INTERNATIONAL MONETARY FUND

2008 Triennial Surveillance Review
Thematic Findings

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In consultation with the other departments

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ACRONYMS

ABCP	Asset-Backed Commercial Paper	HR	Human Resource
ADV	Advanced Economies	IEO	Independent Evaluation Office
AFR	African Department	IIP	International Investment Position
APD	Asia & Pacific Department	LIC	Low Income Country
BIS	Bank for International Settlements	LOE	Language Other than English
BSR	Bilateral Surveillance Review	MB	Macroeconomic Balance
CCA	Contingent Claims Analysis	MBS	Mortgage-Backed Securities
CEMAC	Central African Monetary and Economic Community	MCD	Middle East & Central Asia Dept.
CGER	Consultative Group on Exchange Rate Issues	MCS	Mission Concluding Statement
DEV	Developing Countries	MT/LT	Medium-Term/Long-Term
ECB	European Central Bank	PIN	Public Information Notice
ECCU	Eastern Caribbean Currency Union	PPP	Purchasing Power Parity
ED	Executive Director	REER	Real Effective Exchange Rate
EMC	Emerging Market Countries	REO	Regional Economic Outlook
ERER	Equilibrium Real Exchange Rate	ROSC	Report on the Observance of Standards and Codes
EU	European Union	SADC	Southern African Development Community
EUR	European Department	SAR	Special Administrative Region
FDI	Foreign Direct Investment	SIP	Selected Issues Paper
FINMA	Unified Financial Market Supervisor	SSP	Statement of Surveillance Priorities
FSAP	Financial Sector Assessment Program	TA	Technical Assistance
FSI	Financial Soundness Indicators	TSR	Triennial Surveillance Review
FSS	Financial Sector Surveillance	WAEMU	West African Economic and Monetary Union
FSTF	Financial Sector Task Force	WEO	World Economic Outlook
FTA	Free Trade Area	WHD	Western Hemisphere Department
GFSR	Global Financial Stability Report	WP	Working Paper
GSE	Government Sponsored Enterprises	WTO	World Trade Organization

I. Appropriateness of Focus[1]

Key Messages

- The focus of surveillance on the Fund's core mandate has improved significantly in recent years across income groups and regions, guided by relevance to external stability.
- While focus topics are generally suitable, there remains scope for improved depth of treatment and delivery of more focused messages.
- Vigilance is needed to avoid drifting back toward issues outside the Fund's mandate and comparative advantage; and greater focus on a few key messages is needed.

1. **This chapter assesses progress made in sharpening the focus of surveillance and seeks to measure the distance to current expectations.** The 2004 Bilateral Surveillance Review (BSR) set a sharper focus of surveillance as a monitorable strategic objective for this TSR.[2] At that time, Directors reaffirmed that Article IV consultations should be kept focused on key issues, in particular (i) coverage should be adapted to country-specific circumstances and (ii) topic selection based on macroeconomic relevance.

2. **Focus has two crucial aspects toward which significant effort has been made since 2004**:

- ***Filtering issues through the "principle of proximity"*** to external stability. The 2007 Surveillance Decision —crystallizing the vision of "macro-relevance" repeatedly emphasized in the past—established that "the Fund will focus on those policies that can significantly influence present or prospective external stability." In particular, the Decision notes that exchange rate, monetary, fiscal, and financial policies will always be the subject of Fund's surveillance.

- ***Narrowing in on key messages of relevance for policymakers.*** The Fund's 2006 medium-term strategy included measures to streamline Article IV consultations and enforce tighter word count ceilings, while country-specific medium-term surveillance agendas were introduced to hone in on key areas.

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[1] This paper was prepared by Jean-François Dauphin, with inputs from Chris Marsh and research assistance from Chris Bouzaher.

[2] See PIN/04/95, IMF Executive Board Reviews the Fund's Surveillance.

3. Against this background, this chapter begins by using the ***"principle of proximity"*** to assess progress toward meeting expectations set out by the 2007 Surveillance Decision as regards coverage of issues (see Box 1), before considering whether ***the messages*** delivered are themselves focused.

4. **The assessment was informed by a number of sources, with findings cross-checked**. In addition to sources common to the whole TSR, a case study on the focus of the analytical work underpinning surveillance was conducted. This included (i) a review of the focus of all Selected Issues Papers (SIPs) issued since July 2006; (ii) a similar review of 100 working papers (WPs)—half each from mid 2006 and early 2008, and (iii) with an eye on future use of resources, a review of the work program sections of all surveillance agendas produced after the adoption of the new Decision.[3]

A. Focus on External Stability

Overall progress since 2004

5. **To a large extent, recent efforts to sharpen the focus of surveillance seem to have paid off.** The case study of analytical underpinnings of bilateral surveillance constructed a crude indicator of focus on external stability (see Box 1 for a description of the methodology underlying this assessment, including definitions of categories C1 and C2, the topics always subject to Fund surveillance), based on which:

- **There has been a significant increase in the focus of SIPs.** Focus on issues always relevant to external stability increased from 77 percent of SIPs in the second half of 2006 to 86 percent by the first half of 2008.

- **This increase is consistent across income levels and regions.** It is the least visible for emerging markets, where focus was already much sharper than average in 2006 (Figure I.1).[4]

[3] Detailed results of the case study on the analytical underpinnings of Fund bilateral surveillance are available in Section E of the Statistical Appendix.

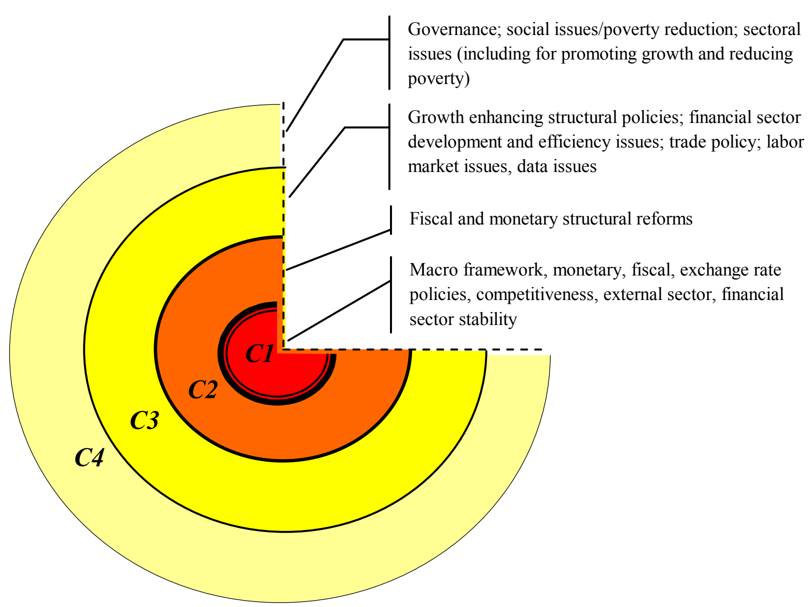
[4] For MCD, the results should be interpreted with caution given the low number of SIPs produced during the two-year period under review (25 compared to an average of 149 for the other departments), which itself reflected MCD's policy of reducing the number of SIPs as part of the department's implementation of the Fund's Medium-Term Strategy.

Box 1. Measuring Focus on the Fund's Core Mandate

The Surveillance Decision articulates a "principle of proximity" to external stability as a rule of thumb to help focus surveillance. It states that exchange rate policies will always be the subject of surveillance, as will monetary, fiscal, and financial sector policies (both their macroeconomic aspects and macro-economically relevant structural aspects). Other policies will be examined only to the extent that they significantly influence present or prospective external stability.

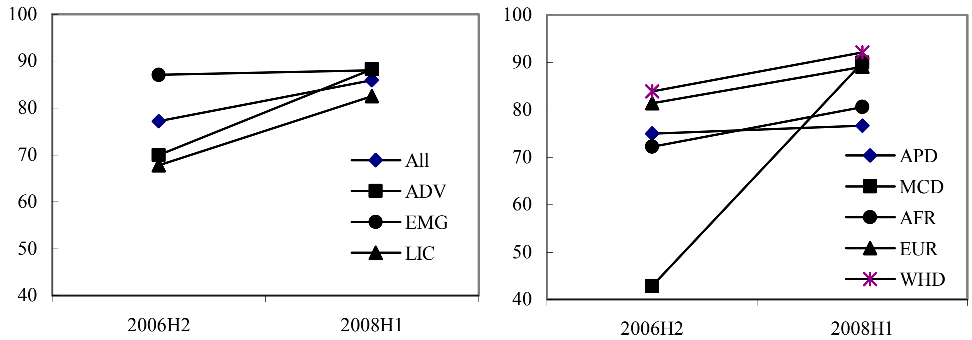
This principle provides a framework for analyzing the focus of surveillance. In analyzing staff reports, SIPs, working papers, and surveillance agendas, topics were classified into 4 circles, defined in the illustration below, representing their likely relevance to external stability. This does not mean that topics in, say, circle 4 are irrelevant. Depending on country circumstances, topics in the outer circles may well significantly impact external stability—but in general would be relevant in fewer cases.

Where surveillance falls on average within this set of circles gives a sense of the focus on core areas. Assigning a grade of 1 to circle 1, 2 to circle 2, and so on, allows an average measure of the proximity to external stability to be calculated. This "proximity indicator" can range from 1 to 4, with a smaller value denoting a sharper focus, allowing for comparisons across groups and over time. This simple indicator builds on the idea that a key weakness in the past has been the unquestioned focus on topics in the outer circles of the below map. As such, a shift through time toward the core areas implies an increase in focus. We describe this as an "improvement" in focus though, as noted, topics in the outer circle can still be relevant for external stability. With this caveat, this simple index gives a rudimentary measure, suggestive of the main trends in the focus of surveillance. Chapter IV.E of the Statistical Appendix provides detailed data on the analytical underpinning of surveillance using this framework.



- **That said, there was some opposite movement in the composition of WPs over the same period.** There was a six percentage point fall in WPs focused on issues always relevant to external stability in the first half of 2008, to 72 percent. While subject to caution, this result suggests a need for vigilance to ensure that resources devoted to noncore issues are not diverted from SIPs to WPs. [5]

Figure I.1. Percentage of SIP Chapters Topics Classified Within C1+C2 Circles



Current distance to expectations

6. **Overall, surveillance is now largely focused on issues expected to be relevant for external stability—though peripheral issues at times still creep into staff reports.** Three-quarters of the 50 staff reports reviewed for this TSR were organized around key questions relevant for external stability. Moreover, the "proximity indicator" for the topics where greater analytical efforts were put was 1.6, denoting a high concentration of topics within C1 and C2. On average, only about 1 paragraph in each staff report was devoted to issues generally expected to be at the periphery of surveillance; i.e., (i) not part of the health check; (ii) not necessary to answer key questions asked in the staff report; and (iii) not issues where greatest analytical effort was focused. However, there is a large variation—more than half the reports (58 percent) were judged to contain no discussion of peripheral issues, while one report contained nine such paragraphs (nearly 15 percent of its text).

7. **This finding is robust across groups of countries, though there are region-specific trends.** The review of SIPs suggested that the sharpness of focus was homogenous across income groups and regions, with less than 15 percent of all (recent) SIPs falling into

[5] This result should be interpreted with caution for several reasons: the samples are relatively small, the drop in the share of C1+C2 issues is largely due to an increase in the share of WPs dealing with financial sector development issues that may well be directly relevant to external stability given country circumstances, and, finally, not all WPs are connected to surveillance activities.

the outer circles of the proximity scale. In specific cases these issues may be directly relevant to external stability, and thus their treatment well-justified. However the pattern of their prevalence—social issues more prevalent for emerging market countries in APD, sectoral issues for LICs in AFR, and labor market issues for advanced economies in EUR—cannot always be explained by differences in country circumstances.[6] It also is not clear that these areas reflect the Fund's comparative advantage; if not, relying on the expertise of others rather than devoting scarce staff analytical resources to them would seem advisable.

8. **Stakeholders broadly share this positive assessment, though they see scope for greater selectivity and timeliness**:

- ***87 percent of authorities who responded to staff's survey considered recent surveillance of their country to have the right focus.*** Dissenters were roughly equally split between "too broad" and "too narrow."

  - **Officials interviewed by the independent consultants generally found the recent, sharper focus of surveillance appropriate**, and supported further progress in this direction, provided flexibility to address outer-circle issues where relevant remains.

  - But a number of officials noted that surveillance **still gave too much attention to structural reform issues**, where they thought the Fund often had little to add. They felt the Fund should be more selective and go deeper into topics chosen according to country circumstances. They also thought the Executive Board should refrain from new mandates outside core areas and not criticize staff if selectivity means some issues are not covered.

  - Some interviewees also noted that **timing was crucial**, quoting examples of consultations that focused on the right issues, but too late to influence the policy debate.[7]

- ***96 percent of mission chiefs said they were guided by potential impact on domestic or external stability when choosing the focus of their Article IV consultation.*** And,

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[6] Albeit for members of the euro-area labor markets are key to the adjustment process, SIPs reviewed in this area often ranged widely, and the External Consultant's Report suggests at least some delved too deeply into structural issues.

[7] See Supplement 2, Chapter II and "IMF Surveillance in Europe: Progress in Refocusing, Report by an External Consultant." (henceforth "External Consultant's Report").

with the benefit of hindsight, 93 percent indicated they were confident recent consultations indeed focused on the most significant issues.[8]

- ***However, Executive Directors were more guarded, criticizing the focus of surveillance in advanced economies***.

  - A large majority of survey respondents thought with hindsight that many or most emerging market and LIC staff reports were appropriately focused, and many noted at least some improvement in focus in recent years for these cases.

  - However, half thought only "some" advanced economy staff reports focused on the right set of issues and saw no improvement in recent years.

B. Clarity and Depth of Key Messages

9. **On average, areas of focus of staff reports were treated thoroughly, but there is still scope for deeper treatment of topics**. Depth of treatment is inevitably a matter of judgment. Nonetheless, an attempt was made to rate the treatment of focus topics of the 50 reviewed staff reports.[9] Reviewers found that these topics — on average, just over 3 by staff report—were thoroughly analyzed, reflected in an average grade of 3.7 on a scale of 1 (very shallow) to 5 (very thorough). Moreover, 65 percent of reports received a score of 4 or 5 (Figure I.2). However, with only 20 percent scoring full marks for "very thorough" treatment, there remains scope for greater analytical depth—as also noted in country officials interviews. In addition, while there was no significant difference across country income groups, differences across regions were noticeable, with WHD and APD ranking the highest. Topics in reports for members with a Fund-supported program

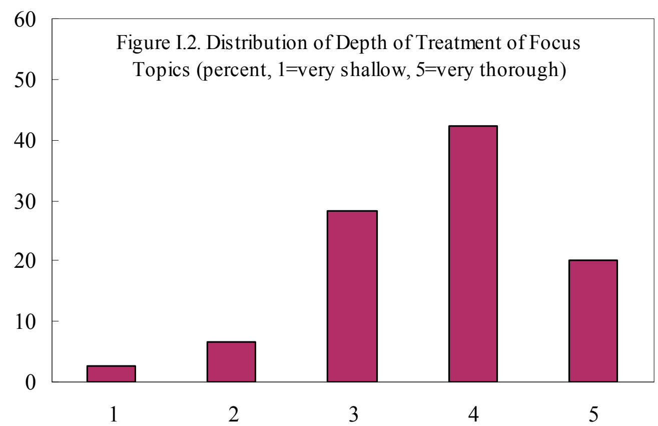

Figure I.2. Distribution of Depth of Treatment of Focus Topics (percent, 1=very shallow, 5=very thorough)

[8] Although one cannot rule out some degree of bias, the anonymity of the survey was meant as a way to foster as candid answers as possible.

[9] Reviewers formed their judgment by assessing depth against questions such as "Is the treatment deep enough to be fully convincing?," "Do I feel other aspects of the issue could have been usefully explored?," "Would the use of other techniques have helped give a more comprehensive picture/be more convincing?," or "Do I feel some relevant questions on this topic were left unanswered?." Supplement 2, Chapter I provides further details on the methodological precautions taken to guard against bias in the assessment.

were found on average to be somewhat less thoroughly analyzed than for other members (average scores of 3.3 and 3.8 respectively).

10. **There appears to be a need to deliver more focused key messages.** Despite progress narrowing in on core mandate issues, a more difficult matter is ensuring key messages are delivered effectively. The review of staff reports found that 60 percent lacked a clear, small set of priority messages for the relevant member country. In addition, some authorities indicated concern about wasting resources reading lengthy SIPs "not always focused on key issues," with some topics appearing "research-oriented rather than policy-oriented." Indeed, the choice of focus topics may not be driven purely by the delivery of key messages of relevance: respondents to the mission chief survey indicated that, in addition to potential impact on domestic and external stability, their choice of topics was often also guided by what was of interest to the authorities (47 percent) and by issues on which staff had done prior research (11 percent). While issues of interest to the authorities are likely to have most traction, or may well be consistent with suitable focus, staff should be careful not to be distracted from the key messages it should deliver.

C. The Way Forward

11. **Despite gains, progress toward sharper focus needs to be further entrenched**. The review of surveillance agendas suggested that recent gains might slip. The concentration of *intended* areas of focus within C1+C2 was somewhat lower, at 76 percent, than in reviewed staff reports, though less for the most recent ones (80 percent for those produced in 2008). In addition to active use of surveillance agendas for work planning purposes, the adoption of a Statement of Surveillance Priorities and the tighter resource constraint should encourage sharper surveillance focus.

12. **Effort is needed to move beyond delivering messages within the core mandate, to delivering *key* messages and, if necessary, in greater depth.** Scope for improvement in depth of treatment, concerns about the prioritization and timeliness of policy messages, and the authorities' concerns about research-oriented focus all suggest opportunities for greater value added in this respect.

II. HEALTH CHECK[10]

Key Messages

- The value added of the health check offered by surveillance is clearly recognized by authorities, the international community, and financial market participants, with special appreciation for the comprehensiveness and integrated nature of the assessment. This perceived value added is quite high for low-income countries but diminishes with the level of development of countries covered.
- Fiscal policy analysis and advice stand out as highly valued across country and stakeholder groups; surveillance in monetary areas, by contrast, is viewed with higher appreciation in lower–income countries than in advanced and emerging market economies.
- The quality of analysis of recent developments, fiscal and monetary policy, and external vulnerability assessments is assessed as adequate overall.
- Greater attention to risks to the baseline scenario and associated policy response is needed. In particular, there is scope to improve the analysis of risks with a quantifiable probability, and to devote more attention to risks with uncertain or low probability, but extreme costs.

A. The State of Play

13. **Fund surveillance should provide, at a minimum, a thorough health check of each member's economy.** This includes: analysis of recent economic developments and outlook, assessment of key macroeconomic policies including exchange rate, monetary, fiscal, and financial sector policies, and analysis of risks to the short-term outlook and medium term scenario, particularly with regard to external stability. This chapter summarizes findings on how surveillance has performed and how various stakeholders view the Fund's contribution in these areas—though exchange rate and financial sector issues are discussed separately (in Chapters III and IV, respectively).

14. **The comprehensive and integrated "health check" that surveillance offers is valued by various stakeholders, for a variety of reasons.**

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[10] This paper was prepared by Yan Sun and Chris Marsh, with inputs from Jung Yeon Kim.

- **Country authorities** are measured in assessing the extent to which surveillance contributes to their understanding of their country's conditions (see Statistical Appendix, Section D1, Contribution of IMF Surveillance questions). But almost all of the authorities interviewed appreciated that the assessments offered by surveillance integrated all relevant aspects of macroeconomic performance and were informed by a global perspective. They noted that these assessments often served as a test for their own judgment. Many also appreciated the policy advice, either as a source of new insights, or more often as a useful comprehensive synthesis. The latter was especially appreciated by interviewees from smaller advanced economies. In some cases, the Article IV mission has become established as a moment for strategic reflection on policy challenges and trade-offs, thereby playing a catalytic role seen as offering major value added. A further source of value added is the Fund's ability to identify swiftly the need for more technical expertise and get it rapidly into the field. [11]

- **The international community is an extensive user of surveillance health checks**, with, on average, over half of respondents to the survey of Executive Directors noting that they, and the government agencies with whom they liaise, rely to a great or very great extent on Fund staff reports for analysis of recent developments and core macroeconomic policies across the Fund's membership. The case study of surveillance in Europe further suggested that the use of the Fund's specialized skills resulted in major savings of time and resources for member country authorities and other multilateral institutions. They referred to official agencies' practice of internalizing (at times indeed, "cutting and pasting"), IMF macroeconomic judgments into their own reports, and depending on the Fund for data verification, especially in non-EU emerging markets.

- **Financial market participants too use the Fund's bilateral surveillance outputs fairly extensively**. A strong majority of respondents to the survey consider surveillance reports to make a significant contribution in traditional health check areas compared to other analyses available: 65 percent for economic developments and outlook and 75 percent for macroeconomic policies. The comprehensiveness and analytical depth of surveillance reports were noted as their main strengths by an overwhelming majority (92 and 88 percent of respondents respectively). But respondents also appreciated the Fund's access to privileged information (a strength recognized by 44 percent of respondents) and global coverage: some respondents commented that Fund reports often are used as a source of information not easily available elsewhere for some countries.

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[11] See External Consultant's Report.

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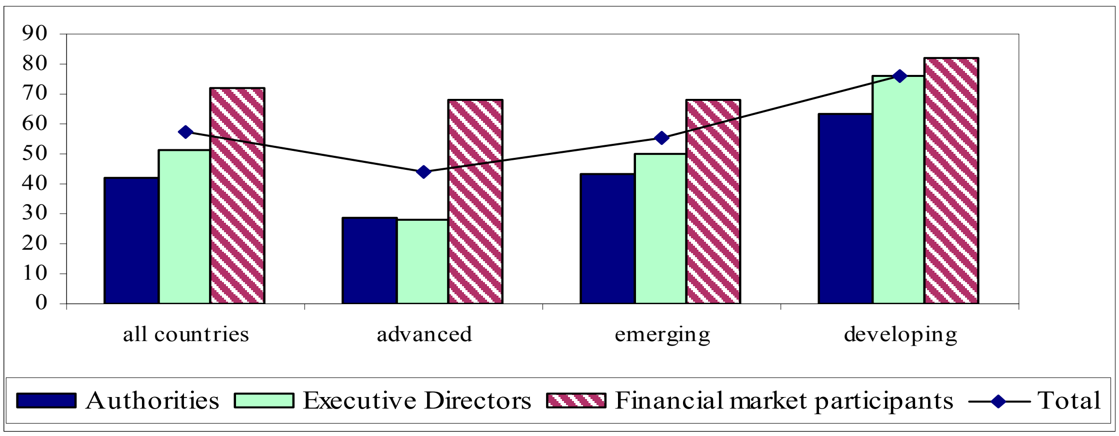
15. **The value added of the "health check" is rated particularly highly, across audiences, for surveillance of low-income countries and to a lesser extent emerging market countries**. Over 79 percent of respondents to the Executive Directors survey noted that they, and the government agencies with whom they liaise, rely to a great or very great extent on Fund staff reports for analysis of various macroeconomic issues in low-income countries (outside their constituency), compared to 43 and 50 percent for advanced and emerging market countries respectively. The same pattern is observed for other audiences (see Figure II.1).

Figure II.1. Share of Respondents to Whom Surveillance Adds Significant or Greater Value in Traditional Areas



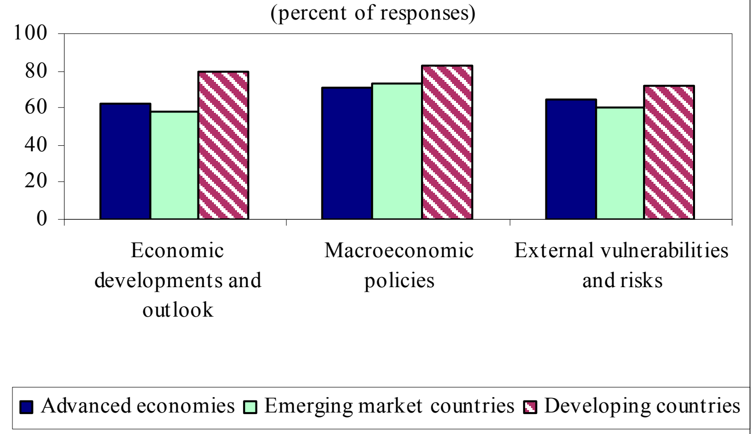
Share of respondents to whom surveillance adds value "To a large (great) extent" and "To a very large (great) extent" among authorities (Executive Directors) or makes a " Significant contribution" from the Financial Market Participants survey in its analysis of recent developments and outlook and fiscal and monetary policy.

Value-added in traditional areas

16. **The analysis of recent economic developments offered by surveillance reports is assessed quite favorably.** In the review of staff reports, about three-quarters of reports are judged to have sufficiently informative coverage when describing recent economic developments and policies. The most frequent deficiency in others is the lack of a clear "story line." In addition, coverage of recent developments in two of the three streamlined consultation reports was found too brief and seemed to presume too much prior knowledge of the country from the reader. This assessment is broadly echoed by the findings from the surveys of Executive Directors and financial market participants: this area is the one for which Executive Directors and the agencies they liaise with rely on Fund staff reports the most, with, on average across country groups, 57 percent doing so to a great or very great extent (Statistical Appendix, Figure D.1.); likewise, a large majority of financial markets

respondents think the Fund's assessments of economic developments add value compared to the analytical products provided by other institutions (Figure II.2).

Figure II.2. Areas Where IMF Country Reports Add Significant Value in Financial Market Participants' View
(percent of responses)

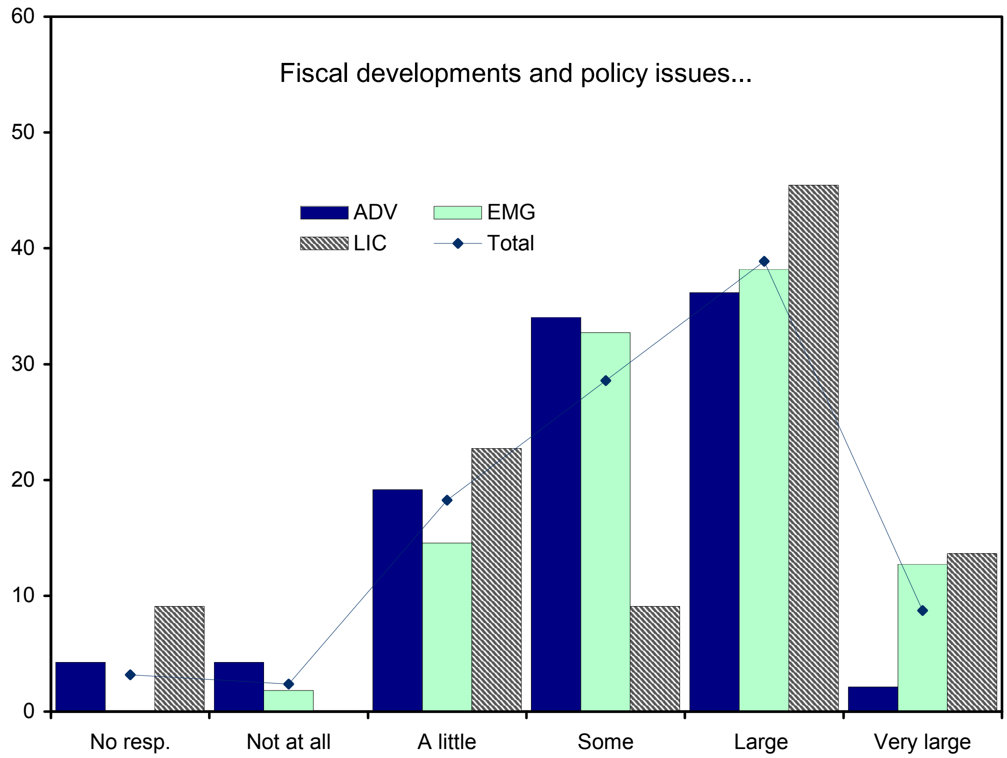


17. **The Fund's fiscal analysis and advice is highly valued by authorities and other audiences, and its quality is also confirmed by the review of staff reports.** The survey of the authorities showed that close to half of respondents considered that Fund surveillance contributed to a large or very large extent to their "understanding" of fiscal developments and policy issues or added "new insights" (Figure II.3)—the highest proportion of all areas covered by surveillance, with only small differences across country groups. This echoes the views expressed by authorities in interviews: many authorities expressed strong appreciation of the value added of the Fund's fiscal analysis, particularly when placed in an integrated macro-framework. Fiscal analysis is the second most valued surveillance area for Executive Directors and their correspondents in capitals, with, on average, 52 percent of respondents relying on it to a great or very great extent (Statistical Appendix, Figure D.1.). Similar appreciation was expressed by financial market participants interviewed for the case study of surveillance in Europe. Further, 75 percent of respondents to the survey of this audience thought surveillance reports made a significant contribution in their analysis of macroeconomic polices. Finally, the staff review of Article IV reports revealed that three quarters clearly articulated medium-term and short-term fiscal policy objectives and that the envisaged short-term fiscal measures were put in a clear medium-term fiscal road map.

