

COORDINATION CRITICAL TO ENSURING THE EARLY WARNING EXERCISE IS EFFECTIVE

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KEY POINTS

- The Early Warning Exercise (EWE) was designed as a joint program between the International Monetary Fund (IMF) and the Financial Stability Board (FSB) to identify low-probability systemic financial risks. Although cooperation between the IMF and FSB is central to the exercise, this needs to be significantly improved and strengthened to effectively alert and warn of potential crises.
- The EWE suffers from unclear goals, a lack of coordination, geographical separation, insufficient organizational capacity and ad hoc procedures.
- The EWE requires specific changes to address these shortcomings and would also benefit from a regular publication to boost its visibility and impact.

INTRODUCTION

The global financial crisis has shown the need for stronger surveillance and better foresight in financial governance. In 2009, the Group of Twenty (G20) sought to bolster these by initiating the semi-annual EWE. Two international institutions — the IMF and the FSB — were tasked with conducting the EWE. Although the EWE is a critical mechanism for identifying systemic risks and vulnerabilities, several problems constrain its effectiveness. The exercises suffer from unclear goals, a lack of coordination, geographical separation, insufficient organizational capacity and ad hoc procedures.

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ORIGINS OF THE EWE

At the April 2009 London G20 Summit, the newly convened G20 leaders established the FSB (Griffith-Jones, Helleiner and Woods, 2010: 6). A communiqué from the summit admitted that “major failures in the financial sector and in financial regulations and supervision were fundamental causes of the crisis,” and the G20 committed itself to “creating a globally consistent supervisory and regulatory framework for the future financial sector” (G20 Leaders, 2009).

The EWE was designed to identify global financial risks and vulnerabilities by leveraging the comparative strengths of the IMF and the FSB (IMF, 2010: 4): the IMF is tasked with investigating quantitative risks, represented by financial flows within and throughout regions, while the FSB investigates regulatory failures that may create major stresses. The two organizations’ differentiated but complementary skill sets would, in theory, provide a more complete view of systemic risk.

The FSB’s involvement in the EWE is political and practical. On the political side, various IMF and government officials have pointed to FSB involvement in the EWE as part of a broader drive for inclusive policy and decision-making processes following the crisis.¹ Conversely, several officials indicated that there is a practical value in the inclusion of the FSB: providing access to data that would otherwise be missed, and bringing a qualitative perspective to the IMF’s more econometric analysis. Moreover, the failure of the IMF to identify the impending crisis highlighted the need to strengthen global surveillance.

1 Confidential interviews with Canadian policy makers at the Bank of Canada and Department of Finance, February 2013; confidential interview with former International Monetary and Financial Committee (IMFC) member, February 2013; and confidential interview with an IMF staff member, November 2012.

MAPPING THE EWE

IMF PREPARATION FOR THE EXERCISE

At the IMF, the exercise is carried out by the Early Warning Group (EWG). The EWG comprises approximately eight staff from four departments: the Strategy, Policy, and Review Department (SPR); the Monetary and Capital Markets Department (MCM); the Fiscal Affairs Department; and the Research Department. The SPR coordinates the EWG's work. The EWG is overseen by the first deputy managing director.

The IMF's contribution to the exercise begins with meetings in which the EWG brainstorms problems — based on available IMF data — that could arise in the global financial system. The EWG then conducts external meetings with key consultants, including academics, central bankers, hedge fund managers and economists from important financial institutions.

Once the EWG completes its empirical work, it carries out the Vulnerability Exercises for Advanced and Emerging Economies (VEAEE). The VEAEE assess regional and global vulnerabilities against different types of shocks. Due to the country-specific nature of the VEAEE, the results are for the EWG's internal use only.

A key objective of the EWG is to produce an Early Warning List (EWL). The EWL documents the risks and vulnerabilities deemed to be of greatest concern. Once the EWG has narrowed down the topics, the SPR gives a presentation to the SPR director. The SPR then gives a second presentation to the first deputy managing director. There are a few rounds of negotiation between the deputy director and his colleagues about the content of the list. Once the list has been finalized, the deputy director presents it to the IMFC at the spring and annual meetings.

