Time reference is fatal

The presupposition that risks "should be" identified with a time frame has damaged the credibility of the IMF—because it failed to see the global financial and Euro Area crises coming right up to the point where both erupted.

That presupposition is also reflected in the broader ex-post question "Why did no-one see this coming?", a question posed most famously of the recent financial crisis by the Queen of England.

The failure to do so—qualified as that failure is—is seen by many as undermining the general credibility of the economics profession.

However, close to the core of modern macroeconomic theory is a long and well-established body of literature—Rational Expectations—which concludes that such time-bound predictions are generally impossible, or no more likely to be correct than guessing the outturn of a coin toss.

So rather than the failure to predict crises undermining the core of economics, it illustrates the validity of that particular core proposition in economics. The fact that many professional economists, including the IMF, try to make such time-bound predictions is because there is such demand (and remuneration) for that analysis, not because the profession claims the ability to supply it.

And both notably and regrettably, the IMF routine "Early Warning System" of analysis, which it set up post crisis to "strengthen" its risk assessments, retains that time-bound framework. That is inherent in the fact that it runs its Early Warning System several times a year "to keep up with newly emerging risks", despite the fact that such time-bound risk assessments are not well grounded in the profession.

However, the profession has a good basis to identify the general conditions that produce crises—such as a drunk on an open cliff top—even if it cannot specify when exactly the disaster—the drunk falling—will happen.

Further, as noted, a good number of Economists pointed these general conditions out in the case of the global and euro Area crises, many years in advance.

And the hope of the IMF Early Warning System "to keep up with emerging risks" itself points to redundancy of the effort: if the aim is to keep track of, rather than add insight into, the evolving concerns of markets, it is unclear what (expensive) exercises yield in addition to just reading market sentiment.

And a better basis for the IMF Early Warning System would not be routine quarterly or six-monthly updates (a frequency which is implicitly motivated by the forlorn aspiration to track immediate horizon risks) but much less frequent assessments of general frameworks which are liable to produce crises.

In sum, as argued in "Global early-warning and the IMF", the correct ex-post question is not "why did no-one see this coming?", but "why were the conditions that were prone to produce crisis not changed when the dangers were pointed out?"

It is the latter question that was and which remains pertinent to the credibility of the IMF.

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