18. **However, fiscal policy advice could be more detailed and better justified.** This point was noted by some authorities in interviews. Similarly, the review of staff reports considered that more rationale for the magnitude, pace and composition, and a discussion of political feasibility of fiscal adjustment when recommended, would be helpful—only 58 percent of reports reviewed provided such information. This echoes the findings of the 2003 evaluation by the IEO of fiscal adjustment in IMF-supported programs that staff reports

related to these programs "often do not explain adequately how the magnitude and pace of the programmed fiscal adjustment have been determined."[12] Thus, further effort is required in this area, although admittedly, both resource constraints and the premium on brevity of staff reports pose challenges in this respect.

Figure II.3. Authorities' Survey Responses to: Surveillance has Contributed to My Understanding of, or Provided New Insights for Me into, My Country's...



19. **The appreciation of the Fund's surveillance in monetary areas is high, particularly in developing countries.** Authorities' appreciation of Fund surveillance of monetary issues is the highest in low-income countries—where 68 percent of authorities surveyed find Fund surveillance "contributed to the understanding of, or provided new insights into," the country's monetary developments and policy issues to a large or very large extent, compared with 36 percent in emerging market economies, and 19 percent in advanced economies (See Figure II.4). The usefulness to Executive Directors of surveillance in this area is likewise skewed: 78 percent rely on surveillance in LICs to a great or very great extent in this area, against only 21 percent in advanced countries (Statistical Appendix, Figure D.1.).

[12] Independent Evaluation Office (IEO), 2003, *Fiscal Adjustment in IMF-Supported Programs*, p. 4. (Washington: International Monetary Fund).

20. **In contrast, staff's review found that the best assessments of monetary policy stance reports were found in staff reports on advanced and emerging market countries.** The review of 50 staff reports finds that all the reports for advanced economies and 93 percent of those on emerging markets provided an adequate assessment of monetary policy stance in applicable cases, while the ratio drops to 65 percent for developing economies (Figure II.4.)[13] While the Fund's analytical advantage is likely to decline as members' own capacity and monetary framework evolves, interviews with authorities suggested areas where the Fund can improve the value-added of its analysis. For instance, in interviews some authorities from the Euro Area noted concerns that the Fund's frame of reference takes more account of growth versus inflation than the ECB mandate allows; and some were of the view that the Fund may underestimate the value of financial indicators in formulating monetary policy. They considered that indicators such as money, liquidity, and asset prices can provide (and recently have provided) valuable clues about the need to tighten policy in an upswing, at times when inflation indicators are benign.[14]

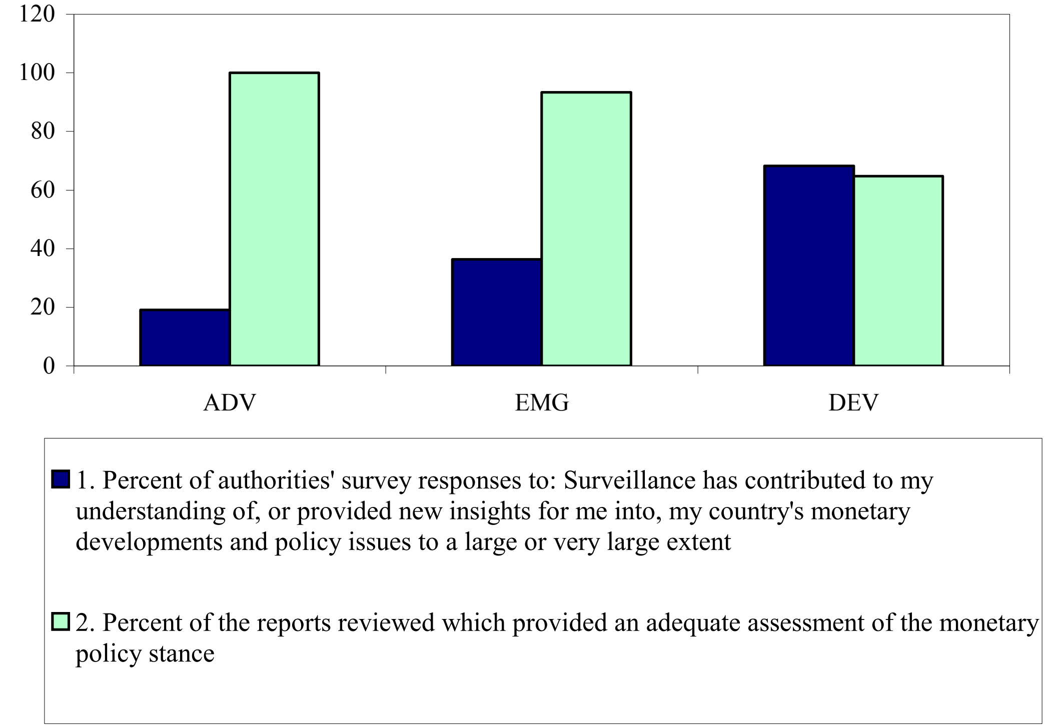
21. **External stability/vulnerability assessments have become mainstream, and are viewed positively by market participants.** In the review of staff reports, about 78 percent contained a clear assessment of external stability—an improvement over the two-thirds of surveyed reports at the time of the 2004 BSR.[15] Moreover, about 65 percent of market participants on average considered the quality of the Fund's analysis of external stability/vulnerability issues above average compared to those from other sources, and agreed that staff reports made a significant contribution in the areas of external stability and risks compared with analytical products of other private and public institutions.

[13] There are no indications that this result may be driven by the higher prevalence of Fund-supported programs in these countries.

[14] Actual differences of view on the timing and scale of interest rate changes were small. See External Consultant's report.

[15] The 2004 BSR found that more than two-thirds of reports "provided views on elements of vulnerabilities to balance of payments, currency, or financial crisis." *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision - Content of Surveillance.* ¶ *35.*

Figure II.4. Surveillance in Monetary Sphere: Quality vs. Value-Added



Analysis of risks

22. **The analysis of risks is an important contribution where staff reports could deliver better.** Simplifying somewhat, staff reports should identify and discuss policy responses to both: (i) most likely risks surrounding the baseline projection; and (ii) high-impact tail risks where relevant—to probe "what if" questions, without necessarily purporting to "call a crisis". The review of the sample of 50 reports suggests some shortcomings:

- **Short-term economic outlook.** Only about 60 percent of staff reports presented the short-term economic outlook, including risks to this outlook, in a substantiated way. Weaknesses in remaining reports relate largely to lack of clarity in describing, or an unconvincing discussion of, risk (including significant tail risks) to the short-term outlook.

- **Risks to the baseline medium-term scenario.** About a quarter of the reports reviewed did not present a clearly identifiable baseline scenario. Of the remaining reports, risk discussion was not always present:

  - Only 49 percent of the reports were considered to include a satisfactory discussion of baseline risks.

- 40 percent provided some discussion of risks, but were deemed insufficient due to some combination of: (i) not seeing beyond the most obvious risks (e.g. failure to reform) where this was necessary; (ii) missing the external risks at specific times when cross-country spillover risks increased; or (iii) providing a long list of possible risks without explaining their relative importance.

- The remaining 11 percent did not discuss risks to the outlook at all.

23. **The subprime crisis case study (Chapter VII) and stakeholder consultations conducted for this review both suggested insufficient attention to risks to the baseline scenario**. In particular, there was a failure to fully articulate the tail risks that later materialized during the financial crisis. This may have contributed to a sense of complacency during the tranquil years. Indeed, the external consultant's report questioned "whether the Fund showed enough risk awareness concerning the global persistence of easy liquidity, expanding credit and low risk premia during the past decade."

B. The Way Forward

24. **Attention should be paid to preserving existing strengths, notably in the fiscal and monetary areas**. Some of the findings raise red flags of possible backtracking on previously well established areas of strength. As greater emphasis is being put on other areas of Fund surveillance (e.g., exchange rate assessments and financial sector issues), vigilance is required to preserve the quality and value-added of the Fund's work its traditional areas of expertise.

25. **A more systematic exploration of risks and tail events is necessary,** especially as they become an increasingly important feature of the macro-financial landscape. Concrete steps that could be taken in this direction include:

- ***An improved toolkit to bring more rigor to quantifiable risk assessments.*** For example, when quantifiable, the selective use of "fan charts" would allow staff to describe risks surrounding the baseline more systematically—akin to techniques currently employed in inflation forecasting by many central banks. Such charts have already been used to good effect in some cases (see Box 2).

- ***In cases with the potential for plausible extreme events with large costs, greater emphasis on tail events and their implications, even if unquantifiable***. When uncertainty dominates and risks cannot be measured, it can be difficult to capture the attention in policy discussions. Yet precisely because extreme events with large costs are often ignored in the domestic debate, surveillance can help focus policy-makers' attention on the need to guard against worst outcome scenarios.[16] While the Fund has demonstrated an ability to push institution-wide preparations for extreme events—such as the "Avian Flu Preparedness" exercise—it can still do more.[17] More multilaterally-driven initiatives on issues relating to external stability may be useful. But in any case staff should ask more "what if" questions on country-specific events in the bilateral surveillance dialogue, with a view to raising awareness more than "calling crises", as the latter is not realistic and would entail costs to the Fund's credibility. Scenario analysis might be helpful for this purpose.

- ***An operational objective for the Statement of Surveillance Priorities.*** Making greater focus on risks and uncertain events an operational priority—and early warnings an overarching objective—for surveillance over the next three years will help align incentives to allocate to this issue the attention it deserves. The Surveillance Committee should help concretely drive this effort.

Box 2. Risk Assessments in Staff Reports

Illustrations of risk assessments in recent staff reports include:

- **Uruguay** (CR/08/45) where staff simulated the probability that—despite the falling debt-to-GDP ratio under the baseline—debt levels would in fact rise. A skewed "fan chart" (¶28) was used to drive home that "larger upside risks reflected in the forecast stem from the historically asymmetric impact of shocks on debt levels."
- **Serbia** (CR/08/54) where Box 2 was devoted to local financial market volatility—particularly due to external spillovers—to caution that policies and contingency plans are necessary to overcome "uncertain political times ... financial and external sector shocks."
- **Japan** (CR/08/253) where staff illustrated the risks to staff's baseline growth scenario again using a fan chart (¶5). Downside growth prospects were further emphasized by simulating a global recession scenario linked to the WEO (¶6).

[16] The point is intuitive to homeowners, who typically take insurance against fire even though the likelihood is minute, given the outsize costs; but experience suggests it is less so to policy makers who may be constrained by the political horizon.

[17] See The Global Economic and Financial Impact of an Avian Flu Pandemic and the Role of the IMF (2006).

III. Exchange Rate Analysis[18]

Key Messages
➢ Significant efforts have yielded noticeable improvements. Nearly all staff reports now contain a clear assessment of the exchange rate level, which, in most cases, is based on reasoned and transparent analysis. Description of the *de facto* exchange rate regime is adequate, and advice on changing it generally well-supported.
➢ Dissatisfaction remains however, along with skepticism about consistency of treatment and methodological soundness. This reflects primarily:
(i) the need for better integration of the exchange rate analysis with the overall macroeconomic assessment;
(ii) a desire for greater transparency in the work underlying exchange rate assessments (rather than "black boxes"); and
(iii) insufficient candor in some cases, potentially reflecting "fear of labeling" after the 2007 Surveillance Decision.
➢ Key recommendations are to stay the course of recent improvements, implement recent guidance consistently, and conduct more methodological work to improve assessments in challenging cases. In addition, exchange rate and external stability assessments are recommended for inclusion in the 2008-2011 Statement of Surveillance Priorities.

26. **This note examines the adequacy of the Fund's exchange rate analysis**—in particular, whether the expectations established with the 2007 Surveillance Decision (hereafter, 2007 Decision) are being fulfilled. It draws on the same sources as the rest of the TSR, plus 13 country case studies selected to illuminate specific challenges (see Appendix I for details) and an overview of exchange rate assessments since the 2007 Decision.

A. Significant Efforts Have Been Made

27. **Significant efforts have gone into improving the quality of exchange rate analysis in recent years,** given momentum by the 2004 Biennial Surveillance Review,

[18] Prepared by a team led by Ketil Hviding and comprising Jung Yeon Kim, Dmitriy Kovtun, Chris K. Marsh, Pedro Rodriguez, and Yan Sun.

when exchange rate analysis became a "priority monitorable objective."[19] The Independent Evaluation Office's 2007 report on the Fund's exchange rate policy advice further stressed the need to: (i) clarify the "rules of the game" of surveillance; (ii) address weaknesses in knowledge and policy guidance; and (iii) improve management of exchange rate work and policy dialogue with member countries. Shortly thereafter, the 2007 Decision provided an updated policy framework, emphasizing external stability as key focus of surveillance and clarifying expectations of exchange rate analysis in staff reports.

28. **These efforts have taken place both at the multilateral and bilateral levels:**

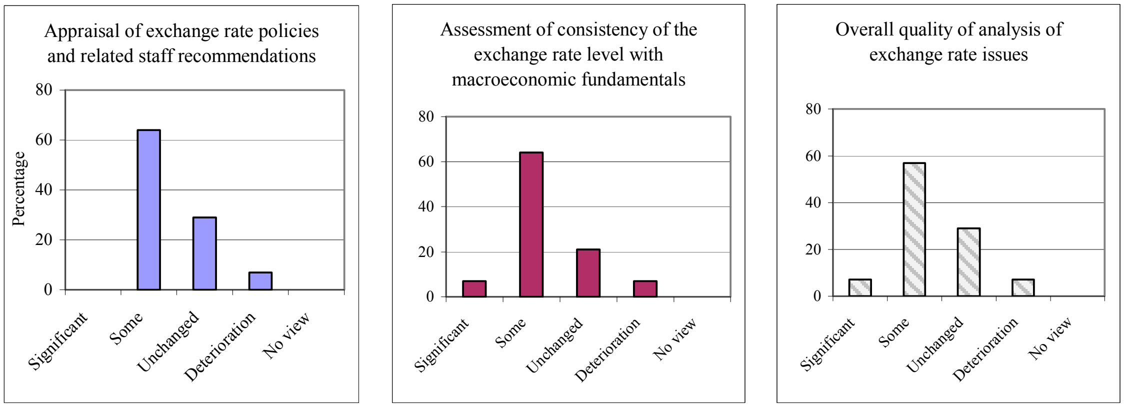
- ***The Fund's multilateral framework***—the work of the Consultative Group on Exchange Rate Issues (CGER)—was expanded in October 2006 beyond industrial countries to include key emerging market economies. Multilaterally consistent estimates are now available for 54 countries using the macroeconomic balance (MB) approach, and for 48 of these also using the equilibrium real exchange rate (ERER) approach. For 27 countries, staff prepares multilaterally consistent summary assessments of the exchange rate level based on the MB, ERER, the external sustainability (ES) approaches, and other country specific factors. This work is being expanded further to oil exporters and LICs.

- ***Bilateral assessments*** have benefited from efforts to raise the quality of exchange rate analysis and dialogue with the authorities, supported, *inter alia*, by increased training. Nearly all respondents to the survey of mission chiefs (98 percent) indicate they paid more attention to exchange rate issues than in "previous years"—of which, about 60 percent "to a large extent " or "to a very large extent." An overwhelming majority (92 percent) noted they discussed the assessment of the exchange rate level more extensively than before. And the number of selected issues papers dedicated to exchange rate issues has increased sharply.[20]

[19] "..a clear identification of the *de facto* exchange rate regime in staff reports and more systematic use of a broad range of indicators and other analytical tools to assess the external competitiveness; and thorough and balanced presentation of the policy dialogue between staff and the authorities on exchange rate issues, particularly when views diverge." See Public Information Notice (PIN) No. 04/95.

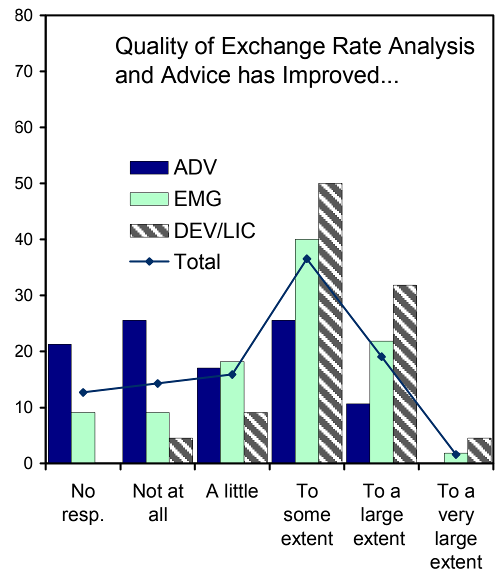
[20] The monthly average of selected issues papers covering exchange rate or competitiveness issues has increased from 1.4 in 2006 and 2.3 in 2007 to 3.4 in the first five months of 2008.

Figure III.1 Executive Directors—Degree of Improvement in the Specified Areas in Recent Years (percent of respondents)



B. These Efforts Have Begun to Bear Fruit, but Challenges Remain

Figure III.2 Survey of the Authorities (percent of respondents)



29. **Survey results suggest that Executive Directors as well as country authorities are generally positive about recent progress.** About two-thirds of Executive Directors responded that there had been some (or more) improvement in the quality of discussion of exchange rate issues (see Figure III.1). About 60 percent of authorities found an improvement in the quality of exchange rate analysis to some extent or more, with low-income country authorities being most positive (see Figure III.2).

30. **Most survey respondents found, however, that further progress is needed.** Only about 50 percent of the Executive Director survey respondents found that either many or most staff reports considered over the last 12 months had met their expectations in quality of analysis of exchange rate issues. Similarly, among financial sector participants, only 52 percent considered that the Fund's exchange rate analysis was better than the average of similar analysis available from other public or private institutions.

Where progress is most visible

31. **Staff's review of Article IV reports suggests the largest gains have been in the clarity and sophistication of the Fund's assessment of exchange rate levels:**

- ***Clarity.*** Nearly all (92 percent) staff reports in the 50-country sample provided a clear assessment of whether the exchange rate was consistent with its fundamental determinants.[21] This compares well with the IEO report's finding of only 63 percent of staff reports (on a 1999–2005 based sample).[22] It is also an improvement on staff's 2006 assessment of the Treatment of Exchange Rate Issues in Bilateral Surveillance (the "Stocktaking Paper") where bottom line assessments were found in 87 percent of the cases.[23]

- ***Sophistication***. The 50-country review found that about half the sample used econometric techniques and that three or more approaches were employed in 56 percent of the reports.[24] A similar proportion of reports provided an adequate assessment of the exchange rate level in terms of its sophistication/depth, disclosure of key information, information used, and internal consistency (hereafter, a "robust" assessment). Again, this compares well with the IEO report—which found that only 8 percent of the reports used multiple methods[25]—and the 2004 BSR—which found that "the use of a broad range of competitiveness indicators [...] or of econometric methods [...] was not common."[26]

32. **Improvement along both of these dimensions is particularly evident for more recent reports.** For the half of the 50-country sample where reports were issued after September 1, 2007: (i) 96 percent of reports contained a clear assessment of the exchange rate level (compared with 92 percent for the full sample); (ii) 68 percent backed the assessment with adequate analysis (compared to the full sample's 56 percent); and (iii) 72 percent of assessments were based on three or more techniques (compared to the full sample's 56 percent).

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[21] This results contrasts with the finding from a review focusing only on how the executive summary and staff appraisals could be perceived by the average college-educated reader, which find a clear bottom line on exchange rate level and policies only in about two-thirds of cases. This may suggest that while technical assessment is clear, some further work on improving communication is needed.

[22] Page 73 in the Background Document 4 of the *IEO report on IMF Exchange Rate Policy Advice*.

[23] *Treatment of Exchange Rate Issues in Bilateral Surveillance—A Stocktaking*.

[24] For example: (i) analysis of basic indicators such as REER, market shares, profitability, etc.; (ii) discussion of current account sustainability; (iii) PPP comparisons; (iv) using CGER assessment; (v) external sustainability assessment; (vi) econometric techniques such as MB or ERER; and (vii) other techniques.

[25] Page 70, *An IEO Evaluation of IMF Exchange Rate Policy Advice, 1999-2005*, Independent Evaluation Office, 2007.

[26] Paragraph 74, Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision, Modalities of Surveillance.

33. **Article IV reports' assessment of <u>exchange rate regime</u> and <u>policies</u> is broadly satisfactory**:

- 96 percent of the 50-country sample provided a **clear description** of the *de facto* exchange rate regime, which compares favorably to the 2004 BSR finding that the *de facto* regime was nearly always simply recorded as identical to the *de jure* regime.[27]

- 71 percent of these reports provided a **reasoned appraisal of the *de facto* exchange rate regime**. In cases where staff recommended a change in regime, staff still seemed to favor increasing exchange rate flexibility—as noted in both the 2004 BSR and the IEO report. This, however, should not necessarily be seen as demonstrating an undue bias toward flexibility: (i) in all of these cases staff provided sufficient analytical support for the advice; and (ii) reports for countries with flexible regimes were no less likely to contain a reasoned appraisal of the regime (73 percent) than reports for countries with fixed exchange rate regimes (68 percent).

- Among cases where the regime allows for discretionary **exchange rate policies** (24 out of the 50 reports), 88 percent of reports included a reasoned appraisal of these policies. About a third provided clear recommendations to adjust the policy, mostly toward more exchange rate flexibility. Argumentation, which was provided for all of these cases, included facilitating adjustment to shocks, increasing effectiveness of monetary policy, or alleviating inflation pressures.

Where improvements are needed

34. **Interviews with country authorities revealed significant dissatisfaction with staff's efforts to assess exchange rates against an equilibrium value**. Several of the country authorities interviewed complained about the uses made of CGER and similar econometric analysis.[28] Many considered that this work was applied too mechanically and that it was given too much attention in the exchange rate assessment. Some also complained about evenhandedness in the treatment of exchange rate issues (see Box 3 for a discussion of evenhandedness in exchange rate assessments).

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[27] Paragraph 72, Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision, Modalities of Surveillance.

[28] Authorities' comments typically did not distinguish between the CGER exercise and "CGER- type" cross-country analysis employed in Article IV reports though in most cases it is likely they were geared at the latter.

Box 3. Is the Fund's Exchange Rate Assessment Evenhanded?

An evenhanded exchange rate assessment requires that only relevant factors influence the Fund's assessment. Thus, variables such as economic size, income level, and exchange rate regime should only matter to the extent they can be deemed to be relevant for the assessment.

The issue of evenhandedness in the Fund's assessment of exchange rate levels was approached in two main ways:

An in-depth review of the case studies revealed the Fund's assessment of exchange rate levels in similar countries to be largely evenhanded. The special status of the two financial centers included in the study (Switzerland and Hong Kong) was recognized in both of the cases included in the sample: in both cases, the large current account surpluses were considered a consequence of the countries' special status as financial centers. Similarly, despite a current account surplus of similar magnitude, the Fund raised more concerns about undervaluation in Saudi Arabia than in Botswana, largely reflecting the much more rapid depletion of Botswana's non-renewable resources. The treatment of the capital inflow countries was also found to be largely consistent as the large current account deficits were either considered to be largely a consequence of temporary factors (Bulgaria) or that the inflows were considered to be a reflection of a sustainable situation (Jordan and the ECCU).

An econometric review of all cases since the 2007 Decision reached a similar conclusion (Appendix II). The evenhandedness of treatment across different countries was assessed by looking for any signs that the Fund's assessment of the exchange rate level (over- or undervaluation or no misalignment) had been influenced by irrelevant factors. A simple logit analysis of the Fund's exchange rate assessment since the 2007 Decision came into effect was conducted on a "relevant factor"—the country's current account balance (in percent of GDP)—and several more or less "irrelevant factors"—a country's size (U.S. dollar GDP), per capita income level (U.S. Dollars), and exchange rate regime. Only the current account balance was found to be significant at the 5 percent level; size was found to be significant only at the 10 percent level, indicating that the exchange rate of larger countries may be more likely to be found misaligned than their smaller peers. Overall, the econometric results do not point to lack of evenhandedness, consistent with the observation that the currencies of all four major economies (China, the United States, the Euro Area, and Japan) have been found misaligned in recent years, as well as a number countries with high GDP per capita.

However, both approaches are very crude, and there are elsewhere indications of some lack of evenhandedness. The case study was based only on 13 countries, and the regression analysis only looks at the effect of crude dimensions of "discrimination," leaving out more subtle ways in which lack of evenhandedness could manifest itself. Separately, a review focusing on non-economist readers' perception of the bottom line assessments of exchange rate issues found that it was slightly less clear for advanced countries than emerging and developing countries (see Chapter VIII, ¶127). Finally, evidence of some bias in staff's assessments toward finding exchange rates in line with equilibrium suggests countries in materially different circumstances receive the same assessment, which also contravenes evenhandedness.

35. **The authorities' concerns likely reflect in part shortcomings in integrating exchange rate analysis with the overall assessment of macroeconomic stability.** The case studies reveal that this concern relates both to surplus and deficit countries: (i) for deficit countries, staff reports often discuss the need to improve competitiveness in the face of a large current account deficit, yet the real exchange rate is considered "broadly in line with the fundamentals" without further discussion of this possible inconsistency; and (ii) for surplus countries, the link between a potential undervaluation of the real exchange rate and inflationary pressures is not always adequately discussed. As a result, in some reports, the exchange rate assessment comes across as a formality, rather than a source of insight into the economic situation and appropriate policy responses. This assessment is consistent with the finding from the staff report review that significantly fewer staff reports presented a clear assessment of present and prospective external stability than a clear bottom line assessment of the exchange rate level (78 against 92 percent).