FSB PREPARATION FOR THE EXERCISE

The FSB secretariat oversees the exercise and issues tasks to the Analytical Group on Vulnerabilities (AGV). The AGV conducts the technical work for the exercise and reports to the Standing Committee on Assessment of Vulnerabilities (SCAV). The secretariat prepares a list of potential risks and vulnerabilities for the AGV to examine, which stems from the FSB's year-round work. The AGV collects and analyzes this data, obtaining most of it directly from the FSB's national members, thus giving its analysis an internal and micro-level perspective of macro-financial imbalances and potential vulnerabilities.

Once the AGV assesses the probabilities and potential impacts of various risks and vulnerabilities, it reports its findings to the SCAV. The SCAV might then suggest additional topics to consider or different perspectives from which to approach these findings. A final draft of the FSB's list is submitted to the plenary for approval. Once the plenary approves the list, the secretariat prepares a short set of slides to present at the IMFC meeting. Typically, the SCAV chair gives the final presentation to the IMFC. The member-driven approach taken by the FSB is a contrast from the IMF's more staff-driven approach to the exercise.

THE SPRING AND ANNUAL MEETINGS OF THE IMFC

At the spring and annual meetings, the FSB and IMF each provide a 15-minute presentation of their respective EWLs to the IMFC. Part of the objective is to make policy makers realize that severe vulnerabilities — which they likely had not considered — could happen. The IMF and the FSB do not produce formal documents for the presentation. The exercise is a highly confidential process due to its market-sensitive content



The IMF’s Managing Director Christine Lagarde (centre) speaks at the IMFC meeting April 21, 2012 at the IMF Headquarters in Washington, DC. IMF Photograph/Stephen Jaffe.

and the purportedly serious consequences that could result from a leak.

The presentations can be contentious. For instance, IMF presentations use a traffic light analogy to indicate the severity of potential country risks. Countries are given a green, amber or red colour code: green indicates “everything is okay,” amber indicates “approach with caution,” and red indicates “trouble.” This practice can be embarrassing for IMFC members whose countries receive a “trouble” code. Moreover, the list may include warnings about fiscal problems that bear greater costs than policy makers initially anticipated. The limited scope and length of the presentations can also be a source of tension.

Although there is no formal opportunity for the IMFC to discuss the presentations, an informal discussion does occur. There is a breakfast meeting, which takes place the morning after the IMF and FSB present their lists to the IMFC. IMFC “heavyweights” are the only attendees, they do not read notes, and there are plenty of interjections — in short, a genuine dialogue occurs among the key players in the IMFC. Past attendees have stated that the private, informal discussion held at the breakfast meetings is just as, if not more, important than what happens at the IMFC meetings.²

² Confidential interview with former IMFC member, February 2013; confidential interview with current IMF staff member, November 2012.

CHALLENGES TO THE EWE

Existing EWE practices must be improved upon significantly if the exercise is to become an effective tool for crisis prevention. In particular, the EWE must overcome six critical challenges pertaining to clarity, coordination, location, capacity, consultation and feedback.

CLARITY OF PURPOSE

Disagreement persists regarding whether the EWE should focus exclusively on tail risks or impending risks.³ In 2010, IMF Deputy Managing Director John Lipsky argued that the purpose of the EWE was to “identify the most relevant tail risks, to demonstrate how the possible emergence of these risks could be recognized, and to specify the policy changes that would need to be implemented if they were to materialize” (Lipsky, 2010). But others have suggested more modest goals, such as the promotion of structured dialogue among national officials. Without a clear consensus on the EWE’s purpose, there is nothing to prevent various actors from working at odds with one another.

COORDINATION

IMF-FSB coordination has been scarce. When asked about how much coordination takes place, one IMF staff member responded that “zero would not be a bad approximation.”⁴ This is a problem, since the EWE is founded on the idea that by coordinating their work,

the IMF and FSB can generate insights that they could not have produced on their own. The complementary mandates and skill sets of the IMF and FSB make it possible for the two to work together in ways that advance a more comprehensive understanding of the risks and vulnerabilities in the global economy.

