentina, can it be said that Fund staff meet reasonable standards of professional integrity? I fear not.