36. **Another ground for these concerns revealed by the review is that, too often, assessments are presented as a "black box," albeit there too there is progress.** The presentation of underlying assumptions or key features of methodologies was found inadequate for 22 percent of staff reports in the 50-country sample. In several cases, staff reports presented the assessment made by CGER without further discussion. In others, results of econometric work were referenced without sufficient technical detail—in the staff report or available background documentation—for the reader to draw an informed view. While it would not be useful to describe comprehensively in staff reports every detail of the analytical work, key information on assumptions and methodology is needed to allow Executive Directors and other readers (i) to assess whether staff's assessment is valid and (ii) to make comparisons across countries to assure consistency of analysis and evenhandedness. That said, there still seems to have been improvement: the IEO found that no details were given on how results were obtained in 27 percent of the cases.[29]

37. **Such lack of transparency is understandably worrisome considering the challenges in ensuring that assessments are analytically sound and operationally consistent.** Two in particular must be acknowledged:

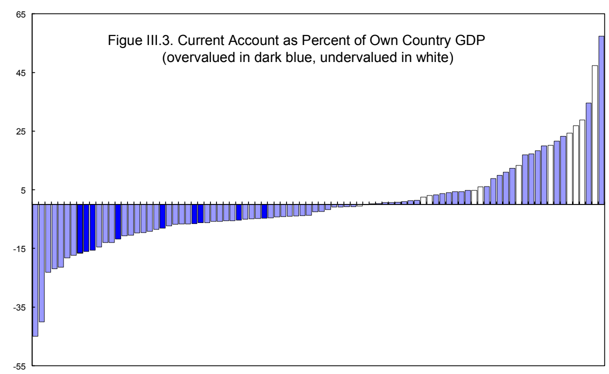
- First, staff's exchange rate assessments are not conducted in a way that ensures **global consistency.** Of course, global consistency is ensured in CGER assessments, which cover countries representing 90 percent of global GDP and 80 percent of global trade flows. However, assessments made in surveillance may differ from CGER's, as country-specific factors are incorporated. And in the rest of the membership, despite increased use of cross-country techniques, no guarantee for such global consistency exists—indeed the wide scope for use of country-specific terms in regressions works

[29] Annex A5.1, question 9 on page 81 of Background Document 5 of the IEO report.

in the opposite direction. Since the 2007 Decision came into effect, the number of assessments of "over-" and "undervaluations" are roughly equal, both unweighted in absolute terms and weighted by the size of their external current imbalance, but there is a need to ensure this occurs through consistent analysis rather than purely by chance. This is particularly important since CGER does not cover some countries with large imbalances.

- Second, for specific types of countries that together account for a significant share of the membership, **standard assessment methodologies** are not well suited and innovations are needed—raising the persuasion bar. The case studies shed light on how staff has dealt with exchange rate issues in: (i) non-renewable resource exporters (Box 3); (ii) large financial centers; (iii) cases with large and sustained capital inflows;[30] and (iv) cases—frequent among LICs— with poor data availability and an economic history with repeated structural breaks and significant distance to the steady state (Box 4).[31]

38. **More fundamentally, the relatively large share of exchange rates assessed to be "broadly in line with fundamentals" raise questions about quality, candor, and evenhandedness**. A very large proportion of exchange rates assessed since the adoption of the 2007 Decision were considered to be "broadly in line with fundamentals" despite large current account imbalances (see Figure III.3):



- The bias may, to some extent, reflect the use of methodologies that—due to lack of good cross-country explanatory variables—have to rely on a country's own (or similar countries') current account or exchange rate history. Thus, a country that has been running a large current account imbalance for some time is generally considered to have a larger current account deficit norm than countries with a different history. Cross-country regressions including countries with

[30] Large and sustained capital account inflows tend to be reflected as an overvaluation in traditional exchange rate models. Indeed, they tend to put upward pressure on the real exchange rate. However, the crucial question is thus whether such inflows are sustainable since they enhance productivity in the export sector. Three of the cases included in the case study sample included a serious attempt to assess the exchange rate level using econometric methods, but the assessment of the sustainability of inflows could have been strengthened.

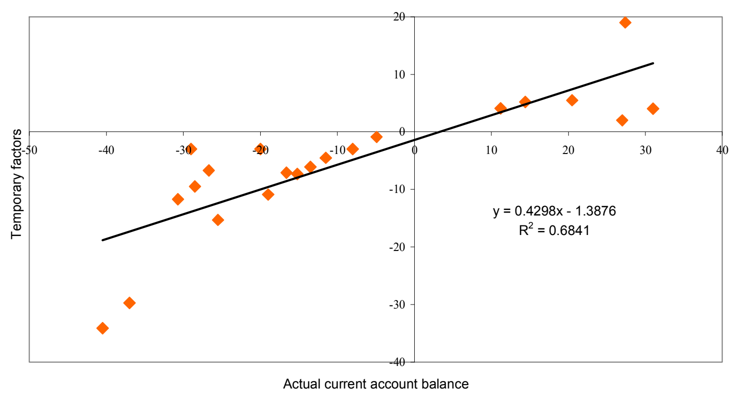
[31] Econometric methodologies often cannot be used in such cases, but careful use of other indicators can partly compensate for this (see Box 4).

very different current account deficits—as in CGER—should help counteract this bias.

- Another bias found is a tendency to explain away imbalances through recourse to temporary factors. An ad hoc internal study of 21 cases in early 2008 showed a strong correlation between the size of the current account imbalance and the estimated "temporary factors" (see Figure III.4). Indeed the temporary factors always served to reduce the estimated imbalance: in no case did the temporary factor result in a larger estimated "underlying current account balance" (deficit or surplus) than the actual current account balance.[32]

39. **This suggests that staff's assessments are biased toward accommodating large imbalances, perhaps driven by fear of the "labeling" introduced for the most worrisome cases by the 2007 Decision**. Such a bias would imply that staff is not delivering the best possible analysis, and, moreover, that it is delivering *similar assessments* for countries in *different circumstances*, which would run against evenhandedness. Evidence suggestive of "fear of labeling" can be found in the mission chief survey and in the protracted delays in completing several Article IV consultations:

Figure III.4. Actual Current Account Balance vs. Temporary Factors: 2007
(percent of GDP)



1/ Temporary factors= Actual CA minus the Underlying Current Account Balance

- Almost one in five mission chiefs considered that the "need to preserve quality relationships with the authorities" had—to some extent or more—posed a challenge for the full treatment of the discussion of exchange rate issues in the staff report. Over a quarter considered that the authorities' unwillingness to discuss certain issues had posed a similar challenge.

- The long delays in completing a number of Article IV consultations where "fundamental misalignment" was being discussed may also point to "fear of labeling"—although the length of these proceedings could also be seen as indicative of how carefully each side considered the arguments of the other.

[32] This is reflected in the fact that Figure III.4 has no observation in quadrants 1 and 3.

Box 4. Exchange Rate Assessments in LICs

Data issues often represent a significant problem for exchange rate assessment in LICs. This may particularly cause problems for the use of econometric methods, which are in most cases data-intensive and sensitive to structural shifts. However, the case studies on Guinea, Guyana, and Vietnam suggest that the challenges of data deficiency can partly be overcome through an indicator-based exchange rate analysis taking into account a broader set of data and economic developments:

In the case of **Guinea,** staff considered that the real exchange rate was consistent with good prospects for mining exports as a result of major investments. Staff used three different variations of the equilibrium exchange rate approach (one single-equation and two panel regressions) to assess the equilibrium level of the real exchange yielding a range of different results, from overvaluation to undervaluation, broadly supporting the indicator based assessment.

In the case of **Vietnam,** staff largely relied on the macroeconomic balance approach because other approaches were not possible due to structural changes and lack of long-run cointegrating relationship for the real effective exchange rate. However, staff referred to the strong expansion of non-oil exports, FDI and other private capital inflows to support its position.

40. **Frank and effective exchange rate surveillance depends not only on the candor of staff's statements to the Board or the public, but also on the clarity of the Board's positions.** While staff and management are responsible for providing clear and persuasive assessments to the Board, it is the Board's discussion that ultimately determines the Fund's message carried to the member and published. Moreover, the Board's attitudes set crucial incentives for staff. A comparison of the staff appraisal and summings up in countries that were considered over- or undervalued since the 2007 Decision show that in about half of the cases the summing up presented a less clear bottom line on exchange rate issues than the staff appraisal. In most of these cases, the summing up seems to indicate that the Board did not fully endorse staff's assessment about over or undervaluation as the summing up stated that the Directors just "noted" staff's exchange rate assessment (despite a clear statement in the staff appraisal).

Box 5. Exchange Rate Assessments in Exporters of Non-renewable Resources

Assessing the level of the real exchange rate is particularly challenging in economies exporting non-renewable resources. In traditional methods, a country's decision to save revenues from the extraction and sale of non-renewable resources tends to be seen as resulting in excessive savings and a real exchange rate misalignment. Staff's assessment of the equilibrium real exchange rate will therefore depend crucially on a view of the level of external savings consistent with external stability, both for the country in question (if it saves "too little") or for other countries (if it saves "too much").

Fund staff has undertaken research to overcome the limitations of traditional methods. These efforts have focused on ways to assess the exchange rate in the context of an inter-temporal allocation model that explicitly recognizes exhaustibility of resources.[1] Depending on the estimated value of the resource, its extraction rate, population's time preferences, risk aversion, and intergenerational equity principles, an optimal current account surplus can be derived. In the framework of the 2007 Surveillance Decision, this could form the basis for the staff's estimate of the "current account norm," and be compared to the actual current account balance, adjusted for temporary factors, to provide an assessment of whether the exchange rate is misaligned or not. While the resulting current account norm depends heavily on the parameter choice of the model, it provides a useful benchmark.

The case study provides three examples of staff's exchange rate analysis in exporters of non-renewable resources:

- In *Botswana*, an explicit evaluation of the sustainability of the mineral resource was made. The 50-year annuity value of the mineral resource was used to derive a sustainable non-mineral current account deficit and a corresponding norm. As the underlying current account balance was in line with its norm thus estimated, the real exchange was not considered to be misaligned.
- In *Russia,* the exchange rate assessment was based largely on the CGER assessment complemented by a study of wage competitiveness, with no special treatment of the natural resource considerations. The real exchange rate was assessed as still moderately undervalued albeit with a possibility of overshooting the equilibrium. While Russia's petroleum reserves are large, the ratio of non-renewable exports to GDP is lower than that of most other major resource exporters.

[1] See, for example, Thomas et al (2008) "Equilibrium Non-Oil Current Account Assessments for Oil Producing Countries," IMF Working Paper, and Bems and Filho (forthcoming) "Saving and Precautionary Motive for Exporters of Exhaustible Resources," IMF Working Paper.

Box 6. Are Exchange Rate Assessments Presented Candidly?

A key purpose of revising the Surveillance Decision was to increase the candor and clarity of the Fund's exchange rate assessments. By clarifying expectations concerning the treatment of exchange rates, it was hoped that staff would be more forceful in bringing often sensitive exchange rate issues to the table. Has this happened?

Nearly all mission chiefs claim that the discussion with the authorities on exchange rate issues was candid, but it is not clear whether this applies to the staff report: nineteen percent of respondents to the mission chief survey indicated that the need to preserve a good relationship with the authorities posed a challenge to their treatment of exchange rate issues in the staff report.

An in-depth comparison of case study reports shortly before and after the 2007 Surveillance Decision suggests that its impact on the candor of the presentation in staff reports has been mixed. While, overall, the degree of candor seems to have increased, in some cases the impact on candor is much harder to discern:

- In a majority of the cases, the clarity of staff statements on the exchange rate issues have increased somewhat, in particular regarding the bottom line assessment of the exchange rate level. The degree of clarity in staff's assessment of the exchange rate regime and policy advice was comparable before and after the Decision. Moreover, a comparison of internal documents and staff reports showed no clear discrepancy between staff's internal assessment and the assessments presented in the staff reports.
- In a few cases, developments in candor were harder to read. The cases of the U.S. and Japan, where candor was already very high before the Decision, are good illustrations: [2]

➢ *United States.* From 2005 to 2007, despite a broadly stable current account deficit and only a 5 percent drop in the real effective exchange rate, the Fund's assessment of the exchange rate overvaluation became more conditional. In the 2005 and 2006 staff reports, the real exchange rate was considered "significantly overvalued,"—by 15 to 35 percent according to the 2006 report—but the 2007 report used less direct language, saying that "a further real effective depreciation of 10-30 percent would be required to eliminate the misalignment relative to medium-term fundamentals." The 2007 report does, however, provide a richer discussion of capital account developments motivating the more nuanced position.

➢ *Japan.* Despite a significant depreciation of the real exchange rate, the 2007 report uses somewhat weaker language on the estimated undervaluation ("the yen appears to be misaligned relative to its long-term value in real effective terms" and "the yen remains undervalued relative to its estimated medium-term level") than the 2005 report ("the yen remains *significantly* undervalued"—emphasis added). However, the assessment in the 2007 report is also more precise as it provides numerical quotes of the CGER estimates and the exchange rate assessment is presented more prominently in the staff appraisal. Moreover, as for the U.S., the 2007 report provides a more elaborate discussion of the capital account and the expected external adjustment process.

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[2] Quotes on the United States are from Box 2, 2005 Article IV staff report (CR/05/257), para. 34, 2006 Article IV staff report (CR/06/279), para. 17, 2007 Article IV staff report (CR/07/264) Quotes on Japan are from para. 9, 2005 Article IV staff report (CR/05/273) paras 14 and 43, 2007 Article IV staff report (CR/07/280).

C. The Way Forward

Keeping up the effort

41. **Major steps were taken toward the end of the period covered to ameliorate these challenges.** In particular, detailed "hands-on" operational and methodological guidance has been disseminated to country teams.[33] This should help strengthen consistency and uniformity of treatment. Further, the new two-step procedure for engagement with members provided for by ad hoc consultations should allow for discussions to take place in a more formal setting without undue haste in reaching conclusions that would require the use of labels, thereby helping reduce "fear of labeling."

42. **The staff's analytical capabilities have improved significantly, paving the way for more progress** as good practices get disseminated and applied to a broader range of countries. Such an expansion is welcome and should be further encouraged. Preferably, however, this work should build on a globally consistent framework such as CGER, which despite its large coverage in terms of world GDP and trade flows is not sufficient to ensure global consistency of bilateral assessments

Integrating exchange rate analysis with the overall assessment of the macroeconomic situation

43. **The pursuit of a clear bottom line on the level of the exchange rate should not detract from integrating this assessment with the overall macroeconomic analysis.** The review underscores that the purpose of the exchange rate assessment is to provide insight into economic developments and policies. Conversely, the exchange rate assessment will not be plausible unless framed in the context of a comprehensive assessment of the economic situation and the forces driving the real exchange rate. It is even possible that in some consultations, *too many* resources were devoted to fine-tuning the exchange rate assessment, to little marginal benefit for the overall analysis. As emphasized in the operational guidance, there will be cases where sophisticated methods are not necessary for this purpose.[34]

[33] Please see the "Guidance on Operational Aspects of the 2007 Surveillance Decision," August 4, 2008. CGER-related material, guidelines on conducting exchange rate analysis for non-CGER countries, and templates have also been made available to desks.

[34] As noted in the *Frequently Asked Questions* section of the Guidance, "where no significant temporary factors are considered to be at play and the [current account] is consistent with an evolution of net external assets that does not cause any particular concern, the discussion can be brief, focused on establishing these two facts."

Pushing further the methodological frontier

44. **Research efforts must continue to be invested to address the methodological gaps identified above.** The mission chief survey indicates that the lack of adequate and readily available analytical tools and data had posed a challenge for the full treatment of the discussion of exchange rate issue in their staff reports: 49 percent of the respondents answered that the lack of such tools and data had posed such a challenge "to some, a large, or a very large extent." This research should also be combined with improved dissemination of in-house knowledge.

45. Including ***exchange rate analysis and external stability risks****—clearer and more robust discussions to be provided in all staff reports, underpinned by further progress in refining assessment methodologies*—among the operational priorities highlighted in the 2008–2011 Statement of Surveillance Priorities should contribute to align incentives in support of this objective.

Selection of Case Studies

Thirteen case studies were chosen to shed light on issues that have surfaced in Executive Board discussions and in the internal review process—in particular, quality and evenhandedness issues.

The selection was made among members for which the Article IV mission began after June 15, 2007—the date the 2007 Surveillance Decision came into effect—and consultation ended before end-July 2008, to reflect the following dimensions:

- *Global imbalances*. The three countries with the largest external imbalances (absolute value of 2007 current account balance) in percent of world GDP were chosen: United States, Japan, and Saudi Arabia.

- *Capital flows.* Selected on the basis of total capital inflow as a share of GDP. Total capital inflow was defined as the current account deficit plus reserve accumulation: Bulgaria, ECCU, and Jordan (the top three) were chosen.

- *Non-renewable resources.* Since Saudi Arabia was already included (above), the non-fuel exporter with the largest surplus of non-renewable exports (2007 data) was added: Botswana. Russia was added as the only country with significant exports of non-renewable resources also covered by the CGER assessment.

- *Financial centers.* The financial centers—countries with a "financial center dummy" in CGER—with the largest 2007 current account surplus in percent of GDP were selected: Switzerland, and Hong Kong.

- *Data issues and underdeveloped financial markets.* Finally, PRGF-eligible countries where the Article IV staff report or ROSC had identified external sector data problems were considered. The countries with the largest current account imbalances in terms of GDP were selected: Guinea, Guyana, and Vietnam.

A LOGIT ANALYSIS OF "EVENHANDEDNESS"

To analyze the influences on staff's findings of over- or undervaluation, a multinominal logit model was applied to staff's assessment of real exchange rate levels since the 2007 Surveillance Decision came into effect.[35] The model was used to test what country-specific factors (right hand side variables) influence the probability of staff's exchange rate assessment: "1" for overvalued; "0" for no misalignment; and "-1" for undervalued. In logit models (as opposed to probit), logarithmic transformations of the RHS variables (except for dummies) are performed.

The RHS variables were: (i) the size of the current account (CA) as a share of GDP; (ii) PPP-based per capita income in U.S. dollars; (iii) PPP-based nominal GDP in U.S. dollars; (iv) a dummy for exchange rate regime ("1" for floating); and (v) a dummy for the export of nonrenewable resources ("1" for exporter).

Multinominal Logit Analysis of Evenhandedness 1/

	Undervalued (-1)		Overvalued (+1)	
	Coefficient	Elasticity	Coefficient	Elasticity
Current account (percent of GDP)	0.070*	0.0066*	-0.069*	-0.0045*
PPP GDP	0.0007	0.00006	0.0006**	0.00003
PPP GDP per capita	-0.00002	-0.000002	0.00004	0.000002
Ex rate regime (dummy)	0.19	0.016	0.10	0.0045
Nonrenewable export (dummy)	0.64	0.067	-0.64	-0.038

1/ Constant not shown. Elasticities are calculated separately since the model is nonlinear. The elasticity records the influence of a discrete change of a dummy from 0 to 1.

* Denotes significant at 5 percent level ** Denotes significant at 10 percent level

[35] The total sample included 103 cases, 24 of which were found to have unambiguous statements of over- or undervaluation.

The multivariate regression results are shown above, with "no misalignment" as a baseline. The model does not reveal evidence of lack of evenhandedness: the only coefficient found to influence the probability of being found misaligned at 5 percent significance level is the current account as a share of GDP. Not surprisingly, a larger current account raises the probability of being found over- or undervalued. However, country size or per capita GDP are not a significant influence on the exchange rate finding. Likewise, dummies reflecting relative flexibility of the exchange rate regime and whether the economy is an exporter of nonrenewable resources are not significant. The measure of country size is found to have some influence on the probability of being found overvalued at the 10 percent significance level—though this does not carry over to the elasticity calculation.

IV. Bilateral Financial Sector Surveillance and Macro-Financial Linkages[36]

Key Messages

- Reflecting increased attention and resource allocation, Financial Sector Surveillance (FSS) in Article IV consultations has improved significantly over the past few years, particularly the coverage and diagnosis of financial sector vulnerabilities.
- Both the official and private sectors see the Fund's FSS as "adding value," but more is needed to fulfill expectations: in refining financial stability assessments and, even more, in improving analysis of the two-way risk transmission between the financial sector and the real economy, including across borders.
- Investment in financial sector expertise is key to better results, but is costly. This puts a premium on further strengthening the Fund's FSS capacity over the medium term through training and more flexible HR policies. Tight budget constraints imply a sharp trade-off between the quality and quantity of FSS in the shorter term, and the need for more strategic and efficient use of specialized financial sector expertise.
- Efforts need to focus on mainstreaming current best practices —by developing a clear and flexible organizing framework for macro-financial surveillance in Article IV consultations; clarifying expectations with regard to financial sector coverage in staff reports (including through the FSS guidance); and further developing the FSS toolkit (reflecting a growing need for increasingly complex diagnostics and policy analysis).

A. Introduction

46. **Financial sector surveillance (FSS) has become a core area of Fund surveillance**, focusing primarily on macro-financial linkages and risks, as well as on institutional weaknesses and vulnerabilities. As emphasized by the Managing Director, "...the Fund is uniquely placed to advance the understanding of macro-financial linkages, make the right connections between events and trends, and provide early warning of problems to our members."[37] The recent subprime crisis is a reminder of the importance of financial sector issues for the macroeconomic stability of individual countries, as well as globally. Article IV consultations remain the Fund's primary instrument for ongoing, systematic FSS of individual countries, while the voluntary Financial Sector Assessment Program (FSAP)

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[36] Approved by Mark Allen/ Reza Moghadam and Jaime Caruana. The main authors of this paper are Anna Ilyina (SPR) and William Lee (MCM), with inputs from Sutapa Amornvivat, Dmitriy Kovtun (both SPR) and Andrea Maechler, Mariano Cortes (both MCM).

[37] *"The Managing Director's Statement on the Work Program of the Executive Board; June 18, 2008"*, .

provides the vehicle for comprehensive, in depth, but lower-frequency assessments necessary to underpin the more continuous FSS.

47. **This paper reviews progress with FSS in Article IV consultations, assesses its current state, and identifies areas for further improvement**. It also follows up on the recommendations of the Financial Sector Task Force (FSTF) on how to improve the *content* and *process* of FSS in bilateral surveillance by (i) using the broad organizing framework for the content of FSS in Article IV consultations proposed by the FSTF (see Appendix 2) as a benchmark in the review of staff reports, and (ii) assessing implementation of the FSTF recommendations in cases with MCM's intensive involvement (henceforth, MCM case study Article IV consultations, see Appendix 1).[38] In addition to sources common to the whole TSR, this paper draws on a review of 20 MCM case study Article IV consultations (10 of which are also part of the 50-country sample).[39]

B. What Has Been Achieved so Far?

48. **FSS in Article IV consultations has received significantly more attention and resources Fund-wide in the past two years or so.** Hard data on time allocated to FSS for the Fund as a whole are not available, but indirect indicators are suggestive: (i) FSS figured prominently in area department business plans for FY06-FY08; (ii) 81 percent of mission chiefs who responded to the survey indicated that they paid more attention to FSS than in previous years (of which more than half to a "large" or "very large" extent); (iii) "in house" financial sector expertise was consolidated (MFD and ICM were merged in 2006) and reoriented toward greater support of bilateral surveillance (Box 7).[40]

49. **There are indications that the increased attention and resources allocated to FSS in Article IV consultations have paid off, delivering much improved financial sector analysis:**

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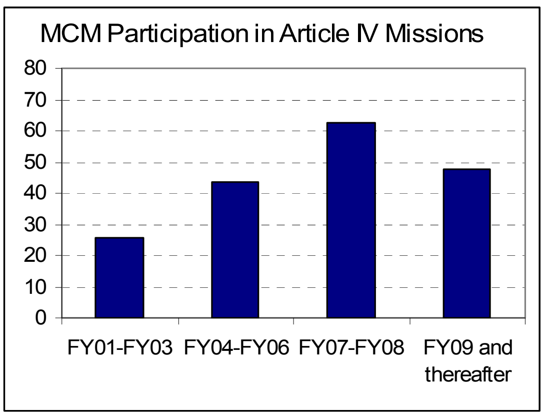
[38] The Financial Sector Task Force (FSTF) was set up in 2006 and charged with examining how the Fund can improve its analysis of financial sector issues and better integrate financial sector analysis into Article IV surveillance.

[39] See Supplement 2, Chapter I for details.

[40] See Supplement 2 for detailed information on the TSR surveys (Section IVD) and document review (Section IVB).

- **Key audiences have noticed an improvement:** At least two thirds of EDs who responded to the survey note at least "some" improvement in the coverage of financial sector and macro-financial issues in Article IVs with advanced (ADV) and emerging market countries (EMC), with this proportion standing closer to a third for developing countries (DEV). About a quarter of country authorities also note a "large" or "very large" improvement in the quality of financial sector analysis and advice compared to previous Article IV cycles.

Box 7: MCM's Support to Bilateral Surveillance



MCM support of FSS in Article IVs also expanded significantly, though this will now have to be scaled back again, following the Fund-wide downsizing exercise. For FY07 and FY08, MCM participation in Article IV missions averaged around 63 per year, compared to an average of about 44 per year in the FY04 – FY06 period, and about 25 per year in the preceding 3 financial years. In addition, for FY08 in particular, MCM put emphasis on more intensive support than normal for a subset of countries (see Appendix 1). For FY09 and beyond, however, MCM will be planning for some 45-50 Article IV mission participations in the tighter budgetary environment that now exists.

In addition, when MFD and ICM were merged into MCM in late 2006, the new department was organized to facilitate better support for area department work, in line with the FSTF recommendations to strengthen the process of FSS (see Appendix 2). "Regional" divisions aim to ensure more continuous and coordinated support to area departments, including more involvement earlier in Article IV cycles, and more effectively tap the specialist expertise in MCM's "functional" divisions on an ongoing basis. More systematic processes were established or strengthened to prioritize MCM Article IV participation, and to plan the support requirements from functional divisions. Further, a significant investment in desk-based FSS by the regional divisions resulted in, *inter alia*, the preparation of *MCM background notes* for a large number of countries that, though experimental and varied by region, provide a "baseline assessment" of financial stability issues and key developmental matters, as well as an overview of priority issues for future monitoring and analysis. For MCM purposes–especially as a convenient store of institutional memory – these notes thus combine what the FSTF formulated as two separate outputs, namely the "baseline assessments" and "financial sector strategy notes." A number of area department desks have also produced similar sorts of background notes, with input from MCM. For example, MCM contributed financial sector material for the strategy notes prepared for a number of AFR countries under the "Lipsky-Daboub Initiative."

- **A comparison with the findings of 2004 Biennial Surveillance Review (BSR) also suggests notable progress**, although direct comparisons are complicated by a much higher level of expectations set out by the FSTF (see Appendix 2). The 2004 BSR found that the scope of financial sector coverage varied substantially across countries, and that summary assessments were not always demonstrably backed up by evidence and analysis, with provision of financial soundness indicators (FSIs) varying across country groups. By contrast, the TSR review of the 50-country sample of staff reports finds that (i) all Article IV reports provide at least basic coverage of main financial sector issues; (ii) provision of FSIs has become nearly universal, with 80 percent of reviewed staff reports using FSIs as part of their assessment of financial sector vulnerabilities (Table 1); and, (iii) all reports for which a *recent* FSAP was available provided adequate coverage of its findings, and most (9 out of 11 cases) used the FSSA as an information source for analyzing financial sector vulnerabilities.[41]

C. How Far Are We From Where We Need To Be?

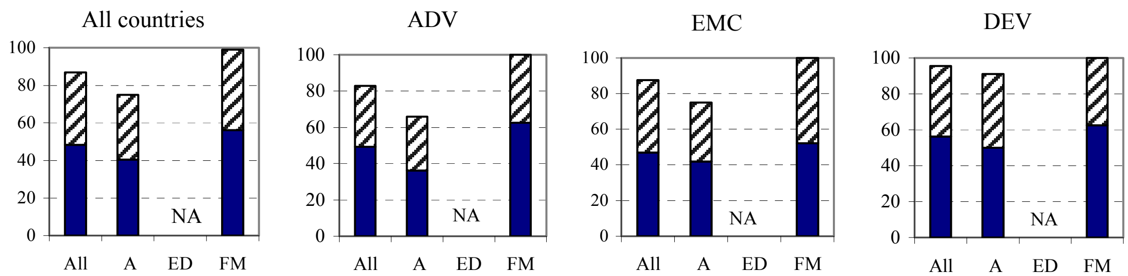
50. **FSS now generally attracts favorable assessments, but more is increasingly expected of it.** Both the official and private sectors see the Fund's FSS as "adding value" (Figure IV.1). About 40 percent of country authorities who responded to the staff survey indicated that surveillance contributes to a "large" or "very large" extent to their understanding of financial sector issues. Similarly, the survey of financial market participants suggests that the Fund's analysis of financial sector issues tends to be "better than average" (compared to similar type of analysis available from other public and private institutions). At the same time, the quality of FSS seems to fall short of the expectations of many Executive Directors: at most half of respondents to the survey (14 out of 24) say that FSS met their expectations in "most/many" Article IV reports discussed over the past 12 months.