Yet, while the IMF and FSB are supposed to prepare and present a joint view of the EWE to the IMFC, Fund staff note that even at this final stage in the process, coordination is limited. Rather, the IMF and FSB each prepare their own EWs, for which they give their own presentations. This separation runs in direct opposition to the basic objective of the EWE: to leverage the comparative strengths of the IMF and the FSB to generate a more complete understanding of the global economy.

LOCATION

Just as firms derive benefits from being located near each other, so too do international organizations. This is especially true when organizations are required to work closely with their counterparts. In the case of the EWE, however, the distance between the IMF in Washington, DC and the FSB in Basel, Switzerland has impeded coordination between the two bodies. If the FSB were located in Washington, DC, there would likely be more coordination and contact between the two organizations.

ORGANIZATIONAL CAPACITY

As a body with no more than 40 full-time staff members, the FSB is dwarfed by the IMF’s 400 employees in the MCM department alone. Moreover, the FSB’s resources are primarily directed toward the goal of financial sector reform. Without substantial resources, it is difficult to imagine how the FSB could be an effective “fourth

³ Tail risks are very low probability risks (<95 percent of not occurring) while impending risks have a higher probability (68–95 percent). This is generally discussed in terms of “standard deviations” away from the most likely events. Impending risks are one to two standard deviations, while tail risks are three or more.

⁴ Confidential interview with IMF staff member, November 2012.

pillar” of global economic governance. This seems to be the general perception at the Fund, where staff members do not tend to see the FSB as an equal partner. When asked about the division of labour between the two organizations, one IMF staff member remarked that the Fund does most of the EWE-related work. Others went so far as to suggest that the IMF could do the EWE without the FSB. It is possible that such (mis)perceptions further complicate FSB-IMF cooperation.

CONSULTATION

As part of the EWE, the IMF conducts external “[c]onsultations with market participants, academics, think tanks, and country authorities” to help them take stock of risk perceptions in a timely way (IMF, 2010: 15). Unfortunately, these external consultations appear to be ad hoc, informal and limited in scope. Consultations with systemically important financial institutions could be beneficial, yet the lack of formality, regularity and structure surrounding the current process mean that these types of consultations have been limited.

PRESENTATION/FEEDBACK

As noted, the primary mechanism through which the EWE findings are transferred to national-level officials is a semi-annual presentation to the IMFC. Due to the confidentiality of the EWE, there is no supporting document to accompany the presentations. It is thus from the 30 minutes of presentation time that members of the IMFC are expected to convey crucial information about the complex risks and vulnerabilities facing the global economy back to their national capitals. This is problematic. For starters, the brevity of the presentations and the complexity of the information being presented may challenge one’s capacity to *absorb* all the information contained in the EWL. One must then *process* this

information (that is, comprehend its implications), which may depend on knowledge of financial and macroeconomic issues. IMFC members must also be able to *retain* this information if it is going to be used to inform national policy. Finally, IMFC members must effectively *convey* the EWL contents back to the relevant policy makers in their respective countries. If this is not done, the purpose of the EWE is undermined.

RECOMMENDATIONS

Given the challenges and faults currently associated with the EWE, the following recommendations would help improve its effectiveness:

- **Clarify the purpose and scope of the EWE.** Debate continues on whether the EWE should focus exclusively on tail risks, impending risks or some combination of both. As a number of participants noted, probabilistic discussions of tail risks are particularly difficult to convey to policy makers and non-specialists. Uncertainty regarding the nature of the risks identified by the EWE is likely to undercut its ability to gain traction among policy makers. As such, the scope and purpose of the exercise should be clarified.
- **Increase the level and diversity of consultation with outside stakeholders in preparations of the EWE.** Given its advantage in staff capacity, the IMF should take the lead in broadening the consultations undertaken in the preparation of the EWE. Greater emphasis should be placed on consultation with market participants, academics and authorities within emerging market countries. Ideally, a formalized system of consultations should be established to ensure balanced inputs from developed and emerging market countries.