[41] This represents an improvement on the situation found by the IEO in its 2005 review that reported problems with the coverage of FSAP results in the accompanying Article IV documents in about 20 percent of reviewed cases (25).

Figure IV.1: Stakeholders' Surveys on the FSS Areas Where Staff Reports Add Value

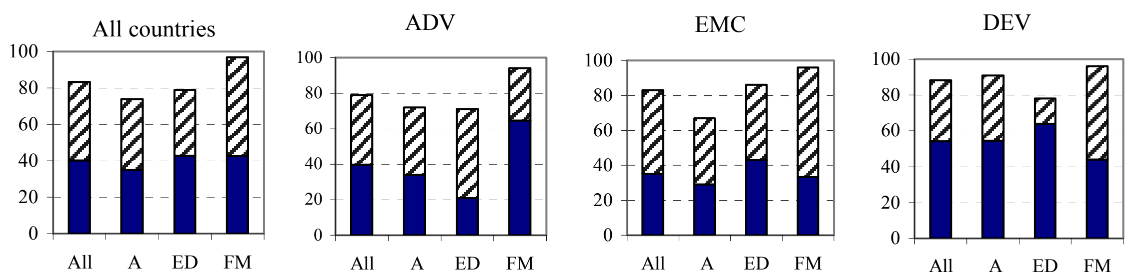
Financial sector vulnerabilities

(percentage response rates: solid ="significant contribution" and striped = "some contribution"
All = "All audiences"; A = "Authorities"; ED = "Executive Directors"; FM = "Financial Market Participants")



Macro-financial linkages

(percentage response rates: solid ="significant contribution" and striped = "some contribution"
All = "All audiences"; A = "Authorities"; ED = "Executive Directors"; FM = "Financial Market Participants")



Note: Significant contribution includes responses "To a large (great) extent" and "To a very large (great) extent" from the Authorities' (Executive Directors') survey and "Significant contribution" from the Financial Market Participants survey.

51. **While there is room for further strengthening the diagnosis of financial sector vulnerabilities, the biggest challenges relate to tracing through macro-financial linkages.** Both the review of staff reports (whose findings are further detailed below) and stakeholder surveys confirm that surveillance is significantly better at assessing financial sector vulnerabilities than at analyzing real-financial risk transmission channels. This is consistent with the experience of mission chiefs: two-thirds of survey respondents identify the latter as one of the two most challenging financial sector issues to cover in Article IV consultations, against 54 percent for vulnerabilities.

Diagnosing financial sector vulnerabilities

52. **Diagnostic evidence and clarity of key messages to inform the reader about the nature and extent of *financial sector vulnerabilities* could be further improved**. The

review of staff reports found that about 40 percent did not provide a clear assessment of financial sector vulnerabilities. These reports typically lacked sufficient evidence or analysis (including of a quantitative nature), or contained overly hedged statements. While supporting analysis need not always be highly technical, it should ideally include empirical evidence to convey the relative importance of emerging trends, or cross-country comparisons. Besides insufficient diagnostic evidence, the excessive hedging of bottom line assessments in staff reports may also reflect the Fund's "culture." A broader acceptance that clearer bottom lines are needed may require a shift in mindset within the Fund—tempered by the need to remain credible. As always, concerns about market sensitivity could be handled through deletions from published reports under the Fund's transparency policy.

53. **Market-based indicators and more advanced quantitative tools and indicators should be used more, bearing in mind their limitations.** While basic—and mostly backward-looking—FSIs are used in most staff reports, more rigorous and forward-looking analysis, including market-based indicators (e.g., credit spreads), balance-sheet analysis, and stress tests, is less common (Table 1).[42] Encouragingly, quantitative analysis seems to be more consistently used in cases where financial sector risks or vulnerabilities are perceived to be relatively high, and also when MCM participates in or supports Article IV missions. But even with better data and more advanced tools, their limitations would always leave an important role for judgment and qualitative information in gauging potential impact and likelihood of event risks—in particular, strengths and weaknesses in supervisory and regulatory systems, and concentration, ownership, governance, and incentives structures in financial institutions and markets are key.[43] Examples of recent Article IV consultations in which qualitative analysis was critical include Brazil and Japan (Box 8).

[42] Some of these tools (e.g., stress tests) require specialized skills to implement, and are significantly more data/resource intensive than others (e.g., market indicators), which may limit their regular use on Article IVs.

[43] E.g., although more advanced data and techniques enriched the analyses in the U.S. and U.K. Article IVs, they did not provide perfect foresight of the threats that actually crystallized (e.g., imbalances in the U.S. sub-prime mortgage market and U.K. bank funding market), or of their impact on the macroeconomy.

Table 1: Tools and Information Sources Used in Reviewed Staff Reports
(in percent of relevant sample)

	All countries	ADV	EMC	DEV	MCM case study Article IVs 1/	FS vulnerabilities are high/medium 2/	No FSAP 3/
Quantitative analysis:							
- financial soundness indicators (FSIs)	80	100	82	72	100	85	50
- market indicators (e.g., credit spreads)	34	63	53	12	70	46	11
- balance-sheet analysis (BSA/CCA)	14	25	29	0	50	31	0
- stress tests	16	38	24	4	60	23	6
Qualitative analysis:							
- analysis of weaknesses in the FS structure or infrastructure (e.g., legal framework, governance, payments);	22	38	29	12	60	31	11
- analysis of weaknesses in FS supervision and regulation;	54	63	47	56	50	77	50
Information sources/references:							
- references to FSAP findings;	22	13	29	20	20	15	0
- references to SIP and/or previous staff analysis;	42	63	41	36	70	46	39
- discussions with market participants and/or credit rating agencies;	4	25	0	0	20	8	0

Notes: 1/ see appendix for the description of the MCM's case study Article IVs; 2/ includes countries where financial sector vulnerabilities were identified as high/medium by reviewers based on the discussion in the staff report; 3/ includes countries that have *never* participated in an FSAP prior to the sample period.

Analyzing real-financial linkages

54. **Difficulties in identifying the key risks and transmission channels hinder the presentation of clear *financial sector stability assessments*.** Document review suggests that about half of reports are not clear on what they consider the key risks to financial sector stability, leaving some/many potentially relevant sources of risk unexplored. In addition, about a quarter to almost a third of the reports do not discuss potentially relevant risk transmission channels between the financial sector and the real economy or between the financial and the external sectors. Possibly reflecting data quality or availability, mission chiefs find the identification of macroeconomic event risks that might trigger financial sector instability to be somewhat less of a challenge in advanced economies than in emerging markets or developing countries.

Box 8: Elements of Good Practice in Financial Sector Surveillance

This Box highlights examples from the MCM case study countries where elements of good practice in key FSS areas have been displayed.[1/] (Unless otherwise indicated, the references are to the 2007 Staff Reports; see also the external consultant's report)

A range of diagnostic *financial sector assessment tools and organizational frameworks*, both quantitative and qualitative, have been usefully deployed in the context of Article IV consultations. In addition to the widespread use of traditional financial soundness indicators (FSIs), various market based indicators (e.g., distance-to-default and Z-scores), contingent claims analysis (CCA), and a range of stress testing techniques were used, at times in combination, to quantitatively gauge the resilience of financial institutions and systems. In the cases of both **Indonesia** and **Uruguay**, CCA and stress testing techniques were used. In the case of **Kazakhstan**, a Z-score was used to assess the resilience of the banking system. In the case of the **U.S.**, developments in various markets (equity, foreign exchange, and money markets) were assessed by reference to the evolution of implied volatilities. Generally, these tools appear to be used with a reasonable understanding of their limitations, as well as usefulness, and in particular with a consciousness of the need for more qualitative analysis of institutional issues. In a few cases, this was done by applying more highly specialized expertise to assess financial sector problems. For example, in the case of **Israel**, supervisory experts examined the stability and supervisory challenges triggered by earlier changes in regulation. Likewise, in **Serbia**, a bank supervisor helped the work on policy responses to rapid credit growth.

Cross-country comparisons in several cases helped frame the assessment of financial sector developments. The Z-scores for **Kazakhstan** were compared to those in other countries also experiencing rapid credit growth. In the case of **Mexico**, the extent of capital market development was put in perspective by comparing various indicators to those in other countries in the region. In the case of **Japan**, bank profitability indicators were compared to those of the U.S. Finally, in the case of **Serbia**, various financial system vulnerabilities indicators were compared to those of other emerging European countries.

Identification of linkages between the financial system and the macro economy was done well in the **Japan staff report,** which highlighted several financial linkages to monetary, exchange rate, and fiscal policy (e.g., it discussed how the resumption of bank lending improved monetary policy transmission and influenced the assessment of the policy stance). In the case of the **U.S.** staff report, which identified possible spillover of subprime mortgage market problems to other financial sectors, and it discussed how this could be a threat to the growth outlook. In the case of **Serbia**, the report highlighted the rapid euroization of the credit portfolios of unhedged borrowers as a key threat to financial sector stability. Finally, developments in financial sector variables in the **U.S.** were identified as key transmission channels for shocks to economic growth abroad.

Instances where FSS findings have been insightfully woven into the overall policy discussions: In the case of **Kazakhstan**, the report highlighted the monetary and exchange rate policy dilemmas confronting the authorities at a time when banks' heavy external borrowing added to concerns over debt sustainability while fuelling very rapid credit growth. In some other cases, financial sector vulnerabilities along with policy constraints in other areas were brought together to highlight a more limited scope for policy action than otherwise. In **Serbia**, the use of tight macro-prudential tools was seen as justified in the context of banking sector fragilities set against an expansionary fiscal policy. In terms of organizing frameworks that helped integrate financial sector issues, the **Japan** staff report explicitly considered financial sector issues as part of the risks around the central macro outlook. The 2008 staff report of **Singapore** reshaped the overall analysis at a higher level into domestic, financial, and external stability issues.

Expert policy advice. As illustrated by the case of **Israel**, specialist expertise may be increasingly needed as financial systems become more complex, and where the policy analysis skills of the authorities themselves (or other sources of advice) are well developed. These specialist skills and experience differ from what is needed to undertake, say, a quantitative analysis of financial sector risks, vulnerabilities, and macro-financial linkages, yet both types of skills may be needed to make a compelling case. Among the case study countries, Israel's authorities requested advice about financial sector-wide reforms including non-banking sectors such as insurance. In this instance, a small subteam of MCM experts supplied the required specialist judgments for the mission to arrive at sound policy advice, while area department staff (who in this case happened to have very well developed financial sector skills) performed the required macro-financial analyses such as stress-testing. While illustrating what can be achieved with a higher level of financial sector resources, this sort of approach cannot be realistically mainstreamed without an increase in resources devoted to bilateral FSS. Like other cases where MCM support was more intensive than normal, such an approach would have to be used on a very selective and strategic basis.

[1/] The case study countries were a broadly representative sample of countries receiving either more intensive, or more normal, levels of MCM support (see Appendix 1). Thus, for example, outside the case study countries, other countries where expert policy advice was supplied include Latvia, Sweden and Nigeria.

55. **Assessing the *impact of financial sector events on the real economy* is the biggest challenge for the Fund, as much as it is for analysts in general, reflecting the current state of economic theory and empirical work.**[44] Shortcomings relate specifically to (i) insufficient analysis of risk transmission from the financial sector to the real economy (in about half of the reports in the 50-country sample), (ii) macro stability implications not clearly drawn out (in about a third of the reports) and (iii) a lack of analysis of the impact of the financial sector on the conduct of monetary, exchange rate, or fiscal policy (in about a third of reports). And even though the MCM case study Article IV reports were assessed more positively than others, there remains room for improvement in all cases.

[44] Significantly more work in modeling and stress testing has examined the effect of macro shocks on the financial sector than vice versa.

Analyzing cross-border risk transmission

56. **While staff reports seem to be paying more attention to cross-border spillovers (including through financial channels), there is scope for improvement.** The review of reports in the 50-country sample indicated that in cases for which global financial market trends were judged relevant, backward-looking (forward-looking) trends were mentioned in 52 (56) percent of cases. Coverage was more consistent in reports on advanced countries than on emerging markets or developing countries. The implications of cross-country spillovers and contagion are arguably best analyzed in a global or regional vehicle, such as the GFSR/WEO and related outputs, regional economic outlooks (REOs), and regional FSS exercises.[45] Nevertheless, Article IVs need to consider closely cross-border implications, both the "inward" linkages to domestic systems and the "outward" linkages from domestic systems, in order to inform these broader exercises and to bring their conclusions back to the national level. In cases where foreign financial institutions play a significant role in the national financial system, or where local institutions have a large foreign presence, assessments of national systems increasingly require more extensive analysis of relevant overseas exposures and transmission channels, and discussions with analysts, financial policymakers, and institutions in other countries.

Providing financial sector policy advice

57. **Financial sector policy prescriptions in Article IV reports are not always sufficiently specific or comprehensive to address all the identified problems.** In some of the reviewed cases, clear policy recommendations were not given even though financial sector vulnerabilities were clearly diagnosed (8 percent), or financial sector development issues were clearly identified as a problem (16 percent). In addition, about a quarter of reports presented financial sector policy recommendations that were either not clearly justified or too generic (e.g., general statements on the importance of vigilance).[46] In some cases, this may reflect lack of diagnostic evidence/analysis. In other cases, mission teams may not have had sufficient specialist expertise or experience in the relevant policy area to go beyond relatively general statements (see next section).

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[45] In a number of cases, MCM has undertaken regional-level FSAPs or financial surveillance exercises as a way to foster both regional cooperation and national level implementation in regions where there is close financial integration (e.g., Central America, the Maghreb, the Nordic-Baltic region) or a supra-national regulatory and supervisory framework (ECCU, CEMAC, WAEMU). MCM has also been contributing to area departments' regional economic outlooks and other topical financial sector issues of a cross-border nature.

[46] Note that some reports provide both types of recommendations: on how to address financial sector vulnerabilities and on how to address financial sector development problems.

D. What Has Been Holding Up Progress?

58. **Mission chiefs see further improvement in FSS as constrained mainly by the lack of a clear analytical framework for macro-financial surveillance and by data limitations.** According to the mission chiefs' survey, the *top three impediments* to analyzing financial sector and macro-financial issues in Article IV consultations include: (i) lack of a clear analytical framework for macro-financial linkages; (ii) lack of clarity on what is expected in terms of integrating financial sector issues into macroeconomic analysis in the context of Article IV consultations; and, (iii) limitations in data or access to information (in the case of emerging market and developing countries). Lack of willingness on the part of the authorities to discuss the implications of low-probability downside risks or lack of staff's familiarity with the relevant tools for financial analysis are viewed by mission chiefs as being much less of a problem than the three impediments above.

59. **Relevant financial sector expertise is an important determinant of the quality of FSS in Article IVs.** Applying more specialized financial sector expertise and resources does appear to deliver more in-depth FSS, in the form of richer analyses of financial sector risks, vulnerabilities and transmission channels, and more specific policy advice. Cases with more intensive involvement of MCM staff/experts or with a recent FSAP/FSAP update tend to produce higher quality financial sector assessments, regardless of the country's income group (Figure IV.2). In particular, MCM case study Article IVs generally use a broader range of information sources and diagnostic tools, with most notable differences in the use of market indicators, balance-sheet analysis, stress testing, and qualitative assessments of weaknesses in financial sector structure or infrastructure (Table IV.1 and Box 8).

60. **However, this expertise is costly.** Various types of financial sector expertise from area departments and MCM are required to deliver specific FS analysis and advice that adds value for the Fund's members (Box 8). Amongst the case study countries with a single MCM participant (9 countries), total MCM staff time was close to 0.3 staff years on average, and several cases were closer to 0.4 staff years. In the other 11 cases where MCM provided more-intensive-than-normal support—either through participation of more than one MCM staff/expert in the mission team, or through specific, preplanned supporting assignments from nontravelling staff[47]-—most cases recorded MCM time of around ½ a staff year, but several took considerably more than that—0.8-0.9 staff years in three cases, and well over one year in another case.[48]

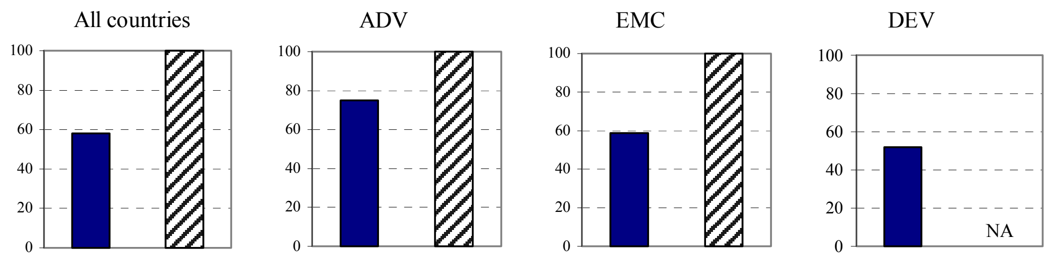
[47] For example, desk based applications of stress testing or "contingent claims" balance sheet analysis, or preparing an SIP on a particular structural or institutional financial sector topic.

[48] The numbers cited are MCM staff time from TRS (including overtime, management support and general backstopping from MCM functional divisions), and do not include area department time. These costs are

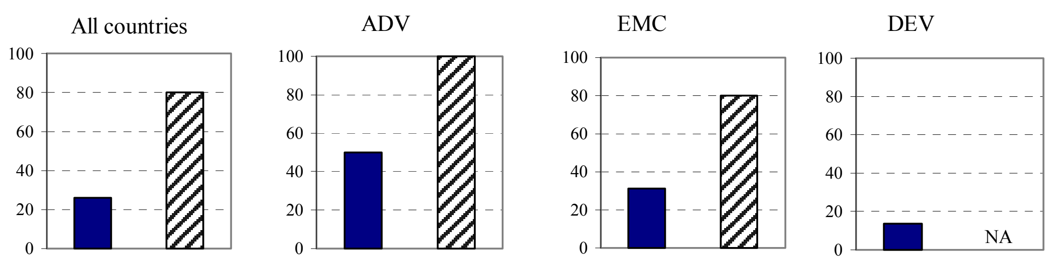
(continued…)

Figure IV. 2: Quality of Financial Sector Analysis in the 50-Country Sample Versus MCM Case Study Article IV Consultations

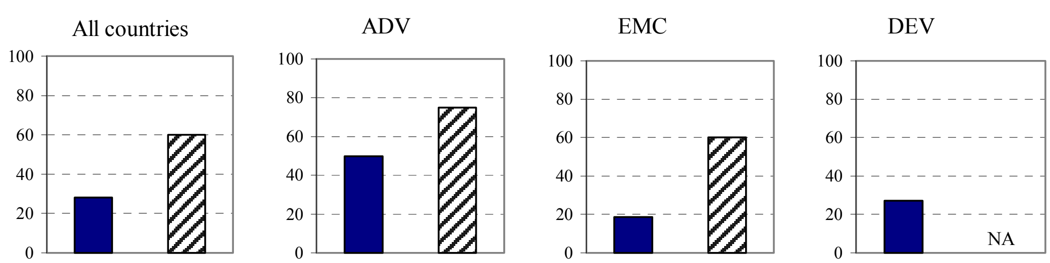
Staff reports that provide clear assessments of **financial sector vulnerabilities**
(in percent of relevant sample, "solid" = 50-country sample, "striped" = MCM cases study Article IVs)



Staff reports that provide clear **financial sector stability assessments**
(in percent of relevant sample, "solid" = 50-country sample, "striped" = MCM cases study Article IVs)



Staff reports that provide sufficient analysis to form a view on whether **financial sector is a potential source/amplifier of macro/external instability** (in percent of relevant sample, "solid" = 50-country sample, "striped" = MCM cases study Article IVs)



Notes: See Statistical Appendix for more details; note that the sample of 10 MCM case study Article IVs (that are also part of the 50-country sample) does not include any developing countries. The two samples were selected independently (see Appendix for details).

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considerably higher than earlier estimates made by the FSTF. Some of the increases may reflect attempts at more careful measurement.

61. **Furthermore, the challenges for bilateral FSS are rising rapidly in the wake of the current market turmoil.** While the distinctions between multilateral and bilateral FSS are—appropriately—being diluted in the current financial environment, there is a pressing need for increasingly complex diagnostics and sophisticated policy analysis in bilateral FSS, in a growing range of countries.

62. **Finally, the lack of integration of financial sector and macro analyses could be related to the traditional focus of staff reports on baseline scenarios and in some cases, to a still weak link between Article IVs and FSAPs.** In many cases, Article IVs concentrate on the baseline outlook and do not sufficiently—even allowing for their relatively tight resource constraints—analyze risks around the outlook that could adversely affect the financial system, let alone risks arising in the financial system that could affect the macro outlook. Further, the interviews with country authorities indicated that the link with FSAPs, while generally improved, is still perceived as too variable, with the FSAP and Article IV work sometimes still seeming to be rather independent. FSAPs are rich sources of information on financial sector issues and financial sector policies, that could be better leveraged and integrated into the analysis presented in staff reports.[49]

E. The Way Forward

63. **Given the breadth of challenges, priority action is needed on several fronts.** Improving the analysis of real-financial linkages in surveillance is proposed as a key operational priority in the 2008-2011 Statement of Surveillance Priorities. In addition, measures are envisaged in the areas of guidance to staff; methodological research and development, strategic and efficient use of existing resources, and capacity development. The following paragraphs elaborate.

64. **Following this review, more *specific guidance* for staff on the conduct of FSS in the Article IV context will be issued by the end of 2008.** Informed by recent Article IV cases where this has been done well, the guidance will cover the following:

- ***A clear and flexible organizing framework for bilateral FSS***: to help systematically categorize, diagnose, and prioritize FSS issues in Article IV reports; and to make better use of the results of FSAPs and technical assistance. Such an organizing framework would focus attention on the need for (i) judgments about the relative importance of financial risks (depending on their likelihood and potential impact); (ii) more systematic analysis of financial sector vulnerabilities and development issues (of

[49] From the FSAP/FSSA perspective, proposals are being developed to foster clearer prioritization and communication of key FSAP conclusions, to facilitate more widespread and effective integration and follow-up in the Article IV context. And more broadly, planning for the next joint Bank-Fund Board review of the FSAP (due in 2009) is getting underway.

domestic or cross-border macro-relevance); and, (iii) more systematic integration of financial sector issues in the macroeconomic analysis, including through risk-based scenario analysis.[50] Such framework would help to guide staff's policy advice, including by better integrating the analysis of tail event risks

- ***A range of more advanced FSS tools and information sources,*** including market-based indicators: to mainstream their use, whenever feasible*,* while bearing in mind their limitations and strengths. Financial innovations place increased demands for new types of data for effective FSS, which can be partly addressed with purchases of diagnostic data from private sector providers (e.g., MCM's recent subscription to Moody's/KMV is being increasingly used by country desks) and also through collaborative arrangements with other international institutions.[51]

65. **The guidance will aim to *disseminate more widely best practices* in the above areas, as well as best practices in the design of key financial sector policies.** MCM is improving *knowledge management* facilities to disseminate guidance and background material on FSS issues, to better support area departments. In this regard, work is already underway to distill the lessons learned from the recent financial crisis, as relevant for bilateral surveillance, and also draw on or link to a range of other resources available within the Fund and elsewhere, including staff contacts with specialized expertise.[52]

66. **Further methodological research and development is needed.** Macro-financial stability analysis is a rapidly evolving field, and the Fund needs to not only keep up with the fast-moving frontier, but also to lead in key areas such as domestic and cross-border real-financial linkages that are particularly relevant given its mandate. The Fund's FSS toolkit will need to be continuously refreshed, and quantitative modeling and other methodological development work needs to continue apace. The most critical areas are the following.

- ***Financial Stability Assessments***: MCM has been investing significantly in development and applications of more advanced stress testing and risk modeling approaches, including the use of Merton-style (contingent claims) analyses. Much of

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[50] Adaptation and experimentation on the focus and structure of Article IV reports may also help to promote better integration of financial sector analysis with macroeconomic analysis, both presentationally and substantively. As noted in Box 8, there are examples of staff reports that have reshaped their analysis/presentation to facilitate a more seamless integration of the financial and macro issues – for instance, by explicitly considering financial sector risks around the central macro outlook, or by reshaping the traditional presentation of monetary, fiscal, BOP, and structural issues into domestic, external, and financial stability issues.

[51] See, *"Review of Data Provision to the Fund for Surveillance Purposes,"* (March, 2008)

[52] In addition to the report on "*The Recent Financial Turmoil—Initial Assessment, Policy Lessons, and Implications for Fund Surveillance; April 9, 2008*", MCM also provided more specific guidance to area departments. .

this work is essentially aimed at better capturing the impact of macroeconomic and other risks on financial systems, including especially second-round effects within financial systems due to various interlinkages and contagion. A related aspect of this work is the derivation of the system-level *financial stability indices*.[53]

- ***Macro-Financial linkages***: Greater effort is needed to improve the identification and analysis of macro-financial linkages involved in the transmission of shocks domestically and across borders. In particular, the work of *Macro-Financial Unit* in RES will especially focus on linkages from the financial system back to the macro-economy.[54] Also, further research should be encouraged to embed *financial sector into structural macro models* that could be used for macroeconomic and financial stability assessments and policy analysis.

- ***Cross-border spillovers***: More emphasis will need to be placed on adapting multilateral surveillance issues (analyzed in the WEO/GFSR) for regional and bilateral surveillance.[55] Improving mechanisms for *early warning* of risks to global financial stability (which is already part of the staff's work program, in particular through development of a Vulnerability Exercise for Advanced Countries) and analysis of financial channels of risk transmission at the regional and global levels should be among the higher-priority projects.

67. **Use of scarce FSS expertise needs to be still more strategic and efficient.** At a time when the expectations of FSS are growing, Fund-wide budget tightening and downsizing presents formidable challenges to the continued improvement of the FSS and its integration into Article IV surveillance. In this challenging environment, there is a need for

- ***Prioritization:*** Given its shrinking budgetary envelope, MCM will need to apply even more strictly its existing prioritization of support activities (including HQ-based monitoring, analysis and review) according to the criteria of s*ystemic/regional importance, importance of vulnerabilities, and importance of financial development issues* (the latter in cases where such issues are critical for present or prospective macroeconomic or external stability). In collaboration with area departments, MCM will need to carefully assess the tradeoffs between intensive support for some

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[53] An example of this latter type was first presented in the April 08 GFSR (Box 1.5), and related applications have been used in some of the latest Article IVs (e.g., Singapore, Sweden, and the United States). Similar approaches were used in the REOs (Asian REO).

[54] Work on this topic is already informing surveillance—see for example Chapter 4 of the Fall 2008 WEO, which investigates links between financial stress and economic downturns.

[55] See Chapter V for specific recommendations.

Article IV consultations versus a more normal level of support for more Article IV consultations.

- ***Greater role of area departments***: Between FSAPs/FSAP Updates (or in their absence), area department desks will, overall, need to continue to do more on FSS, including by better leveraging the results of FSAPs and TA in Article IV consultations. When circumstances appear to be changing significantly, follow-up financial stability assessments in Article IV consultations may need to become more intensive, with or without MCM support.
- ***More efficient use of MCM expertise***: As the specific needs of Article IV teams vary widely, it is critical that MCM support be well planned and resources well matched to the needs of the case. This will become increasingly important as area departments build up their own familiarity and comfort with financial sector issues (especially as identified in FSAPs), and also in view of limited "fungibility" of financial sector experts. To ensure more efficient use of specialized financial sector expertise, clear expectations should be set at the early stages of the Article IV cycle as to the nature and extent of MCM support and deliverables.[56]

68. **Further capacity development is needed.** Efforts must continue to facilitate the deepening and broadening of financial sector expertise in the Fund:

- ***New training programs*** (directed at area-department mission chiefs and staff) have been developed by INS and MCM, and will expand familiarity and comfort with forward-looking market-based indicators and other diagnostic tools.[57] It can be expected that these indicators and tools will be applied more broadly.

- ***More flexible HR policies*** are being developed to facilitate training assignments, swaps, and the recruitment and retention of financial sector specialists. It is important that these be implemented as soon as possible.

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[56] Given the cost and relative scarcity of the requisite financial sector expertise, the operational trade-offs (e.g., between deeper FSS in fewer countries, and less intensive FSS in more countries) can be expected to become sharper still. Moreover, specific follow-up on the implementation of policy lessons from the crisis—including the Financial Stability Forum recommendations—creates additional demands on scarce resources. Indeed, depending on the intensity and timeframe for monitoring follow-up on the FSF recommendations, this latter work may require a special program with more resources.

[57] The courses on "Foundations of Macro-Financial Surveillance" (MFS) and "Extracting Information from Financial Data" were developed and presented jointly by INS and MCM to help mission chiefs and area department desk economists become more familiar with the terminology of finance with a view to deepen the dialogue with country authorities and the private sector on financial issues.

MCM Case Study Countries

In order to monitor the implementation of FSTF recommendations and also to explore the limits of what is feasible within the available resource envelope, MCM selected a reasonably representative set of 20 "case study" countries from among the Article IVs that it planned to directly support during 2007 and early 2008. [58] These case study countries represent all regions/departments and span a broad range of significant FSS issues that would typically warrant MCM's involvement (see Table below).

Over half of the case study countries were supported by MCM in a more intensive fashion than normal—normal meaning one MCM staff member or expert participating in the mission team. This more intensive involvement included either direct participation by more than one MCM staff member or expert (Germany, Israel, Serbia, Saudi Arabia, Brazil, Mexico); specific, pre-planned "offsite" inputs from an additional MCM person not formally participating in the mission team (India, Indonesia, Japan, Kazakhstan); or both (U.S.). The pre-planned offsite support included instances where MCM ran desk-based stress tests,[59] "contingent claims" analyses, or other analysis of market indicators to support the stability assessments of the mission teams (Indonesia, Kazakhstan, U.S.); and other cases where SIPs were written on particular institutional or structural issues in the financial sector (India, Japan).

MCM "Case Study" Countries

AFR	APD	EUR	MCD	WHD
Cameroon Madagascar Nigeria South Africa*	China India †* Indonesia † Japan †	Germany †* Iceland * Israel †* Serbia †* Euro Area	Kazakhstan † Lebanon* Saudi Arabia †	Brazil † Mexico †* United States †* Uruguay*

Note: † more intensive than normal MCM involvement
* included in the broader 50-country sample

[58] These countries have sometimes been described as MCM "priority" cases. However this terminology is somewhat misleading, as their selection was not guided solely by their degree of vulnerability or systemic importance, but also by the need for a fairly representative sample in order to draw lessons about the extent of involvement from different cases. Reflecting this, amongst the case study countries the ratio of cases with high/medium financial sector vulnerabilities to those with low vulnerabilities is broadly similar to that in the broader 50-country sample (see Table IV.1).

[59] While similar in spirit, such desk-based stress testing would not usually be as intensive as what is done in FSAPs. For example, FSAPs can often arrange to have stress tests run through the risk models of the main financial institutions, and allow for more detailed discussions on e.g., scenarios, results, and potential second round effects not captured directly in the stress tests.

2007 FSTF Recommendations

On how to integrate FSS into Article IV surveillance:

The FSTF outlined a broad organizing framework for the content of FSS in Article IV consultations, stressing the need for Article IV missions to address four questions:

First, what are the critical channels of interaction between the macro-economy, financial markets, and the financial sector, and what do financial data tell us about these interactions?

Second, what is the role of the financial sector per se in initiating, amplifying, or muting disturbances to the economy, and in transmitting such effects internationally?

Third, what does the diagnostic information available from financial markets tell us about risks of financial crises?

And fourth, what is the role of the financial sector in facilitating or retarding growth? Are there ways the financial sector can be developed so as to reduce risks, foster stability, and enhance growth, both domestically and globally?

On how to strengthen the FSS Process:

In terms of process, the 2007 FSTF called for:

- A more systematic approach to prioritizing financial sector work in Article IVs;
- Greater continuity in MCM's work agenda and dialogue with country teams for systemically and regionally important countries and for countries at risk;
- Better use of FSAP findings, including through greater emphasis on their macro-relevance, clearer prioritization of FSAP recommendations, and ongoing maintenance of *country-specific baseline assessments* summarizing available data and information on their financial sectors;
- More effective cooperation between MCM and area departments, through close involvement in the prioritization and planning of financial sector work and preparation of multi-year financial sector strategy briefs.

V. CROSS-COUNTRY SPILLOVER EFFECTS[60]

Key Messages

- The analysis of regional and global spillovers has become more common and deeper since the last review and there are many examples of good coverage, both for inward and outward spillovers. However, it is not yet as mainstream practice as it should be, and therefore warrants being proposed as a high operational priority in the SSP.

- Though significant effort is being expended, unmet expectations remain. Work in this area needs to be better focused by: (i) analyzing cross-border transmission mechanisms, real and financial, to assess how and to what extent countries influence and are influenced by global and regional developments; and (ii) drawing out any policy implications.

- To this end, existing processes should be better leveraged by: (i) making use of all possible data sources; (ii) ensuring that spillover analysis is explicitly linked to global and regional risks that may materialize, as identified in multilateral surveillance (thereby also helping to integrate better multilateral and bilateral surveillance); and better sharing knowledge within the Fund, including through the review process. Making provision of a multilateral perspective an operational priority in the SSP should support such progress.

69. **In a globalized world, bilateral surveillance must analyze cross-border economic and financial linkages and transmission mechanisms, or spillover effects**. Such analysis can help assess threats to systemic stability. In turn, new insights from the global perspective should feed back into the bilateral perspective, prompting further assessment of whether and how risks identified at the global and regional levels could affect member countries. This analysis should encompass both "inward" and "outward" spillovers (Box 9). The need for improvements in such analysis was one of the primary monitorable objectives set in 2004. Guidance developed thereafter consistently calls for staff reports on systemic countries to discuss outward spillovers and those for other countries to pay greater attention to inward spillovers, including risks identified in the WEO/GFSR.

70. **Coverage of cross-border economic linkages goes beyond integrating consistent global assumptions into forecasts**, and should aim to help members better place their country in the global context. Discussions of inward spillovers can help pinpoint which external developments—including risks identified at the multilateral level—are most

[60] This paper was prepared by Piyabha Kongsamut.

relevant, and their policy implications. Discussions of outward spillovers help the international community assess the impact of a member's policies on others, allowing members to "collaborate with the Fund and with one another" to promote systemic stability.

Box 9: Spillover Taxonomy

What are "spillovers"? Developments and/or policy actions (e.g., macroeconomic developments, financial market movements, monetary or fiscal policy actions) in one country/group of countries having a significant impact on other economies, either within the region or globally, due to sizeable economic and financial linkages. Analysis of spillover effects thus examines the impact in one or several countries of developments in one or several others, as well as economic and financial transmission mechanisms.

The direction of spillover felt or sourced from a single country can be analyzed as below, but all countries have the potential for both types of spillovers:

Outward spillovers from systemically important economies

General: Actual/potential impact of "home country" developments on global economic environment, incl. system of exchange rates

Current account:
•actual/potential impact of "home" country policies and developments on global/regional trade, income, and services

Capital account:
•actual/potential impact of developments and policies on global/regional capital and financial flows

Inward spillovers to all economies

Current account: impact of
• global trends in commodity prices
• general global economic environment,
• neighboring economies

Capital account: impact of
• developments in global financial markets
• regional financial markets, if different from global
• neighboring economies

71. **This review assesses progress since the 2004 BSR** and the 2006 IEO evaluation of multilateral surveillance, and documents to what extent bilateral surveillance analyzes spillover issues, and how.[61] It draws on sources common to the whole TSR and on an analysis of 2007 SIPs. It takes as given analysis done from a multilateral perspective, as presented in the WEO, GFSR, and seeks to assess how well such analysis is reflected in bilateral surveillance. A case study on the subprime crisis examines more deeply a particular example of spillover analysis (Chapter VII).

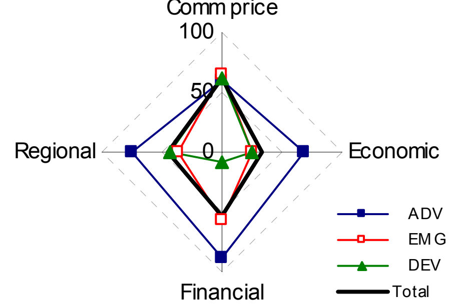
[61] *IEO Report on the Evaluation of the IMF's Multilateral Surveillance* (An Evaluation of The IMF's Multilateral Surveillance, 2006).

A. Some Progress

Inward spillovers

72. **Staff reports place countries in the global context better they used to.** More staff reports now refer to at least one global factor (e.g. commodity prices, global economic environment; see Box 9 for a listing)—82 percent of reports reviewed, up from three-quarters in the BSR. But coverage of individual factors is more spotty (Figure V.1). Indeed, one dimension saw deterioration—the IEO found that global capital markets developments were discussed in 75 percent of cases where these issues were considered relevant, while this is the case in only 54 percent (of those with similar characteristics) in this review.[62] Though at the technical level such factors are well-integrated into macro projections, including through the WEO processes, staff reports pay little attention to explicitly placing the country in the global context.[63] Providing a better sense of how and to what extent global and regional factors have influenced domestic economic conditions would enrich the understanding of the relevant country-specific transmission channels of spillover effects, and provide a basis for assessing spillover risks.

Figure V.1. Coverage of Global Context, by Factor
(in percent of relevant cases)



73. **Moreover, more than half of Article IV consultation documents in 2007 comprised SIP chapters strongly emphasizing cross-border issues, suggesting that significant analytical effort is being expended** (Table 2).[64] This seems consistent with the mission chiefs survey result that over half of respondents noted they have paid more attention "to a large extent" or more to analyzing inward spillovers. Examples of published chapters include effects from aid flows (Madagascar, Mozambique), how to manage large natural resource revenues (Bhutan, Bolivia), growth spillovers (Colombia, Mexico), trade and capital flows (Mexico, Peru), cross-border banking (Austria, Slovenia, U.K.), interest rates and spreads (Uruguay, U.S.), carry trade (Japan, New Zealand), labor flows (Portugal, U.K.), competition from third parties (Hong Kong, Korea).

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[62] The two figures from this TSR (54 percent and earlier figure of 82 percent) were averaged across backward and forward looking trends.

[63] Staff reports for program countries tend to do so even less, possibly reflecting the focus on matters of immediate importance to the program.

[64] See list in annex. Cross-border issues cover a somewhat broader range than spillovers as defined in the Box.

Table 2. 2007 Selected Issues Papers: Chapters on the Multilateral Perspective

	Spillovers	Cross-country
Total (in percent of all SIP chapters)	28	28
Total (in percent of consultations with SIP chapters)	54	60
Number of SIP chapters with multilateral emphasis	77	77
Where is this analysis being done? (in percent of chapters with a strong emphasis in the respective category)		
Advanced	29	30
Emerging Market	35	43
Developing	36	29
African	25	22
Asia and Pacific	21	29
European	26	36
Middle East and Central Asia	1	4
Western Hemisphere	27	10

Source: Staff estimates.

74. **Also, some good examples can be highlighted**. In interviews, some authorities expressed appreciation for the analysis of potential spillovers from bank subsidiaries in Eastern Europe, and the Nordic-Baltic regional financial sector study. The case study of Europe also finds good integration of macro-financial linkages, including through cross-border spillover effects, in Austria, Hungary, Iceland, Russia, and Sweden (External Consultant's report, Sections 3 and 4).

Outward spillovers

75. **Discussions of outward spillovers for systemic countries remain few and far between**. This review found only three staff reports (of the 10 countries in the sample with GDP at PPP within the top 30 largest economies and six others considered systemic on other grounds) with substantial outward spillover analysis. Staff reports for several countries with outward spillovers potential through their economic size (and spillover growth effects through trade/financial channels) or degree of external vulnerability (and potential for contagion to other cases), did not discuss these issues. Survey audiences (authorities and

EDs) consistently expressed less satisfaction with outward spillover coverage than with inward spillovers (chart below).[65]

76. **Where such coverage is present, though, it has been growing deeper**. Of the three staff reports with substantial analysis of outward spillovers, the U.S. staff report's coverage was the most extensive, including through growth, bond yields, and financing of the current account deficit, supported by SIPs. This analysis established the important conclusion that financial sector spillover channels (rather than trade) predominated, in the outward direction. Germany's staff report discussed growth spillovers, and South Africa's covered the regional impact of its exchange rate and fiscal policies.[66] Some progress seems therefore to have been made in treating spillover issues in more depth–the 2004 BSR and IEO review assessed coverage in the G-3 and wider, respectively, and found limited references to the systemic impact of their economic situation and policies. Further efforts along these lines should be encouraged, and could also be discussed in other surveillance vehicles such as regional economic outlooks (as has been done in WHD).

B. But Still Some Way To Go

77. **Survey results suggest that the potential for this work is well recognized, but unmet expectations remain**. It is clear that stakeholders look to the Fund for analysis of economic spillovers, and its quality is recognized: a significant proportion of the international community (as proxied by the Executive Directors survey) relies on Fund spillover analysis to a great or very great extent (Figure V.2 and V.3), and more than half of *market participants* considered the

Figure V.2. Extent of International Community's Reliance on Country Reports for Spillover Analysis
(in percent of respondents)

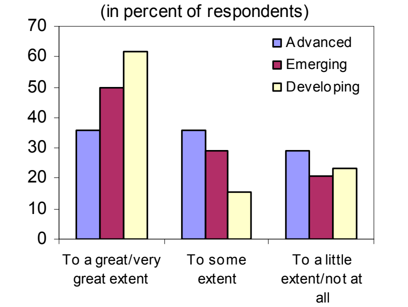
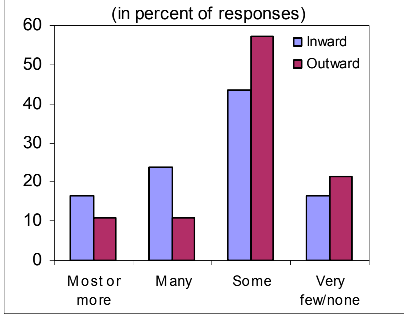


Figure V.3. Proportion of Reports Meeting International Community's Expectations on Spillovers
(in percent of responses)



[65] The review process may have contributed: review comments tended to focus more on inward spillovers than outward spillovers (in relevant cases).

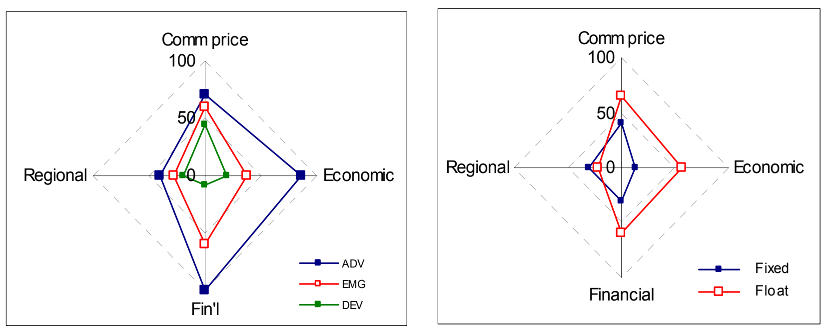
[66] The U.S. and Germany cases explored cross-country spillovers using econometric techniques, including VARs, to test empirically which spillover channels were stronger (e.g., trade vs. financial), as well as the direction of spillover effects. Another U.S. paper examined various implications of theories that could explain the financing of the current account deficit, and tested these against the data. The South Africa staff report discussed the benefits of closer regional linkages through the Common Monetary Area (impact on inflation stability and competitiveness of other members), the Customs Union (revenue sharing), the Southern African Development Community (trade linkages), as well as labor flows.

quality of such analysis to be better or much better than average.[67] However, only a minority of *Directors* felt that many or most staff reports met their expectations in this dimension, and only 27 percent of *country authorities* considered that surveillance had provided greater understanding or new insights "to a large extent" or more of the impact on the economy of developments elsewhere (i.e., inward spillovers). *Market participants* considered that cross-border transmission was among the analytical areas in which the Fund's contribution was weakest. One area in which both market participants and country authorities would have liked to see more analysis was regional and cross-border financial links and risk transmission channels.[68]

78. **Risks identified at the multilateral level are insufficiently recognized in staff reports, and consequences of such risks seldom explicitly drawn out**.

- While baseline global projections are automatically reflected in country-level forecasts, only 60 percent of staff reports picked up for discussion in the text at least one of the relevant identified risks in the WEO/GFSR, with those for advanced countries more likely to do so (Figures V.4). Curiously, staff reports for countries with fixed exchange rate regimes—where, perhaps, public discussion of risks could have sharper consequences—were less likely to refer to commodity price, economic, and financial risks than those with floating exchange rate regimes. Overall, there seems to be a missed opportunity to explore and assess possibly important transmission channels of risk.

Figure V.4. Discussion of WEO/GFSR-Identified Risks
(in percent of relevant cases)



- Risks identified in multilateral surveillance could also have been better integrated with bilateral surveillance as part of SIP analysis and ultimately reflected in staff reports. Some good practices exist: for example, 2007 WEO and GFSR issues

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[67] Chart on the left hand side excludes the "no view" responses reported in the statistical appendix.

[68] One country's authorities gave a more specific example—they would have liked to have seen more analysis of how the subprime crisis (already underway) would affect their economy indirectly (given no direct exposure), such as through the associated repricing of risk and the loss of liquidity.

highlighted the risk of an abrupt reversal of capital inflows, and the downside risks to global growth and the U.S. economy. The impacts of these possible risks materializing were quantified in some cases (e.g.,banking system in Chile, Uruguay; size of growth spillovers in Colombia, Mexico). In half of the 18 countries (from the 50 country sample) with SIP chapters emphasizing spillover issues, however, opportunities to follow up on some WEO/GFSR identified risks were not seized. These opportunities included: how to respond to a possible projected deterioration in the terms of trade in vulnerable countries, and implications of capital flow reversals (particularly in countries reliant on portfolio flows). In these cases, the vulnerabilities to such risks were highlighted, but possible consequences of these risks materializing, including through possible macro-financial linkages and transmission channels, were not explicitly discussed.

- An analysis of a subset of the 50-country sample since the outbreak of the subprime crisis focused on emerging market cases with high financing requirements.[69] It found that, while most reports mentioned the turmoil, they did not go beyond noting that the external environment could worsen further. In cases with high external vulnerabilities, more explicit analysis of how spillover risks could affect the economy would have been desirable, by tracing through their transmission channels and interaction with domestic conditions and risks. This would include an assessment of just how severe the impact could be, even if it were considered highly unlikely. The Serbia report goes some distance in this regard, by outlining the channels through which the financial turmoil could affect the country, and also drawing out possible macroeconomic consequences of abrupt exchange rate depreciation in the debt sustainability analysis, through effects on external debt. This line of analysis should be pursued in more cases where the potential for large spillovers is high.

C. The Way Forward

79. **Improving analysis of spillover effects seems to require primarily a refocusing of existing resources to better integrate multilateral and bilateral surveillance.** Mission chiefs felt that the most binding constraints to doing more have been resource constraints and data limitations, and, to a lesser extent, word count ceilings. However, the record on SIPs suggests that significant resources are already being expended on these issues. Thus, what needs to be done is to integrate this analysis better into surveillance discussions, and to refocus it to draw out more explicitly possible consequences of risks identified in multilateral surveillance, should they materialize. Beyond assigning greater priority to this task and

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[69] These were a subset of the 50-country staff reports, comprising Bulgaria, Lebanon, Pakistan, and Serbia.

making sure that teams explore all possible data sources (e.g., BIS data, Joint External Debt Hub, IIP, STA financial sector balance sheet data), the following steps could help:

- **Staff reports should be more explicit and specific about how and to what extent the global context affects their economies**, and not only refer to the global forces at play. Such coverage would provide for a richer understanding of transmission channels affecting the country, and a balanced perspective on the relative role of external forces vs. domestic policies in shaping both outcomes and prospects—helping to counter a tendency to optimism when recent economic performance is favorable (Chapter VII). Even when not much specificity can be provided, country authorities find considerable value added in staff simply bringing to them, as part of the policy discussions, the Fund's view on the global and regional outlook.

- **Greater prioritization in the choice of spillover topics covered can be achieved through a more systematic selection process** which could take place when surveillance agendas are prepared**.** Risks identified at the multilateral level could be assessed for relevance at the regional and country levels. Those considered relevant could then be broadly ranked at the country level, along with domestically-sourced risks, based on the perceived probability of materializing and the extent of possible loss. A choice on which topics to pursue more in depth could be made on this basis. Clearly, such resource-intensive analysis would not be needed for all countries, but only in cases where spillover effects are potentially large.

- **More efforts must be dedicated to sharing relevant knowledge.** The stock of good examples could be emulated more widely. The review process could help bring them to the attention of country teams, as relevant. Moreover, to facilitate analysis of outward spillovers, there may be a need for mechanisms that bring to country teams the necessary knowledge of economies on the receiving end of the spillovers. Often, interdepartmental cooperation will be required. **Making provision of a multilateral perspective an operational priority in the SSP, as recommended, will further strengthen incentives for progress along the above lines.**

2007 Published SIP Chapters with a Strong Emphasis on Spillover Issues

African

Trade in the WAEMU: Developments and Reform Opportunities
A Medium-Term Fiscal Strategy (Republic of Congo)
Improving The Trade Regime for Growth (Republic of Congo)
Cameroon—An Application of the Permanent Income Approach
Macroeconomic Management of Scaled-up Foreign Aid in Mozambique
Trade Policy in Mozambique: An Overview
Macroeconomic Implications of "Scaling-Up" Foreign Assistance and Foreign Direct Investment in Madagascar
The Economic and Fiscal Impact of Joining the SADC FTA (Madagascar)
Implications of Oil Inflows for Savings and Reserve Management in the CEMAC
Fundamental Determinants of the Real Exchange Rate in Angola
Assessing Lesotho's Real Exchange Rate and Competitiveness
Zambia: Assessing Reserve Adequacy
Vulnerabilities Related to Rainfall and Terms of Trade Variations (Burkina Faso)

Asia and Pacific

The Kiwi Dollar–Getting Carried Away?
The Ready-Made Garment Industry in Bangladesh: An Update
The Cyclical Properties of Workers' Remittances (Bangladesh)
Aid Flows to Bangladesh
Is Indonesia Adequately Integrated into Global and Regional Trade and Finance?
Indonesia, 1997 vs. 2007: How Far Has Crisis Vulnerability Been Reduced?
Recent Developments and Outlook for Japan's Capital Flows
Capital Flows and the Yen-U.S. Dollar Exchange Rate
The Potential Macroeconomic Impact of Oil Production of Cambodia
Korea's Competitiveness in the Global Marketplace
Internationalization of the Won
Managing the Macroeconomic Impact of the Hydropower Sector (Bhutan)
Vietnam's WTO Accession: Opportunities and Challenges
The 2006–2007 Stock Market Boom in Vietnam: Policy Response and Challenges Ahead
Hong Kong SAR as a Center for Asia's Financial Integration

European

External Debt and Balance-Sheet Vulnerabilities in Croatia
Absorption of EU Funds: Issues and Challenges (Czech Republic)
U.K. Inflation and Relative Prices Over the Last Decade: How Important was Globalization?
The Macroeconomic Effects of Immigration in the U.K.

Transmission of Shocks in the International Banking System and Implications for London as a Global Financial Center
Cross-Border Banking Issues for the Austrian Banks and Their Supervisors
Bank Risks from Cross-Border Lending and Borrowing in Slovenia
Alternative Fiscal Rules for Norway
Credit Growth, Bank Soundness, and Banks' Foreign Liabilities (Bosnia & Herzogovina)
The Market in Financial Instruments Directive and the Transformation of Europe's Capital Markets (euro area)
The Euro and the New Member States
Estimating Iceland's Real Equilibrium Exchange Rate
Iceland: Financial Sector Developments and Risks to the Outlook
The Challenges of Globalization for Small Open Economies with Independent Currencies: Summary of Conference Proceedings (Iceland)
Spillovers to Ireland
Portugal's Export Rebound in 2006: Recovery or Blip?
The Importance of Labor Market Flexibility in Regaining Competitiveness (Portugal)

Middle East and Central Asia
External Competitiveness and the Real Exchange Rate in Egypt

Western Hemisphere
The Performance and Prospects of the Peruvian Textiles and Clothing Exports
Chile's Structural Fiscal Surplus Rule: A Model-Based Evaluation
Risks in the Chilean Banking System: A Contingent Claims Approach
Credit Cyclicality—A Cross-Country Analysis (Chile)
Explaining Chile's Trade Performance
The Natural Gas Sector and Dutch Disease (Bolivia)
Monetary Policy Transmission in Bolivia
Long Term Management of Hydrocarbons Resources (Bolivia)
Summary of Foreign Entanglements: Measuring the Size and Source of Spillovers Across Industrial Countries (U.S.)
Summary of The Ties that Bind: Measuring International Bond Spillovers Using Inflation-Indexed Bond Yields (U.S.)
Summary of Globalization, Gluts, Innovation, or Irrationality: What Explains the Easy Financing of the U.S. Current Account Deficit?
External Financial Linkages: What Drives Uruguayan Sovereign Spreads?
Bank-Lending Behavior in Uruguay
The Optimal Level of Reserves in Financially Dollarized Economies: The Case of Uruguay
Has the Financial System Become More Resilient to Shocks? An Analysis Adapting the Merton Framework to a Country without Equity Market Data (Uruguay)

External Shocks and Business Cycle Fluctuations in Mexico: How Important Are U.S. Factors?
Mexico’s Integration into NAFTA Markets: A View from Sectoral Real Exchange Rates and Transaction Costs
External Linkages and Economic Growth in Colombia: Insights from a Bayesian VAR Model

VI. CROSS-COUNTRY ANALYSIS [70]

Key Messages

- Much cross-country analysis is being done and is highly valued, but there is not enough of the type of analysis most valued—that is, policy-oriented analysis, illustrative of how other countries dealt with certain policy challenges.

- Insufficient leveraging of cross-country analysis to draw clear and specific policy recommendations, and inadequate use of policy implications from the WEO/GFSR analytical chapters in bilateral surveillance further constrain the potential for high value added cross-country analysis.

- More cross-country analysis should be done in an efficient manner, rather than a rush to "just do more." To be persuasive, the analysis needs to (i) draw clear and concrete policy conclusions well-grounded in the analysis, (ii) be based on appropriate comparator(s), and (iii) be sufficiently deep and rigorous, including careful examination of similarities and differences between countries that may impact on conclusions. The review process may help to pinpoint appropriate comparators, and internal incentives may also need to be adjusted to foster more policy-oriented, illustrative analysis. For efficiency's sake, some work could be designed to inform bilateral surveillance in more than one country.

- Improvements in the multilateral perspective from cross-country analysis is proposed as a an operational priority in the 2008-2011 Statement of Surveillance Priorities.