- **Increase the organizational capacity of the FSB.** The FSB's lack of organizational capacity is an impediment to robust coordination with the IMF in the preparation of the EWE. Policy makers have begun to recognize this weakness. At the Cannes G20 Summit in 2011, the need to strengthen the FSB's capacity, resources and governance was highlighted. To fulfill this mandate, the FSB established itself as an association under Swiss law in January 2013. Efforts to strengthen the capacity of the FSB through improvements and regularization of its budget should continue, as per the recommendations of the 2011 High-Level Panel on the Governance of the FSB. Moreover, the FSB should consider increasing staff levels in line with the greater expectations and responsibilities being placed upon the organization. In this vein, it should be possible to increase the capacity of the secretariat without undermining the member-driven structure of the FSB, which is valued by officials (see Lombardi, 2011).
- **Create a publication to showcase the core findings of the EWE.** Through direct publication, the IMF's current multilateral surveillance products — the Global Financial Stability Report (GFSR) and the World Economic Outlook — gain significant traction with mid- and high-level national officials (Independent Evaluation Office, 2006). In contrast, the lack of publication of EWE findings limits the ability of the exercise to inform discourse among national officials. Objections to publishing the findings of the EWE are most often premised on the market-sensitive nature of its findings. Several public and private sector actors have suggested that this objection is not sufficient to preclude the creation of a publication based on EWE findings. Therefore, the Fund and the FSB should produce a short document summarizing the core findings of the EWE. It should be aimed at communicating the findings of the EWE in order to generate discussion among national officials. This document could be published as a stand-alone publication, or included as a section within the GFSR.
- **Improve cooperation and coordination.** Creating a cooperative atmosphere between the IMF and the FSB is essential to improving the quality of the exercise. Measures should be sought that limit the animosity that appears to have developed between the organizations. Two actions should, therefore, be taken:
 - **Establish an FSB liaison office in Washington, DC to facilitate coordination between the FSB's secretariat and IMF staff.** Perceptions of the quality of coordination between the IMF and the FSB in the preparation of the EWE vary between and within the respective institutions. While some actors praised the level of coordination, others indicated that interaction between the two institutions has been challenging. Coordination difficulties are compounded by geographic barriers, variations in institutional structure and differences in organizational culture. Given these difficulties, the FSB should consider establishing a liaison office in Washington, DC dedicated to establishing more robust coordination between IMF staff and the FSB secretariat. Other Switzerland-based organizations like the World Health Organization have established similar offices in Washington, DC to facilitate information exchange with the IMF and the World Bank. The presence of a full-time member of the FSB secretariat in Washington, DC would improve coordination between the two organizations,

both in the preparation of the EWE and other areas of mutual concern.

- **Emphasize areas of productive disagreement in the presentation of the EWE.** National-level policy makers indicated that there is frequently little direct contradiction between the findings of both organizations. Policy makers noted that areas of divergence often proved helpful in highlighting particularly intractable policy problems and showcasing different perspectives. Thus, coordination in the preparation of the EWEs should highlight nuanced differences in the approaches taken by the two organizations and emphasize areas of productive divergence in order to spur dialogue among policy makers.

CONCLUSION

The EWE was established as part of a broader call to improve national-level intelligence regarding the character of systemic risk in the aftermath of the 2008 global financial crisis. Nevertheless, weaknesses in the EWE process undermine its efficacy. There are a number of ways that the process surrounding the EWE may be improved. In particular, collaboration between the IMF and the FSB needs to be strengthened in order to leverage their comparative strengths. Although the EWE will remain challenging due to the complexity of the task, implementing the above recommendations would greatly improve the overall effectiveness of this important process.

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ACRONYMS

AGV	Analytical Group on Vulnerabilities
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
EWE	Early Warning Exercise
EWG	Early Warning Group
EWL	Early Warning List
FSB	Financial Stability Board
GFSR	Global Financial Stability Report
G20	Group of Twenty
MCM	Monetary and Capital Markets Department
SCAV	Standing Committee on the Assessment of Vulnerabilities
SPR	Strategy, Policy, and Review Department
VEAEE	Vulnerability Exercises for Advanced and Emerging Economies

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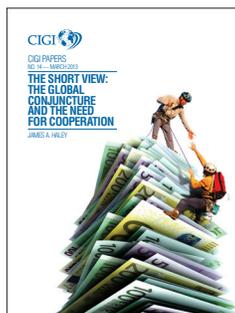


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