80. **Cross-country analysis has long been recognized as an area of comparative advantage for the Fund, but the demand has been only partially met.** The 2004 BSR called for more cross-country comparative studies to feed into discussions with authorities, and most recently in the refocusing exercise this call has been renewed. When a policy line is backed up by cross-country analysis, based on actual experiences of member countries, rather than based purely on theoretical arguments, it is much more persuasive. This section documents how much and what type of cross-country analysis is being done and the extent to which it satisfies stakeholders' expectations, and provides recommendations.

81. **As no benchmark on the use of cross-country analysis exists, this review establishes a baseline**, based on the assessment tools common to the whole TSR, as well as an analysis of 2007 selected issues papers (SIPs). The review identifies three types:

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[70] This paper was prepared by Piyabha Kongsamut.

- A **comparison of indicators** across a peer group. This approach serves a diagnostic function. Comparators shown are usually within the region or the same income group.

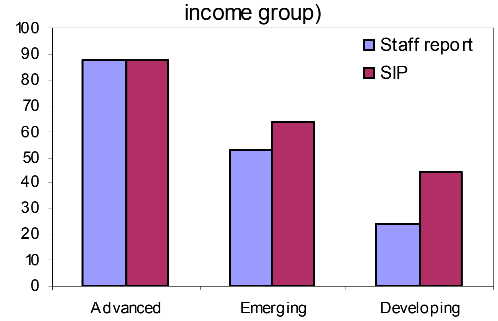
- A **case-study, illustrative approach** describing the experience of one or several countries. This approach tends to be limited to a few comparator countries and involves deeper analysis, illustrating how others have faced similar policy challenges and how their experiences might be relevant for the country at issue. Such comparisons may involve countries from other regions and/or differing time periods.

- Use of **quantitative techniques**, predominantly econometric. Cross-country regressions tend to involve panel data with a wide set of countries, seeking to empirically support particular hypotheses. Use of multi-country modeling (e.g., the Global Integrated Monetary and Fiscal Model) is also in this category.

A. Much is Being Done, but Potential is not Being Met

82. **The great majority of Article IV consultation staff reports bring some cross-country perspective, with 44 percent of staff reports doing so more extensively.** There are large variations in the degree of use across departments: EUR staff reports used this technique most extensively, and MCD least (Figure VI.1). By income group, consultations with advanced economies use this technique most extensively in both staff reports and SIPs; in developing countries, cross-country analysis is more likely presented in SIPs than in staff reports (chart; Box 10 discusses some of the topics pursued).[71] The survey of mission chiefs provides some perspective on trends: over 80 percent of respondents noted that, to some extent or more, they paid more attention to analyzing issues from a cross-country perspective in recent consultations.

Figure VI.1. More Extensive Cross-Country Analysis
(in percent of consultations in each income group)



83. **Survey results show that the analysis currently carried out is highly valued, but is not meeting its potential to bring new insights**. A significant proportion of *EDs* responded that they (and the agencies with which they liaised) relied on staff reports to a great extent or more, for cross-country analysis of countries outside their constituencies, particularly with respect to emerging market and developing economies (around 65-70 percent, see Figure VI.1). Also, more than three-quarters of *financial market participants*

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[71] Staff report sample is 50-country; for selected issues it is those issued in 2007. See also Table 2 of chapter V.

Box 10. What Topics are Being Analyzed From a Cross-Country Perspective?

Topics of published selected issues papers with a strong cross-country emphasis range widely, such as how to spur growth (Croatia, Ghana, Philippines, Vanuatu), inflation targeting challenges (Peru), assessing competitiveness (Belgium, Italy, Sri Lanka, Lesotho), evaluating public spending (Czech Republic, Egypt, Italy, Zambia), potential for revenue and taxation (Haiti), and financial sector issues such as credit growth (Croatia, Chile), and financial development. More broadly, two-thirds of selected issues topics fall within the range of the "core" topics (C1 and C2) discussed in Chapter I, with a further 20 percent in the third circle (including growth and trade issues).

found the quality of cross-country analysis to be better or much better than average. Less satisfactory is the fact that only around a third of *authorities* felt that surveillance had contributed at least to "a large extent" to their understanding of, or provided new insights into, lessons from experience in other countries (Figure VI.1). It is noteworthy that WHD seems to do well in this dimension, with half of the survey's participating country authorities expressing this view (perhaps because policy implications are especially clearly drawn in these cases, see below).

B. What are the Problems?

84. There may be a mismatch between the types of analysis produced and those most valued, with not enough use of the illustrative approach relative to demand. The indicators approach is most commonly used, and the illustrative approach much less so. This assessment holds for both staff reports and SIPs (FigureVI.1, VI.2 and VI.3).[72] [73]

Figure VI.2. Cross-Country Analysis in Bilateral Surveillance (in percent of total)

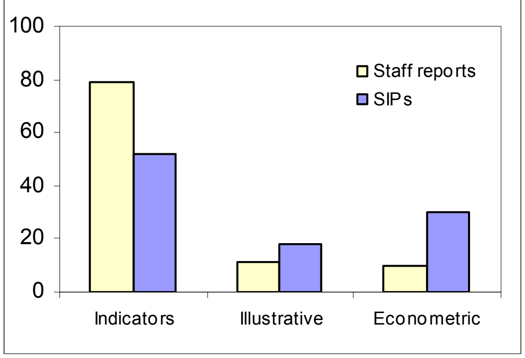
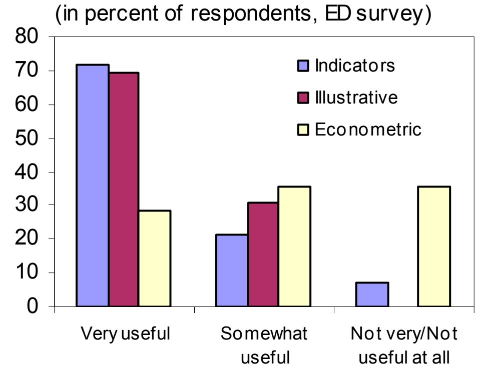


Figure VI.3. Useful Types of Cross Country Analysis (in percent of respondents, ED survey)



[72] The staff report sample is the 50-country sample. For SIPs, 156 chapters issued over June-December 2007 were classified by type of cross-country analysis used.

[73] Chart on the right hand side excludes the "no view" responses reported in the statistical appendix.

However, among the three types of cross-country analysis, EDs clearly considered the indicator and illustrative approaches more useful than econometric analyses. Interviews of authorities suggested a similar preference for the illustrative approach; that is, to look more deeply at a few cases of countries facing similar specific policy challenges, to learn from their experience.

85. Further, only about a third of SIPs substantially based on cross-country analysis draw clear and specific policy recommendations. In over half the cases, the link between the analysis and the policy recommendations was not always clear, with resulting recommendations too vague or with too little operational content. In the same vein, some authorities felt selected issues papers were too research-oriented and not sufficiently policy-oriented. WHD stands out in this respect (and, to a somewhat lesser degree, AFR), which may explain the higher satisfaction rate detected above: over 70 percent of its SIPs with strong emphasis on cross-country analysis also drew clear policy implications—a rate higher than in other departments.

86. **Policy implications from the WEO/GFSR/REO analytical chapters are underleveraged in bilateral surveillance.**[74] These chapters present the latest IMF research on topical issues relevant to a broad section of the membership, and can potentially support staff's arguments with the weight of cross-country evidence. The review of staff reports found that 82 percent of reports in which a reference could be considered useful did not contain one.[75] For example, the October 2007 WEO chapter on managing large capital inflows, or the September 2006 GFSR chapter on household credit growth, presented highly relevant analysis for many emerging market countries, but were rarely referenced. With respect to REOs, there is potential for greater leveraging as well. There is evidence of some cross-fertilization when direct references to the REO are made, but in other cases it is not clear whether the analyses in the REOs have been used to their fullest extent in supporting bilateral surveillance.[76]

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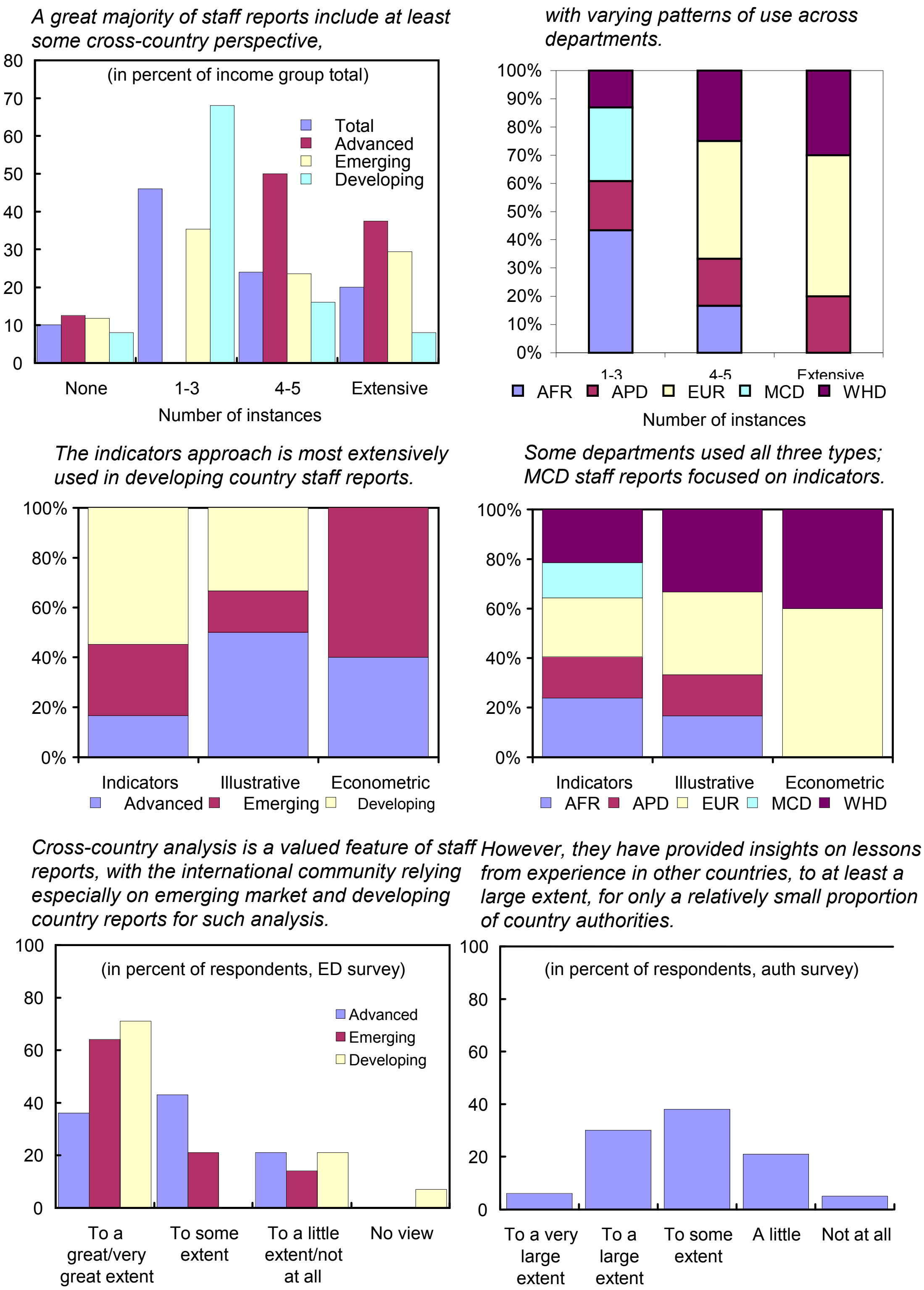
[74] Analytical chapters refer to those following the lead chapters which assess the global outlook. They focus on a specific issue (e.g., capital inflows) and usually use cross-country econometric techniques for a broad sample.

[75] That is, cases for which specific WEO/GFSR/REO chapters (2006-2007 issues) seemed relevant to the country and pointing to these findings could have helped strengthen the case for recommended policies.

[76] A more detailed analysis of the integration between REOs and bilateral surveillance was done for the European region by the External Consultant (section 5 of the external consultant's report). The report pinpoints competitiveness analysis in bilateral surveillance as not yet placed in the framework of dynamic adjustment within a monetary union.

Figure VI.4. Cross-Country Analysis in Staff Reports



Source: Staff report reviews (Panels 1-4) and TSR stakeholder surveys (Panel 5: ED survey, questions 11-13. Panel 6: authorities survey, question CS9).

C. What are the Obstacles?

87. **Mission chiefs have pointed to key impediments to greater use of cross-country analysis**, including resource constraints, data limitations and difficulty in identifying appropriate comparators, and word count ceilings. However, word count ceilings are only a constraint in staff reports and are thus not binding on the use of cross-country analysis *per se.*

88. **The dearth in the illustrative approach could be further explained by information availability constraints and by internal incentives**. Improved databases both within departments and Fund-wide have helped facilitate greater use of the indicators and econometric analysis approaches. By contrast, difficulty in identifying the appropriate comparators for specific issues could be hampering more illustrative approaches. Institutional knowledge of such experiences is not easily accessible, as relevant information could be scattered among different sources, such as selected issues chapters, working papers, occasional papers, TA reports, or particular staff members. In addition, internal reputational incentives favor displaying analytical skills through rigorous econometric or modeling techniques and research-oriented analysis, rather than more policy-oriented qualitative analysis. Finally, the comparators chosen in more qualitative analysis can sometimes be controversial—with "this country or region is different" an easy reaction—further diminishing the incentives to using this approach.

D. The Way Forward

89. **There is a clear need for more cross-country analysis, but it should be done in an efficient manner, rather than a rush to "just do more."** While all three types of cross-country analysis have a role in helping to persuade, bilateral surveillance needs to deepen cross-country analysis using especially a more qualitative, illustrative approach. To be persuasive, the analysis needs to (i) draw clear and concrete policy conclusions well-grounded in the analysis, (ii) be based on appropriate comparator(s), and (iii) be sufficiently deep and rigorous, including a careful examination of the similarities and differences between countries that may influence the policy conclusions.[77] However, this could be a very costly undertaking. Leveraging resources efficiently is therefore key.

90. **The following recommendations could help**:

[77] The latter two points are particularly relevant for econometric analysis, which can provide important cross-country insights. However, as the exchange rate chapter finds, sample selection and rigor in technique are key to quality econometric analysis.

- ***Leverage more the cross-country analysis presented in multilateral surveillance in bilateral surveillance***. This is a cost effective way for country teams to add a cross-country perspective. The internal communication already being done by the WEO and GFSR teams should help disseminate findings, including through circulating powerpoint slides and posting them on internal websites.

- ***Better information flows***: (i) Improve search engines, to facilitate information sharing and to help identify relevant comparators easily—the recent "e-library" initiative is a useful step, but needs to further improve the searchability of selected issues papers. The "my page" initiative could also be helpful in pinpointing staff members with the right knowledge. (ii) Purposeful use of surveillance agendas as a tool to help teams identify similar work being done elsewhere should be encouraged. The review process could also help in this regard.

- ***Better topic selection and planning***. To be efficient, topics with most value added from a cross-country perspective could be selected in consultation with the authorities, consistent with the Fund's mandate and Fund-wide surveillance priorities. Improved access to information above, and the review process, would also help pinpoint the right cases to compare, and some work could be designed to apply across more than one country, so that a common SIP or SIP-like background document could inform Article IV consultations with a set of countries (a recent example is France, Greece, Italy, Portugal, and Spain -Competitiveness in the Southern Euro Area, CR/08/145). One topic commonly mentioned by a number of authorities is the need for more concrete, operational advice on the interlinked issues of capital market reform, financial sector liberalization, and foreign exchange markets (see Supplement 2, Section II).

- ***Improving incentives.*** Making provision of a multilateral perspective an operational priority in the SSP, as recommended, should support the aforementioned efforts **.**On a more specific point, Departments should encourage and reward the production of cross-country analytical work based on its contribution to the surveillance dialogue and not primarily on its degree of technical sophistication.

VII. Macro-Financial Links and Spillover Effects: A Subprime Case Study[78]

Key Messages

- Bilateral surveillance was successful in identifying most contributing factors, vulnerabilities, and individual risks that subsequently developed into the "subprime crisis," but the scale and impact of the crisis were not foreseen (by the Fund or most other observers).
- The reasons are four-fold: (i) "known unknowns;" (ii) failure to "connect the dots"; (iii) "unthinkables," and (iv) wrong calls. Not much can be done about (i), but surveillance should be able to do better on (ii) and perhaps (iii), and should strive to avoid (iv), though not at the cost of overly hedged assessments.
- On "connecting the dots" better, progress will likely be incremental, as it is linked to strengthening analysis of macro-financial linkages, financial sector spillovers, and other related challenges.
- Difficult prioritization challenges lie ahead, particularly with respect to keeping institutional framework assessments up to date, and selecting the appropriate tail risks on which to focus analytical efforts ("to think the unthinkable"), as both are very resource intensive and can only be done selectively.

A. A Valuable Opportunity

91. **Assessing surveillance in the run up to the 2007 subprime crisis is of particular interest for this TSR because it featured prominently macro-financial and cross-country linkages of major consequence.** The "subprime crisis" refers to the turmoil in financial markets that began in earnest in August 2007, manifesting itself most immediately in several mature markets, with the U.S. at the center. Rising delinquencies in the subprime mortgage market triggered turbulence in the subprime mortgage-backed securities market, which spread to other asset-backed markets, money markets, and financial institutions, with further effects gradually being felt in other markets, across borders, and in the broader economies (Box 11). As the effects of the crisis have not fully worked themselves out, it is too soon for a complete post-mortem. This study focuses on bilateral surveillance in the period leading up to August 2007, in four countries directly impacted—the U.S. at the center, and cases experiencing distress from direct exposures to the subprime assets as well as

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[78] Product of a team effort led by Piyabha Kongsamut, with Anna Ilyina, Pedro Rodriguez, and Chris K. Marsh. Collaboration from EUR, MCM, and WHD is gratefully acknowledged.

spillover effects, comprising the U.K., Switzerland, and Germany.[79] Consistent with the rest of the TSR, the focus is on Article IV consultations with these countries, including the extent to which they properly integrated messages from multilateral surveillance (in particular, the GFSR and the WEO). However, the study does not claim to provide a comprehensive assessment of the latter. Unless specified otherwise, "analysis" refers to that presented in the Article IV context.

92. **This study asks four questions:** (i) to what extent did surveillance recognize the signs of a growing crisis, given the available information at the time? (ii) to what extent did surveillance flag the building vulnerabilities and provide appropriate policy advice to mitigate these risks? (iii) to the extent that the problems were foreseen, how were these views communicated? (iv) was bilateral surveillance well supported by and well integrated with multilateral surveillance and FSAPs?[80]

93. **This assessment attempts to be realistic about what could be expected to have been foreseen, while still holding high expectations of the Fund's work.** Academic analyses of a long history of financial crises have shown that crises do recur (though not in exactly the same form), that signs pointing to crises can be seen, but that it is near impossible to pinpoint the timing of crises or actual crisis triggers.[81] Indeed, as Goodhart (2008) notes: "Almost every central bank which published a financial stability review, and … the BIS and IMF … had been pointing for some time prior to the middle of 2007 to a serious under-pricing of risk." He goes on to note that the trigger for the crisis "could have happened anywhere." That the Fund could not have been expected to have foreseen the crisis was a view voiced by many country authorities interviewed for the TSR.[82] But this does not diminish the Fund's responsibility to continuously search for and assess signs of trouble, and advise on how best to deal with them.

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[79] Each of the four cases under study meet most of the following criteria: (i) direct exposure to subprime assets; (ii) reliance on a similar funding model of mortgage-backed securitization; (iii) public intervention via the creation of central bank special facilities, and/or (iv) recapitalization of institutions (using public or private money).

[80] The case study's methodology includes a review of documents (Article IV documents, GFSR, WEO, news articles, academic papers, financial stability reports, and others), interviews of mission chiefs and MCM staff involved, and the broader TSR interviews of authorities conducted by the external consultants.

[81] Kindleberger (1978).

[82] A few market participants surveyed considered the Fund to be ahead of the curve. The External Consultant's Report also notes that the Fund's Economic Counsellor, R. Rajan, had issued warnings on the long period of unusually low risk premia and high liquidity, which were reflected in formal Fund surveillance documents "simply as 'benign."

B. Did Surveillance See the Crisis Coming?

94. **In conducting an ex post assessment, it is useful to distinguish between what surveillance saw, what it did not see, and what it could have been expected to see.** This section assesses bilateral surveillance in the four cases along these lines. Figures VII.1-4 summarize by country the key elements contributing to the crisis, grouping them into macroeconomic and financial sector trends, features of the institutional framework (i.e., financial regulation and supervision, legal framework), ensuing vulnerabilities, and risks. Supplement 2 provides more evidence by country (see Section III).

What was called

95. **Across all four cases, all of the underlying conditions and trends (the state of the world) had been comprehensively documented in surveillance**. The macroeconomic and financial trends were well documented in all cases (see apex box "macroeconomic trends" and top left box "financial sector trends" in Figures VII.2-5). The low interest rate environment was common to all, and in the U.S. and U.K. the rise in housing prices also contributed. Financial sector trends had been picked up, with common trends across most cases including the securitization model, rapid financial innovation, and the reliance on credit rating agencies to assess risks associated with complex financial instruments.

96. **Many aspects of the *institutional frameworks* had been comprehensively investigated, and weaknesses since exposed had been identified, but some were—wrongly—not assessed as critical at the time** (see top right "institutional framework" box in Figures VII.2-5).

- Staff reports discussed the fragmented nature of **U.S.** financial regulation, weaknesses in the regulatory framework for the government-sponsored agencies, including moral hazard issues, and, in some cases, recommended specific measures (e.g., a 2006 SIP included a suggestion to consider bringing investment banks under the Federal Reserve's oversight) (Figure VII.2). The weak regulatory standards in the subprime market, and inadequate consumer protection, were discussed as well, though perhaps should have been raised earlier and followed through more decisively.

- In the **U.K.**, some of shortfalls in the financial stability framework were recognized in the 2003 FSAP, but were not seen as critical at the time. The deposit insurance scheme and crisis management framework had been assessed, with some recommendations to strengthen the former and a favorable assessment of the latter, though noting that it was untested (Figure VII.3). The relatively low thresholds before coinsurance under the authorities' deposit insurance scheme was interpreted as consistent with the authorities' strong stance against encouraging moral hazard; moreover, that there is no accepted best practice on appropriate levels of deposit insurance complicates this assessment. The long and uncertain payout period was not explicitly discussed, though the report recommended the authorities consider a contingent credit line from the government. In addition, the UK's lack of special insolvency statute for financial institutions was noted in the FSSA, but not considered a problem. Instead, the enforcement actions available to the Financial Services Authority, and the "expeditious nature of the UK's legal system" were considered appropriate—though this later proved inadequate in the case of Northern Rock.

- In **Switzerland**, some regulatory weaknesses were identified in the 2007 FSAP Update, including on monitoring liquidity risk and capital adequacy thresholds (Figure VII.4). In **Germany**, the need for structural reform of the three-pillar banking system and a move toward risk-based supervision were highlighted by the 2003 FSAP (Figure VII.5). Overall, these issues had not been considered critical at the time, and were raised with varying degrees of emphasis in FSSAs and staff reports.

97. **Against this backdrop, most vulnerabilities had been recognized and risks individually investigated** (see boxes in the bottom half of Figures VII.2-5)**.** Several key vulnerabilities of the U.S. financial system stemming from the securitization boom, in the context of low interest rates and with prudential supervision lagging behind financial innovations, were explored in 2005-2007 SRs/SIPs and GFSRs. They included: (i) the increasing exposures of the U.S. financial institutions to the mortgage-backed securities (MBS) market, (ii) growing dependence of financial institutions on liquidity in markets for structured products, (iii) increased leverage (including through off-balance sheet positions), and (iv) lack of transparency on the ultimate risk exposures. Recognized and flagged as well were the associated risks stemming from hypothetical house price declines, a sharp rise in delinquencies in the subprime and Alt-A market segments, liquidity shocks in particular market segments, and a volatility spike. The April 2006 GFSR also noted the risk of multiple notch downgrades in structured credit products, and expressed concerns about the pricing models used by credit rating agencies. In the U.K., key risk factors were highlighted, such as the limited liquidity and lack of transparency associated with the expanding role of credit risk transfer products (2005 Article IV consultation); the increasing reliance on wholesale funding and the associated liquidity risk (2006); and cross-border banking linkages and risk of contagion (2006). In Switzerland, the exposure of the two large banks to external and liquidity shocks was accurately identified by the FSAP Update. In Germany, there was recognition since the 2003 FSAP that gradual structural changes to public banks and their search for a new business model created incentives for risky behavior. These various risks were analyzed separately, however, without "connecting the dots" to see what they amounted to in aggregate (see below).

98. **The potential for spillovers, and the financial channels of transmission, were identified in most cases.** The U.S. 2007 SIP analysis identified financial spillovers as being more important than trade spillovers in their impact on growth in industrial countries, and the

direction of the spillover being outward. The U.K. and Switzerland cases documented the increasing integration of international financial markets and thus the degree of exposure to financial sector spillovers. The spillover analysis was partly driven by the priority given to thinking through a scenario of abrupt unwinding of global imbalances. As discussed below, though, the impact of the spillovers was larger than initially expected. In Germany however, the spillover impact was not foreseen, mainly due to an "unthinkable" (see below).

What could have been done better?

99. **In the U.S., many issues were analyzed in depth, but the bottom line reached was overly optimistic, perhaps reflecting a tendency of surveillance to be "star-struck" by past good performance, or to give the authorities too much benefit of the doubt:**

- **The likelihood and magnitude of the U.S. housing market correction was misjudged, and "what if" questions not sufficiently explored**. The degree of heat in the housing market, and therefore the size of the needed correction, was a hotly debated issue. The economics profession itself was divided on this assessment, including within the Federal Reserve. Some leading economists had sounded warnings on the U.S. housing market since 2005 (e.g., Shiller (2005), Krugman (2005), Rogoff (2006)). Staff analysis in 2005 could not rule out that fundamentals explained most of the run-up in prices. In 2006, after the correction had started, updated staff analysis suggested a 15-20 percent overvaluation of house prices, but the fact that the U.S. had never experienced house price declines at a national level was repeatedly raised by various interlocutors as a counter-argument. Successive WEOs found that, compared with international experience, the run-up in U.S. housing prices seemed less worrisome than other cases such as Australia and the U.K. (in 2003), and Ireland, the Netherlands, and Spain (in 2004). However, a later WEO (2005) discussed the risks of synchronous housing market declines across countries.

- **The overall fragility of the U.S. financial system, including the potential impact of a house price correction, were underestimated**. Favorable views were expressed in multilateral surveillance: The April 2006 GFSR noted that the securitization model " … increases the ability of the financial system as a whole to absorb potential shocks," and that "a wider dispersion of credit risk has "derisked" the banking sector, which still occupies a strategically important role in the economy...". [83] Article IV SIPs examined the interaction between the housing market and financial structure (2005), the role of financial innovation and securitization (2006), financial regulation (2007), and the subprime market (2007). The adverse incentive effects of the

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[83] Similarly, the September 2005 WEO noted that "the broader distribution of real estate–related risks through asset securitization and other financial innovations have reduced financial market risks."

securitization model on maintaining loan quality had been flagged (2007). Thus, much analytical effort had been expended in looking at these issues individually, and some possible stress to the system had been detected through knock-on effects (see below), but in 2007 the resulting risks were presented as medium-term regulatory challenges, with the core of the financial system still judged to be "in a sound financial position," with systemic risks "low." Underlying this assessment was faith in the sophistication and resilience of the financial system, and in the Fed's demonstrated ability to deal with past short-term stresses (e.g., Russia; LTCM; September 11, 2001).

100. **Also in the U.S., the aggregate implications of individually identified factors were not recognized, and perhaps could have been explored more.** As discussed above, though actually calling a bubble would have been highly controversial, more probabilistic assessments could have been made based on analysis connecting the factors. The following factors could have been combined to construct a plausible argument that financial market conditions were becoming irrationally exuberant: the housing boom; the originate-to-distribute model; the burgeoning market in structured products; evidence that loan conditions were becoming too lax; consumer protection lacking; and the global low interest rate-high liquidity environment. The contributing factors had been individually identified and discussed, but surveillance failed to foresee that their confluence created the preconditions for a "perfect storm." That said, it would have been difficult to gauge the full impact of the crisis without anticipating all the direct and indirect effects of the real estate shock on the financial sector (and vice versa), much of which would have required data that was nonexistent (see below on the "known unknowns").

101. **In the U.S. and UK, some *institutional* weaknesses might have been uncovered if assessments usually done in the FSAP context had been made**. Weaknesses in central bank liquidity facilities became apparent, with respect to investment bank access (U.S.) and the type of collateral accepted (U.S. and U.K., Figures VII.2 and VII.3, right top dashed boxes). The European Central Bank seems to have been better prepared on the latter front. An inadequate systemic crisis management framework with respect to investment banks was also laid bare. These types of institutional arrangements would usually be explored in an FSAP, when the required expertise is available. Such expertise could have also helped to assess more comprehensively the fragmented U.S. regulatory system. On the U.K., the FSAP was five years before the crisis, and dramatic changes had taken place in the financial sector. Whether the institutional framework was keeping up with such changes (e.g., on liquidity facilities) would usually be assessed in the context of an FSAP update, though there is no guarantee that the inadequacies in the crisis management framework would have been found. These institutional issues are difficult for Article IV surveillance to keep full pace with in the context of the resource constrained FSAP follow-up.

102. **More generally, the possible impacts of risks materializing turned out to be underestimated, or were not assessed quantitatively.** In cases where stress tests were carried out, their limitations had been flagged. In Switzerland, FSAP stress tests did not capture the impact of systemic market events on the banks' trading portfolios (but this omission was flagged as important and qualitative analysis was carried out). In the U.S., more rudimentary sensitivity analysis in 2006 based on public information excluded MBS holdings.[84] However, even had such stress tests been conducted, it is not clear whether they would have yielded much different insights, because standard stress tests are unlikely to have included all relevant tail risk exposures, such as the risk of market illiquidity, or risk interactions, such as that between credit and market risk.

Known unknowns, and unthinkables

103. **That some of these risks were unforeseen largely had to do with the effects of uncertainty, reflecting lack of information on exposures and the complexity of the securities themselves—known unknowns**. As the April 2006 and 2007 GFSRs made clear, respectively, "the details of who holds which risk and in what amount are less transparent outside the banking system because of less stringent reporting requirements," and even the holders of the securitized products did not know, "because the complex market structures of mortgage related securities can disguise how risks are allocated, who holds them, and the degree to which they are hedged." Absent evidence to the contrary, it was assumed that risks had been distributed away from financial intermediaries to a greater extent than was actually the case. Thus, the reassessment of counterparty risks due to increased uncertainty about the credit quality of major financial institutions was also not foreseen, though the issue of counterparty risks had been discussed in the context of exposures of regulated financial institutions to highly leveraged hedge funds. These overall uncertainties generated the spillover effects across markets and borders, including to the other three countries in the study, both through direct exposures to subprime instruments, and through knock-on effects as markets seized up more generally.

104. **In all four cases, some liquidity developments came as an "unthinkable" surprise.** Though many issues relating to liquidity risk had been flagged, many other aspects of liquidity problems were unanticipated. Liquidity issues had been flagged for specific market segments (U.S., U.K, GFSR) or for the trading book (Switzerland), but not in Germany as the focus there was on solvency. The funding liquidity risk coming from the use

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[84] More comprehensive stress-tests would have been conducted in an FSAP and could have helped uncover potential pressure points and risk-transmission channels, as well as identify critical information gaps. However, more broadly, with the correction in the U.S. housing market already underway, staff did carry out in 2006 a detailed analysis of its potential macro impact on consumption, residential investment, and GDP, under different assumptions about the magnitude of the shock.

of off-balance sheet vehicles (such as SIVs), combined with the reputational risk, and their impact on parent banks, were a surprise. The risk of a more widespread liquidity freeze, particularly in the interbank money market, had not been explicitly considered, though possible knock-on effects across markets were flagged in the April 2007 GFSR and the 2007 U.S. staff report. Even so, the succession of crises across markets was a surprise.

C. Was the Right Policy Advice Given?

105. **Policy advice to mitigate the emerging risks was given, though sometimes little more could be done than to raise awareness of the identified risk.** In Germany, the focus since the FSAP has been on the need for reform of the three-pillar system, which also included an ongoing move toward risk-based supervision supported by the Fund, for which the FSAP had provided detailed recommendations. The costs to the public purse of propping up Landesbanken had also been calculated, to back up the argument that such fundamental reforms were needed. In Switzerland, the FSSA provided advice on assessing capital adequacy of the two large banks and strengthening supervision of their liquidity risk. In the U.K., the 2007 staff report flagged funding liquidity as a tail risk but—given resource constraints on Article IV consultations—deeper analysis would have been very difficult in the absence of an FSAP update. These prescriptions all proved to be on target.

106. **However, the consequences of certain risks materializing were not always fully drawn, hampering calls for policy action**. Analysis of the potential consequences on the public purse, by looking at a complete public sector balance sheet, was found a useful tool with which to engage the authorities in the cases of Germany and Switzerland. In the U.K. however, while risks to the financial system were presented as "low-probability but potentially high impact," no further discussion of how high the impact might be was offered. Flagging risks may not be sufficient to persuade of the need for action, until policymakers are shown explicitly the possible magnitude of macroeconomic consequences if they fail to act.

107. **In the U.S. case, staff views conformed with those of the authorities, and staff mostly expressed support for policy measures already taken, or under consideration**.

- In contrast with some other observers (e.g., BIS), staff judged monetary policy to be less of a contributing factor, though the role of asset prices in monetary policy is the subject of continuing controversy. In 2005, the authorities' monetary policy stance was assessed as "effective," though staff also noted that "a more aggressive pace of interest rate hikes cannot be ruled out." The most recent staff report found that, more so than monetary policy, "financial supervision and regulation failed to rein in lending excesses," while also pointing out that "the role of asset prices in monetary policy bears reexamination."[85]

- Since the risks from subprime exposures were not seen as cause for serious concern, detailed policy advice was not provided. Rather, in successive Article IV consultations (through 2006) the analysis of risks focused on the scenario of a shift in investor preferences away from U.S. financial assets, triggering a disorderly unwinding of global imbalances. Policy advice was geared accordingly. In 2007, the emphasis on shifts in investor preferences lessened, but financial sector policy advice was couched as a more medium-term challenge, such as meeting new regulatory challenges, and improving the effectiveness of regulation, including via rationalizing its structure.

D. Were Views Communicated with Enough Emphasis?

108. **Many risks were flagged, but the degree of concern related to those risks was not always clear, and headline messages tended to be reassuring.**

- In the U.S., staff reports suggested that a soft landing would be most likely, and that core financial institutions were sound. Risks were presented as more medium-term in nature, rather than as more immediate threats to systemic stability. To some degree, the buoyant economy in that period, and the financial system's resilience to previous shocks, may have dampened somewhat the relative emphasis given to emerging risks. In addition, the tone of the message may have been influenced by the fact that the burden of proof is very high and ultimately a matter of judgment, particularly when key data gaps exist and the authorities' resources far exceed the staff team's.

- In the U.K., similarly reassuring headline messages on the economic outlook were given, and in 2006 the banking system was considered "well positioned to absorb substantial shocks." However, in 2007 the risks were presented as low probability but potentially high impact, striking a stronger tone.

- In Switzerland, the FSSA comprehensively discussed its assessment on capital adequacy, liquidity issues and the trading portfolio, and the proposed new FINMA law, and the staff report picked up these issues and voiced some concerns. However, other headline messages, particularly on stress testing, reassured that "the financial system [was] resilient to significant shocks." Two issues arise: (i) important caveats to the stress tests discussed in the FSSA were not adequately reflected in the staff report, thus reinforcing the reassuring headline message; and (ii) while areas in need

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[85] 2008 U.S. Article IV consultation country report (IMF Country Report 08/255, 7/2008), ¶3, ¶24.

of improvement were also highlighted, it is not easy to discern how keenly those concerns were felt. The degree of concern may have been apparent to more specialist readers, but much less so to others.

- In Germany, tough overall messages on the need for structural reform (including the banking system) were delivered. The Landesbanken's ongoing search for a new business model was well-known and flagged in staff reports, and the past fiscal costs from bailing out this category of banks were calculated. However, incentives for greater risk taking were noted only in passing in the FSSA, without reference in the staff report. The focus was on the more medium-term challenges of the three-pillar system. Making more explicit such incentive structures, in the global context of ample liquidity and the search for yield, as well as some Landesbanken's external ventures, could have suggested more strongly that more immediate trouble could be brewing.

E. Was Bilateral Surveillance Well Supported By, and Well Integrated With, FSAPs and Multilateral Surveillance?

109. **The FSAP, where available, provided invaluable support.** The Switzerland 2007 FSAP update was instigated by the mission team and was able to be accommodated, providing a good example of cooperation and integration. In the Switzerland case with the most recent FSAP, EDs praised the integration of financial sector issues in the staff report. Other FSAPs (Germany and U.K., both in 2003), though somewhat dated, had provided an assessment of risks/vulnerabilities that existed at the time, in the context of the institutional framework, including standards assessments, legal framework, and implementation capacity. These provided a comprehensive baseline for follow-up work in Article IV surveillance, pointing to key areas for continued monitoring.

110. **MCM participation outside FSAPs also worked well in identifying emerging risks, though less so for keeping abreast of institutional factors.** Across all cases, risks identified with the help of MCM participation proved on target (some of which had been flagged in FSAPs, where they had been done). However, assessing institutional developments posed a greater challenge, given the specialized resources needed to do so. In a period of rapid financial innovation, it is important to assess whether institutional capacity is keeping up, both in terms of supervisory capacity, and in considering whether the institutional framework itself remains adequate. However, with staffing and resource constraints, the Fund would not be able do this every year, even in systemic countries.[86] MCM participation in all four cases seems to have contributed to well-integrated staff reports. In the case of the U.S.,

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[86] FSAPs are in principle updated at five-year intervals, with institutional aspects (e.g., banking supervision) usually updated at that time. Around 20 FSAPs are conducted per year.

some members of the GFSR team were also on the U.S. team, making for close cooperation and integration.

111. **As for the integration with multilateral surveillance, this case study found both good examples of integration and areas for improvement.** The stress tests for the Switzerland FSAP explicitly incorporated a global imbalances scenario, pursuing a line of analysis consistent with the key risk identified in the WEOs in recent years. However, another opportunity for integration was missed by the stress tests. The April 2006 GFSR warned of possible multiple-notch downgrades in ratings of structured products; this finding could have been used to strengthen staff's case for deviating from historical default rates in stress tests; instead historical correlations were used (following commonly agreed practices) which did not adequately capture the risks. Staff corrected for this in additional qualitative analysis, noting the risks from structured products. But the ideal would be to integrate such elements fully into a quantitative stress test.

112. **Some arguments could have been strengthened if they had found explicit support from multilateral surveillance**. Specific examples that emerged: (i) the pattern across European banks of high risk-weighted capital adequacy but low unweighted measures, relating to Basel II; (ii) advancing stress testing methodologies and assumptions; (iii) monitoring the emerging risks from the credit risk transfer market.[87] [88] Raising these issues at the bilateral level was met with resistance by authorities and banks (e.g., "this has never happened before"); raising them in a multilateral context, such as in the WEO or GFSR, could have helped provide greater backing to pursue such issues.

F. What Does this Mean for Surveillance?

113. **Justified concern at the fact that the full scale and impact of the crisis were not foreseen should not obscure the progress made in monitoring and analyzing financial systems**. In each case, risks were being regularly monitored in the Article IV process, and much analytical work of financial sector issues supported the assessments in the staff reports. When the crisis broke, the Fund was in a much better position to understand financial sector risks and vulnerabilities in these countries than on the eve of the Asian financial crisis.

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[87] In cases with sophisticated risk management, stress tests based on historical correlations are not likely to create much stress, as the risk management techniques strive to be robust to those same correlations. Stress tests in such cases are usually carried out by the banks themselves, after discussions with staff on agreed parameters. These agreed parameters are usually based on historical data.

[88] Monitoring risks associated with credit risk transfer would have required more data, which, given the cross-border interlinkages and the difficulty in pinpointing specific series to collect, was hard to tackle through bilateral surveillance. The April 2006 GFSR did note the need for better data, though the example given–"information on tranche structures for portfolio swaps"–may have been difficult for non-specialist mission teams to use. The BIS (2005) provided clearer guidance on specific information needs.

Therefore, it also had a better sense of possible spillover effects to the global economy (e.g., impact on emerging markets).

114. **That said, surveillance should strive harder to (i) avoid wrong calls, including by asking "what if" questions and not being blinded by past good performance, (ii) think the unthinkable, and (iii) highlight known unknowns more forcefully** in the hopes of spurring action. However, avoidance of wrong calls should not come at the cost of overly hedged assessments–these should be made based on rigorous defensible analytical work. Thinking the unthinkable should not be done indiscriminately, but only in such cases when the potential losses and spillover effects are so great as to warrant further exploration. Finally, known unknowns usually come down to unreported information about exposures; to the extent that the Fund can highlight where the gaps are, thereby possibly spurring international efforts to close these information gaps, this would contribute to a better early warning framework.

115. **Greater analytical efforts are needed to improve the Fund's ability to "make the right calls" and to "connect the dots" in the future.** This review suggests a key challenge is to recognize connections between existing and emerging "dots." Such analysis requires integrating macro-financial linkages and spillover analysis, as well as institutional factors. The Financial Sector Task Force highlighted key areas in which to develop better diagnostic tools, including techniques to analyze macro-financial linkages, and to assess the macroeconomic impact of specific financial risks and fragilities. Advancing stress testing methodologies, including to work toward global or regional stress tests, would be desirable. The role of institutional factors in shaping incentives, leading to possible macro consequences, also needs to be explicitly considered. Chapter IV on financial sector surveillance provides further recommendations. Progress in these areas is likely to be incremental, reflecting analytical difficulties and resource constraints. Finally, another area that may need re-thinking is assessing when monetary policy should focus more broadly on asset prices, as well as price stability.

116. **Many of the diagnostic "misses" reflect resource allocation choices that were not necessarily misguided at the time they were made. Thus, difficult prioritization challenges lie ahead:**

- *One challenge is how to monitor the evolution of institutional capacity and assess its ability to handle the identified risks in the context of rapid financial changes*. A priori, advanced economies were considered to have well-developed systems which other countries sought to emulate. The crisis has highlighted how important such institutional frameworks are, and that even those at the frontier need to constantly evolve to keep up with developments, implying that surveillance would need to check on these carefully as well. At the same time, assessment and reform of these factors in other economies also are of high priority, as the authorities seek to upgrade their systems in increasingly globalized markets. Staffing and resource constraints are binding; resource allocation decisions need to consider update frequency, context (within FSAPs or separately?), and how to prioritize among cases—put differently, not prioritizing the UK for an update in 2006 did not seem unreasonable then.

- *Where warranted, if connections suggesting high-impact tail risks are indeed made, the next step is to draw out the macroeconomic consequences, should the risks materialize*. The counter-argument that "this has never happened before" has been seriously weakened. In such a context, it can be useful to start with asking "what if" questions challenging consensus views, thinking through possible consequences (e.g., on public sector balance sheets and on the financial sector). The choice of which risk to pursue in bilateral surveillance must be made deliberately, with risks at the country level assessed both for the likelihood of the risk materializing, and the resulting potential for damage at the macro level (i.e., an expected loss approach). In cases where rigorous analysis has been done and considered plausible, such scenarios could be discussed with the authorities, and highlights shared with the Executive Board under suitable confidentiality safeguards. Such analysis could also suggest particular developments as concrete markers of signs of trouble.

- *Resource constraints dictate against being able to pursue in great depth more than a few such questions at a time, however.* Prioritization at the institution-wide level could help, with senior management involvement (e.g., in the Surveillance Committee), to determine which risk warrants further exploration *across countries* based on the potential for spillover effects that could threaten systemic stability. This type of analysis has already been done on global imbalances, which featured in almost all the cases studied here. It should be recognized and accepted that, under such an approach, sometimes choices made will ultimately prove to have been wrong.

117. **Closer attention to feedback between multilateral and bilateral surveillance would also help.** This case study has revealed examples of instances where greater feedback could have been useful: some issues need the multilateral context to help back up bilateral discussions, and other issues aggregated from the bilateral level can take on different significance when examined from a multilateral perspective. They argue for stronger processes to identify and discuss implications of feedback, including for the consistency of views expressed across the range of bilateral and multilateral surveillance reports.

118. **Finally, the Fund needs to learn to be bolder in communicating its concerns, including on known unknowns.** In addition to the perennial issue of balance between the "confidential-advisor" and "ruthless-truth-teller" roles, the communication of concerns about serious risks presents thorny tradeoffs: how to provide a balanced view without losing traction, and when to sound the alarm without crying wolf on the one hand, or actually precipitating a crisis on the other. However, it should be possible for surveillance to take

clear analytically defensible positions where possible, including by identifying signs of trouble to watch for, instead of providing a fully hedged and therefore less informative assessment. Explicitly drawing out the possible macroeconomic consequences of tail risks, particularly but not only on the public sector balance sheet, would help make the case to the authorities more arresting and persuasive, though may be difficult to communicate to a wider audience given the likely sensitivity of the discussions.[89] At least, key information gaps should be flagged. Clear views expressed in multilateral surveillance could also help provide support to bilateral views. In this regard, the BIS concluding chapter in the annual reports over 2005–08 conveyed a degree of concern more clearly than the Fund, which suggests there is room for the Fund to move toward greater boldness of expression.

[89] In any case, the transparency policy allows for deletion of market-sensitive material before publication.

Box 11. How did the "Subprime" Crisis Manifest Itself in These Four Cases?

This box summarizes the crisis' impact on financial institutions in the four countries (see Figure VII.1).

United States

Subprime mortgage lending in the U.S. picked up in earnest in 2004, as housing affordability began to erode and private mortgage institutions stepped in to substitute for the Government Sponsored Entities (GSEs, including Fannie Mae and Freddie Mac) funding. The consensus view now seems to be that subprime lenders tried to maintain volume by making riskier loans, as the housing market started to falter in 2005-06. The degree of risky lending was possible within the context of official faith in financial innovation, contributing to lax lending, underwriting, and monitoring standards, and inadequate consumer protection. Subprime mortgage delinquencies picked up in 2006, but it was not until February 2007 that rising delinquencies led to a jump in spreads on higher-risk mortgage-backed securities (MBS). Yet, there was still little evidence of spillovers to broader financial markets until late spring-summer 2007, when troubles in the Bear Stearns' SIVs, a series of downgrades of mortgage products by Moody's, S&P and Fitch, and poor earnings announcements by U.S. home lenders and builders led to further deterioration in the MBS market. The latter was quickly followed by widening of corporate spreads and drying up of the asset-backed commercial paper market (ABCP) which led to several headline cases of funding shortages (e.g., IKB, American Home Mortgage Corp.) and culminated in a full blown liquidity crisis centered in the interbank market in August 2007.

United Kingdom

The subprime crisis in the U.K. was defined, in particular, by the first bank run since Victorian times—the run on Northern Rock (NR). The main causes of NR's downfall relate to specific management and regulatory weaknesses, related to increased liquidity risk from reliance on wholesale financing. As liquidity dried up across the asset-backed markets in a spillover from the subprime MBS, Northern Rock found itself squeezed. Rumors of its troubles, and a slow official reaction, weaknesses in the insolvency framework, combined with low deposit insurance thresholds and long and uncertain payout periods, culminated in the run on the bank, a government guarantee of deposits, and its eventual nationalization.

Switzerland

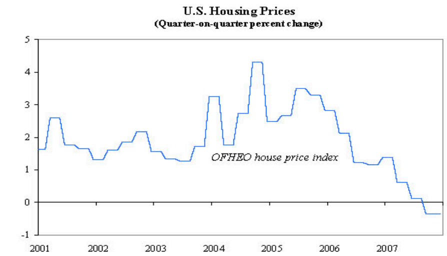
Switzerland's two largest banks, UBS and Credit Suisse (representing two thirds of the Swiss banking system's global assets and one third of local market assets), were severely impacted by spillover effects from the subprime crisis. The banks had large trading portfolios exposed to subprime-related risks, including direct exposures. Under Basel I, additional capital was not required for such positions. Thus, ahead of the crisis, both banks looked adequately capitalized (risk-weighted) but unweighted capital adequacy ratios were much lower. Exposure to risks via hedge funds was lower. As of early June 2008, UBS had subprime-related losses/writedowns of $38 billion (second behind Citigroup) while Credit Suisse was ninth with $9.6 billion in writedowns. Both banks have needed to raise substantial private capital to strengthen their balance sheets—UBS has raised $28 billion.

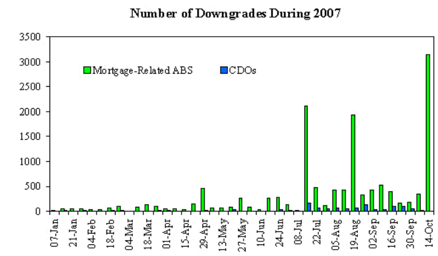
Germany

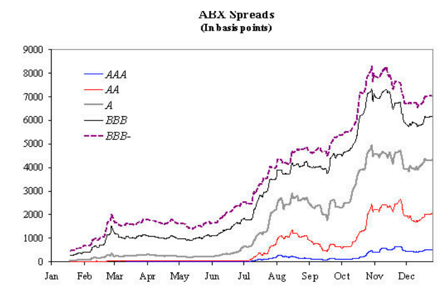
The spillover effects from the subprime crisis on Germany have involved bail-outs of two banks (IKB and Sachsen LB) by publicly-owned financial institutions. In both cases, the problems came to light when the banks' conduits, set up to invest in asset-backed securities including subprime assets, lost access to funding in the short-term ABCP market. While the impact on Germany's banking system has appeared limited so far compared to the other cases, the costs to the public sector have been appreciable and may continue to mount. The rescue of IKB, the first German bank that succumbed to the financial market stress, has raised the costs to the public until now to about 9 billion euro. Losses of some of the state-owned Landesbanken, including Sachsen LB, Bayerische LB, and West LB, have also been considerable, with losses/writedowns totalling around $10.8 billion as of early June 2008.

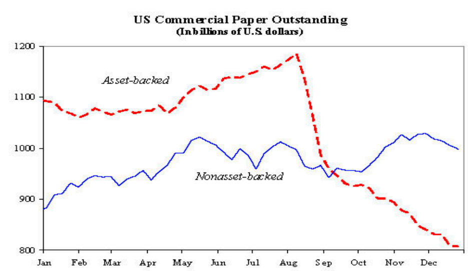
Figure VII.1. Timeline of the "Subprime Crisis"[90]

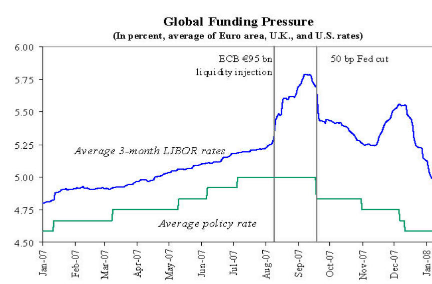
2006	
	Significant cooling in the US housing market and rising inventories. Rapid growth in covenant-lite loan issuance to finance leveraged buyouts (LBOs)
2007	
January - February	Recognition of the deterioration in collateral in recent vintage mortgages, as delinquency rates on US subprime loans rise, and rapid widening of spreads on CDOs containing such mortgages *Staff report on 2006 A-IV Consultation with the United Kingdom*
March	Non-prime mortgage originators begin to experience problems
April	Subprime mortgage lender New Century declares bankruptcy. *Staff report on 2007 A-IV Consultation with Switzerland*
May	UBS shuts down Dillon Read Capital Management after the fund posts heavy losses stemming from its investments in the subprime sector *FSAP Update: Switzerland*
June	Two Bear Stearns hedge funds collapse from bad subprime bets
July	**Credit rating downgrades:** S&P announces ratings downgrades on subprime mortgage related securities. **Losses/writedowns** : German IKB bank reveals subprime related losses. **Markets:** Credit spreads (e.g., credit default swaps on mortgage related ABS (ABX spreads)) rise. Pullback/shelving of financing of major LBO deals (sale of $12bn in Chrysler loans delayed and $10bn in loan financing for Alliance-Boots withdrawn) *Staff report on 2007 A-IV Consultation with the United States*
August	**Bankruptcies:** American Home Mortgage files for bankruptcy. **Losses/writedowns:** Indymac, the second largest independent mortgage lender, reports lower earnings and a spike in NPLs, Countrywide and Wells Fargo issue profit warnings; **Capital injections/bailouts**: Countrywide borrows $11.5 bn, Barclays taps BoE for emergency funds twice; IKB ($5.5 bn) and Sachsen LB rescued by other public banks. **Markets**: asset backed commercial paper rates surge as rollovers cease and Libor rates rise on uncertainty on banks' credit quality. **Regulators:** ECB injects 94.8 bn euros as interbank market dries up; Fed cuts discount rate 0.5%
September	**Capital injections/bailouts**: the UK mortgage lender Northern Rock experiences a classic bank run. **Regulators:** BoE rescues Northern Rock, guaranteeing all its deposits. Fed cuts federal funds rate by 0.5% to 4.75% and cuts discount rate by 0.5% to 5.25%.
October	**Losses/writedowns:** UBS writes down $3.4 bn, Merrill Lynch announces $5.5 bn in losses later increased to $7.9 bn and CEO resigns, BoA announces $4 bn writedown.
November	**Losses/writedowns:** Citigroup, Morgan Stanley, Freddie Mac announce losses, Goldman Sachs issues a report estimating subprime related losses for the whole financial system between $211bn and $281bn. **Capital injections:** Citigroup raises $11.8 bn, Freddie Mac sells $6 bn in new shares, IKB received additional $4.1 bn from German banking association. **Regulators**: Fed pumps $47 bn into banking system.
December	**Lossess/writedowns:** UBS, Citigroup. **Capital injections**: Merrill Lynch ($5.6bn), Morgan Stanley ($5.6 bn), UBS ($12.4 bn). **Downgrades:** Rating agencies lower the outlook on ratings of bond insurers Ambac and MBIC and cut ACA's rating from A to CCC, warn about ratings cut on securities insured by bond insurers. **Regulators**: Fed cuts Fed funds rate by 0.25% to 4.25%; Fed and other central banks coordinate liquidity support using term-auction facilities or similar tools. ECB pumps record 350 bn euros ($502 bn) into 390 European banks; Fed uses term-auction facilities to provide $40-60 bn to US banks.
2008	
January	*2007 staff report on A-IV Consultation with Germany*











[90] Focuses on the key developments that are relevant for this case study; not meant to be exhaustive. Distilled from various issues of the Global Markets Monitor.

Figure VII.2: Underlying Trends and Constellation of Risks and Vulnerabilities in the Run-Up to the Subprime Crisis: the Case of the U.S.

Macroeconomic Trends:

(1) low interest rates in the U.S. and globally
(2) rising housing prices in the U.S. and globally

Financial Sector Trends:

(3) increased use of securitization model by non-depository lenders and mortgage originators;
(4) increased purchases of structured products (including MBS) by domestic and foreign institutional investors;
(5) increased reliance on credit rating agencies for assessing risks associated with complex financial instruments;
(6) increased reliance on risk-management models for managing risks associated with complex financial instruments.

Institutional Framework:

(7) fragmentation of the U.S. financial regulation (e.g., different regulators for commercial and investment banks);
(8) systemic role and weakness in the regulation of GSEs;
(9) lax lending, underwriting and monitoring standards in the subprime market;
(10) weak consumer protection

(11) weaknesses in the liquidity mgt framework
(12) weaknesses in systemic crisis mgt framework (e.g., lack of resolution framework for investment banks)

Vulnerabilities:

Increased borrowing by households (including by increasingly less creditworthy borrowers) in the form of mortgage loans => increased sensitivity of the economy to the real estate shock

Increased exposure of major financial institutions to the MBS market => increased exposure to market risk induced by a real estate shock

Increased reliance of major financial institutions and institutional investors on liquid markets for securitized assets => increased exposure to market liquidity risk

Increased leverage in the financial system (due to the widespread use of structured products, procyclicality of standard risk mgt models; lax internal risk controls in some major financial institutions...) => increased exposure to volatility shock

Little/no information about the ultimate exposures to real estate linked structured products => increased counterparty risk

Increased use of off-balance sheet vehicles (like SIVs), with explicit or implicit credit support from sponsors, increased reliance on ABCP and interbank market for funding => increased exposure to funding liquidity risk

Risks:

A deceleration/decline in house prices

A sharp rise in delinquencies on mortgage loans in subprime and Alt-A segments;

Sharp price declines in securitized assets markets (due to reassessment of assumptions about credit risks and risk correlations underlying the pricing of structured products)

A volatility spike in a number of asset markets

A reassessment of counterparty risk (because of increased uncertainty about the creditworthiness of financial institutions due to unknown MBS exposures and liquidity positions)

A sharp rise in the cost of funding due to squeezes in the ABCP and interbank money markets.

= “underestimated” = “unanticipated”

Figure VII.3: Underlying Trends and Constellation of Risks and Vulnerabilities in the Run-Up to the Subprime Crisis: the Case of the UK

Macroeconomic Trends:

(1) low interest rates in the UK and globally
(2) rising house prices in the UK and globally

Financial Sector Trends:

(3) increased reliance of wholesale funding by banks, especially to expand mortgage portfolios;

(4) expansion of credit risk transfer market;

(5) reliance on credit rating agencies for assessing risks associated with complex financial instruments;

(6) increasing international exposure, especially through inter-bank market;

Institutional Framework:

(7) fiscal-financial-monetary "tripartite agreement" seen as setting the standard globally, though not crisis-tested;
(8) lack of special insolvency statute for financial institutions;
(9) looser lending standards, and some movement toward subprime;
(10) low deposit insurance threshold, long and uncertain pay-out period, lack of public understanding;

(11) weaknesses in central bank emergency lending framework

(12) framework for cooperation and exchange of information with foreign regulators (Swiss and U.S.);

Vulnerabilities:

Increased HH sector exposure to real estate shock

Increasing bank reliance on wholesale funding => exposure to liquidity/funding risk.

Increased use of credit risk transfer instruments, with limited information on ultimate holders of risk => counterparty credit risk.

Contagion risk from the inter-bank market given the UK's international exposure.

Untested crisis management arrangements.

Risks:

Disorderly unwinding of global imbalances.

Decline in house prices, rise in mortgage-related defaults.

Drop in liquidity in wholesale funding, and other markets.

Reassessment of counterparty risk due to increased uncertainty about the credit quality of a number of major financial institutions

Shock to international banking system transmitted to UK through inter-bank market.

= "underestimated"   = "unanticipated"

Figure VII.4: Underlying Trends and Constellation of Risks and Vulnerabilities in the Run-Up to the Subprime Crisis: the Case of Switzerland

Macroeconomic Trends:

(1) low interest rates in the Switzerland and globally
(2) strong global growth
(3) rising global housing prices

Trends in Large Banks' Activities:

(4) increased international exposures;
(5) expansion of trading portfolios;
(6) expansion of securitization activities;
(7) reliance on credit rating agencies for assessing risks associated with complex financial instruments;

Institutional Framework

(8) Good financial sector supervision, but with the need to improve its: (i) budgetary independence and (ii) monitoring of liquidity risk, particularly of the large banks;
(9) Financial supervision relies on external auditors and insufficiently on on-site discovery by the regulator itself;
(10) A framework was in place for cooperation and exchange of information with foreign regulators (US and UK);
(11) Thresholds for capital adequacy ratios (CAR) higher than suggested by Basel Principles, but regulation applies only to weighted CAR and not to unweighted CAR.

Vulnerabilities:

Increased leverage: although the weighted CAR remained consistent with regulatory thresholds, the unweighted CARs were very low.

Exposure of banks to external risks, particularly a disorderly unwinding of global imbalances

Exposure of banks to liquidity risks, primarily via their large trading portfolios and their securitization activities

Large direct exposure of banks to securitized subprime-mortgages that had high credit ratings, but that lost value very quickly.

Risks:

A disorderly unwinding of global imbalances, particularly a depreciation of the US dollar and a correction in the US housing market.

A liquidity squeeze that lead to a disruption in international money markets and to an increase in interbank interest rates in Switzerland and Europe.

High delinquencies in the US subprime-mortgages sector

= "underestimated"   = "unanticipated"

Figure VII.5: Underlying Trends and Constellation of Risks and Vulnerabilities in the Run-Up to the Subprime Crisis: the Case of Germany

Macroeconomic Trends:

(1) Global: low interest rates and housing boom
(2) Germany: cyclical pickup in growth

Financial Sector Trends:

(3) Low bank profitability relative to EU peers; need for restructuring and innovative products to boost revenue;
(4) Landesbanken (LB): search for a new business model, after a 2005 expiration of public guarantees on new borrowing raised funding costs, but the banks retained their implicit public backing and ownership, and legal constraints on domestic activities outside of their region were only slowly being removed;

Institutional Framework:

(5) move toward risk-based supervision in environment of gradual structural change in the banking sector;
(6) gradual legal reforms to allow joint stock (public and private) ownership of public banks, including LB.

Vulnerabilities:

LB Search for higher revenues => incentives to engage in riskier investments

Exposure of the public sector balance sheet to problems in public bank pillar

Increased use of off-balance sheet vehicles (like SIVs), with explicit or implicit credit support from sponsors, increased reliance on ABCP and interbank market for funding => increased sensitivity to liquidity funding risk

Risks:

Risk that relatively high-yield investments may turn sour in a downturn

Risk of insolvency of LBs

A sharp rise in the cost of funding/liquidity squeeze in the ABCP and interbank money markets.

= “underestimated” = “unanticipated”

VIII. Candor and Evenhandedness [91]

Key Messages

- The oral policy dialogue between staff and the authorities appears quite candid, but staff reports less so.
- Staff must strive for greater candor in Article IV reports on all countries so that the Board can have a candid policy dialogue with members. Given, however, that there are limits on the candor of written staff reports, separate (e.g., oral) communications to the Board could be further developed.
- There are no clear-cut signs of lack of evenhandedness, but significant variations in the quality of staff's assessments across regional groups and income groups exist. The review process needs to pay more attention to such discrepancies to guard against them.

A. Introduction

119. **The importance of candor and evenhandedness in surveillance has long been recognized.** Candor is important because without it surveillance becomes meaningless: the dialogue between the authorities, staff, and the Board needs to be candid to be effective. Evenhandedness is a key legal foundation of Fund operations, including surveillance, and a cornerstone of a cooperative institution. Both dimensions have been reaffirmed explicitly in the 2007 Surveillance Decision, which notes that: "The Fund, in its bilateral surveillance, will clearly and candidly assess relevant economic developments, prospects, and policies of the member in question, and advise on these. […] the Fund will be evenhanded across members, affording similar treatment to members in similar relevant circumstances."[92]

120. **Yet both concepts are elusive and hard to measure**. The level of candor is highly subjective and cannot be directly observed. While it is often associated with clarity of expression, this is not necessarily so, as a statement can be very clear yet not candid. Moreover, confidentiality in the Fund's relations with the membership puts constraints on how candid staff can be toward the public and, in some cases, the Board. Evenhandedness too is a difficult concept to measure, as it is in fact consistent with differences of treatment, so long as they are justified by relevant circumstances. In both cases, the judgments required are best made in a case study context, which allows in depth examination of the facts and

[91] Prepared by Ketil Hviding and Jung Yeon Kim, with inputs from Chris K. Marsh.

[92] Decision No. 13919-(07/51) (the 2007 Surveillance Decision), Paragraph 8.

circumstances. This approach was taken to assess candor and evenhandedness in exchange rate surveillance (Chapter III).

121. **Nevertheless, some indirect measures of candor and evenhandedness can be obtained in survey data and staff reports:**

- Candor can be gauged by asking stakeholders for their assessments of their candor and that of others. A more indirect gauge is the rigor with which staff presents medium-term projections, as less candid staff reports would tend to present inconsistencies among the underlying facts, the projections, and their rendering in words.

- A review of the quality of staff reports for countries with different characteristics—economic size, income level, regions, and exchange rate regime—sheds light on whether these characteristics, which in principle should not be relevant, influence staff's treatment of the member in surveillance. A large difference in quality along key dimensions that cannot be given a reasonable explanation would reflect uneven treatment of member countries.

B. Candor of the Policy Dialogue and Staff Reports

122. **Mission chiefs consider that the policy dialogue between staff and country authorities is largely candid.** Almost all mission chiefs who responded to the survey indicated that the discussions, on the part of the team, were "largely" or "totally" candid. This is consistent with the IEO finding that staff was both respectful and willing to approach discussions with candor.[93] Most mission chiefs (73 percent) also perceived the authorities to be "largely or totally candid" in their discussion with staff.

123. **Mission chiefs and the authorities agree that staff reports are generally less candid than oral discussions.** Almost 30 percent of respondents to the mission chief survey indicated that they had felt constrained to a large or very large extent in presenting a candid staff report. Of those, 87 percent (25 percent of total) indicated that more candid messages were delivered separately from staff reports, largely through oral discussions. Similarly, 44 percent of the authorities considered that a more candid message had been delivered separately from the staff report. The main constraint on candor mentioned by mission chiefs was the "need to preserve quality relationships with the authorities," with 14 percent of respondents noting this constrained their presentation of a candid staff report to a large or very large extent (and 35 percent to some extent or more). Consistently, 40 percent of mission chiefs acknowledged pressures from members (the country at issue or others) that

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[93] IEO Evaluation Report - IMF Exchange Rate Policy Advice, May 2007, Paragraph 44.

constrained their work to "some" or "a little" extent—though reassuringly none reported having been constrained more than this. Only 14 percent of Executive Directors found most staff reports to be candid about differences of views between the authorities and the staff.

124. **Medium-term scenarios, examined for possible evidence of a lack of candor, were found wanting in over a third of cases.** In about 26 percent of staff reports, it was not possible to identify a most probable (baseline) scenario, and in 10 percent of reports the medium-term baseline scenario was not convincing. The most frequent reason for the latter shortcoming was that policy assumptions did not appear realistic and the staff report did not provide justifications for them. The survey of Executive Directors suggests they may share this assessment: only 29 percent of respondents found the medium-term scenario to be unbiased in most reports. About 22 percent found that the medium-term scenarios in all or most reports suffered from a general bias toward undue optimism.

125. **A lack of clarity of the bottom line messages can also be an indication of insufficient candor.** The review of staff reports found that only 58 percent of staff reports contained a clear assessment of financial sector vulnerability. Similarly, a review focusing on the perception of the average college-educated reader suggests that only about two-thirds of staff appraisals contained a clear bottom-line assessment of exchange rate issues. The latter may, however, reflect lack of effective communication rather than of candor, as the review by staff economists found that almost all staff reports contained a clear assessment of the exchange rate level (see Chapter III).

126. **Against this backdrop, it is noteworthy that country authorities are almost universally satisfied with the candor of staff reports on their country**: as many as 92 percent found candor in these reports "appropriate."[94] This rather overwhelming support for the status quo could be a constraint on change in this area.

C. Evenhandedness in Staff Reports

127. **A review of basic measures of the quality of Article IV staff reports reveals features that could be interpreted as a sign of uneven treatment of members.**[95] The review gauged whether staff reports satisfied some basic quality indicators; the "scores" refer to the percent of staff reports satisfying a given indicator.[96] Figure VIII.1 shows the summary

[94] This result is in striking contrast to the view of Executive Directors who—albeit representatives of the authorities—recognize the need for more candid staff reports.

[95] For discussion of evenhandedness in exchange rate assessment, see Chapter III, Box 6.

[96] The assessment of quality was not based on one-size fits all, but focused only of features that were considered relevant in a particular case. For procedures used to reduce the degree of subjectivity, see Supplement 2, Chapter I. For questions used to assess evenhandedness, see Statistical Appendix Section B, Table 10.

measures along five crude indicators of the following quality dimensions: focus, health check, financial sector, multilateral perspective, and candor.

- ***Income.*** Reports on advanced countries get a higher score on all quality dimensions, (Figure VIII.1, top left panel).

  - The high score on the *health check*, *focus*, and *financial sector* dimensions may reflect better availability of data and already available research in higher-income countries. But it might also indicate differences in the amounts and quality of inputs. While such differences would be questionable in a world of unlimited resources, they could be seen as the result of rational resource allocation decisions, as these countries tend to have larger outward spillover effects and the bar is higher for surveillance to add significant value.

  - A closer look at the *clarity of staff bottom line (used as proxy for candor)* assessment of the financial sector, exchange rate, and external stability does not reveal systematic differences across income groups. More reports on advanced countries were considered to present a clear bottom line on financial sector vulnerability (75 percent) than in emerging market and developing countries (59 and 52 percent, respectively). But the opposite was true for the assessment of exchange rate and external stability, with smaller differences.[97]

- ***Economic size.*** (Figure VIII.1, lower left panel): The largest and the smallest countries scored the highest. Indeed, the very smallest countries (with GDP below U.S.$ 10 billion in PPP-terms) scored better than the very largest countries (with GDP above U.S.$ 1 trillion) on candor. This is reassuring, showing that Fund staff provides a thorough health check for smaller members, who may need it most. And the very largest might need a thorough health check because of their systemic importance, an interpretation consistent with their strong score on the spillovers dimension.

- ***Geographic distribution.*** Results were varied on several dimensions: reports in the regions covered by the European (EUR), Middle East and Central Asia (MCD), and Western Hemisphere (WHD) Departments were highly focused with well-identified questions, and EUR and WHD reports scored particularly high on the health check dimension. Low scores on health check in countries in the regions covered by the

[97] A review of staff reports focusing on average colleague educated readers' perception of staff reports indicated that the bottom line assessment of exchange rate issues was clear in 33 percent of advanced countries, compared to 39 and 53 percent for emerging market and low-income countries, respectively. The corresponding percentages for a review of the clarity of staff reports' assessment of current and prospective external stability were: 80 percent (advanced countries), 82 percent (emerging market economies), and 75 percent (low-income countries).

African (AFR) and Middle Eastern and Central Asia (MCD) Departments may reflect, to some extent, higher concentration of countries with data problems, resource constraints, and, in the case of the AFR region, developing countries.[98]

- ***Exchange rate regime.*** The distribution of results on exchange rate regime mimics that for income groups. In fact, all the advanced countries in the sample had floating exchange rate regimes.

D. The Way Forward

128. **While this review does not offer definitive conclusions, it does reveal issues about both candor and evenhandedness that warrant attention:**

- Staff must strive to reduce the ***candor*** gap between policy discussions and staff reports, as far as can be done without harming the frankness of the policy dialogue. The essence of surveillance is a dialogue between the authorities and the Fund (which represents, through its Executive Board, the international community), on the basis of the staff report. If the latter is not candid, surveillance is impaired. Partly as a function of the authorities' preference for the status quo in this area, there are clear limits on the candor of staff reports. Existing provisions allowing market-sensitive information to be deleted from published documents should be kept. Moreover, separate (e.g., oral) communication of more sensitive information to the Board—which is currently rarely used—could be further developed.[99]

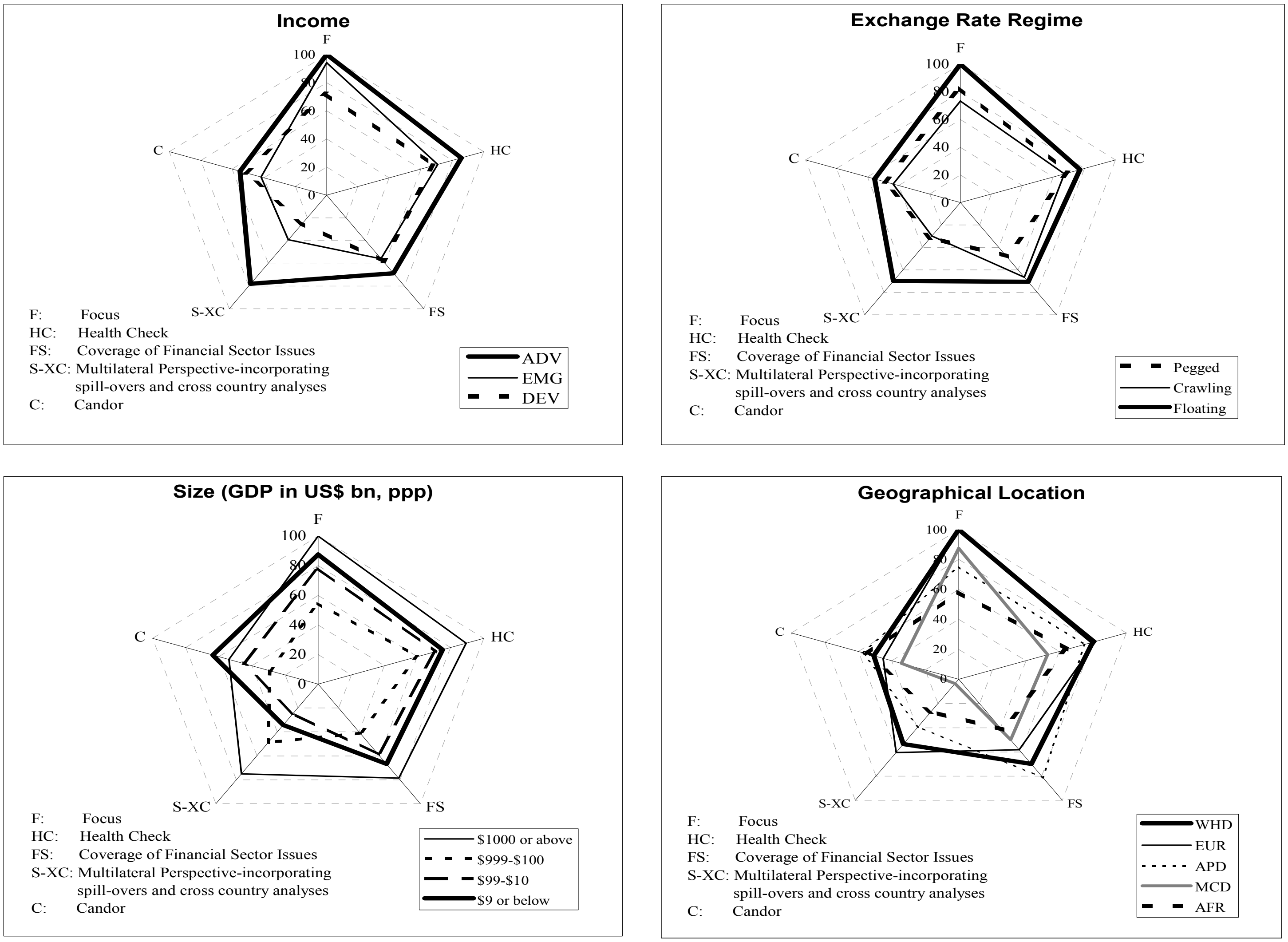
- It may also be important to ensure that staff incentives are aligned with the need for candor. While, reassuringly, no mission chief reported that pressures from members had constrained their work more than "to some extent," it remains crucial to shield mission chiefs from undue pressures against candor, and to signal concretely that candor—if backed up by rigorous analysis—is to be rewarded, not sanctioned.

- The results on ***evenhandedness*** are mixed and provide little guidance on further efforts, beyond the need to ensure that an adequate health check is applied in all member countries. Moreover, the interdepartmental review process should pay attention to the observed regional discrepancies.

[98] However, the higher share of program countries in the regions covered by AFR and MCD does not seem to explain the regional differences: program countries' score on health check dimensions is equal or higher than non-program countries.

[99] A similar recommendation was made before in the IEO report on IMF Exchange Policy Advice, page 51, paragraph 6.

Figure VIII.1. Evenhandedness by Different Classification[100]



100 See Statistical Appendix Table 10. Summary of Staff Report Review—Evenhandedness for questions used in this assessment.

IX. THE COMMUNICATION OF SURVEILLANCE [101]

Key Messages

- The Fund has a suite of surveillance communication vehicles, valued by different audiences, but confusion about the roles of the different vehicles hampers the effectiveness of communication.
- Surveillance communications are considered credible and broadly comprehensible, but suffer from insufficient conciseness, timeliness, and persuasiveness.
- Key recommendations that could be implemented via careful experimentation to achieve increased effectiveness include: (i) rationalizing and modernizing the key communications vehicles; (ii) implementing a more tailored approach that emphasizes a few key messages and matches the message and medium to the target audience; and (iii) providing more context to surveillance information, so that key messages gain resonance and staying power. [1]

[1] Some of these recommendations were not endorsed by the Board and will be considered further in the upcoming review of transparency policy.

A. Introduction

129. **Good communication of surveillance messages is key to the overall effectiveness of surveillance** and something the Fund is accountable for alongside the substance. Strategic work on effective surveillance undertaken in recent years consistently assigned an important part to its communication.[102] And successive discussions on methodology for assessing the effectiveness of surveillance have made clear that the Fund's responsibility does not end with the production of the soundest possible analysis and advice. Rather, it extends to communicating them clearly to the relevant audiences, in particular the authorities, the Executive Board, and the public, so that they comprehend the Fund's diagnosis and the critical actions required to reach specific economic goals. A challenge in accomplishing this is that these distinct groups of stakeholders have different roles and (sometimes conflicting) interests and information requirements. This chapter, which draws on a wide range of sources of information, assesses to what extent good communication has been achieved and how

[101] The main author of this paper is Lynn Aylward. Invaluable help from EXR to canvas journalists' views is gratefully acknowledged.

[102] See *Statement by the Managing Director on Strategic Directions in the Medium-Term Budget* (4/12/08); *The Managing Director's Report on Implementing the Fund's Medium-Term Strategy* (4/05//06) and *Biennial Review of the Implementation of the Fund's Surveillance of the 1977 Surveillance Decision—Modalities of Surveillance* (8/24/04).

improvements may be sought, against the backdrop of discussions held by the Board on the format of Article IV reports.[103] Background information on surveillance communications is provided in Appendix I. For practical reasons, the primary focus is on written communications. However, good oral communication—whether with country authorities or with the media—is also key. The External Consultant's Report sheds more light on communications with authorities.

B. Assessment of the Vehicles and Quality of Surveillance Communications

Effectiveness of communications vehicles

130. **Among compact summary vehicles, the mission concluding statement (MCS) appears to be effective, while the more commonly available summing up/Public Information Notice (PIN) is frequently found wanting.** The vast majority of country authorities (88 percent of respondents to the survey) agreed that the MCS is an effective communications vehicle to convey surveillance messages to policy-makers, against only 50 percent for the summing up. Furthermore, interviewed European journalists, country officials, and think tank members said MCSs (which are often launched in press conferences) got the most public attention of Article IV information releases, including the PIN. 36 percent of mission chiefs judge that the press conference at the end of the mission (which typically includes MCS release) has "a good or a great deal" of communications impact for their country, while only 18 percent made the same judgment for the publication of the PIN. Further, 80 percent of Executive Board respondents to an IEO survey said that summings up, which are recycled as PINs, are sometimes or often vague and/or contradictory.[104] However, publication of MCS and press conferences are allowed only by a minority of the membership, whereas publication of PINs is almost universal (see Appendix). Moreover, only the PIN conveys the views of the Executive Board.

131. **Staff reports and Selected Issues Papers (SIPs) too are valued by certain audiences, albeit some could be more effective.** These vehicles, for which the Board is the main audience, are sought out by a narrower range of interlocutors, more interested in analytical depth, than are the MCS or PIN. Nevertheless, about three quarters of country authorities find staff reports effective to convey surveillance messages. At the same time, 25 percent of mission chiefs judge the publication of the staff report to have a good or great

[103] The main sources of information were as follows: internal review of staff reports; internal review of surveillance agendas; focus groups with media from around the world attending the Spring Meetings at headquarters; focus groups and interviews of media and other audiences in the context of EUR and MCD REO launches; interviews with country officials by the external consultants; communications-related results in other TSR surveys, e.g., of financial market participants; a Media Relations consultancy commissioned by EXR; and interviews with EXR and area department staff.

[104] "*Summarizing the Views of the IMF Executive Board*," Background Paper to the IMF Independent Evaluation Office Report *"Aspects of IMF corporate Governance–Including the Role of the Executive Board* (April 2008).

deal of communication impact, which suggests room for improvement. Surveyed financial market participants said that they consider SIPs almost as useful as staff reports, and both significantly more useful than MCSs, with SIPs' comprehensiveness and analytical depth praised by 90 percent of financial market respondents. Country officials, often already well-aware of information in the staff report, value SIPs for their in-depth treatment of priority topics. However, SIPs should be kept focused and targeted to their audience to maximize communication impact; only 58 percent of country authorities find SIPs effective communication vehicles.

132. **Meanwhile, external audiences express confusion about the many different documents released by the Fund on a single Article IV consultation.** In the focused interviews, many journalists did not grasp distinctions among the MCS, staff report, summing up/PIN, and post-Board meeting outreach. They indicated that multiple releases strung out temporally on the same Article IV consultation added noise to surveillance communications. Indeed, the suite of surveillance communication vehicles were designed for internal consumption in an era of low transparency. They have never been re-thought to take into account that the vast majority of these documents are now published and could serve not just transparency, but also proactive communications.

133. **Moreover, outside audiences are only weakly aware of the inter-relationship of bilateral, regional, and multilateral surveillance.** Feedback across different audiences indicated that the WEO/GFSR and the REOs are valued, but that public awareness of the integration of information from these high-profile vehicles with bilateral surveillance messages is not as high as it could be; for example, journalists other than key Fund-watching ones associated the WEO almost exclusively with coverage of the Spring and Annual Meetings and viewed it as distinct from, rather than being integrated with, bilateral surveillance.

Quality of communication

134. **Surveillance communications benefit from favorable priors among external audiences.** Across different audiences and surveys, Fund communications were considered credible. Indeed, credibility got among the highest ratings from journalists when they were questioned about various quality attributes, and over two-thirds of financial market respondents rated objectivity as a strength of country reports. External audiences also generally find Fund releases candid, albeit within the constraints of the Fund's institutional nature.[105] Fund assessments are also generally considered newsworthy, though respondents

[105] That is, the Fund is seen by some audiences as being at a disadvantage in terms of candor as a source of economic assessments and policy prescriptions for countries, compared to think tanks. In the words of a key Fund-watching journalist "With [think tanks], it's not diplomacy all the time (while) the Fund, it has its shareholders, and can't make assessments which are, let's say, controversial, as easily as an independent institute."

emphasized that this greatly depends on the individual country circumstances and policy context of a given Article IV consultation.

135. **However, improvements in brevity, timeliness, and clarity would help capture the attention of a broader audience:**

- **Almost all audiences indicate that shorter reports would increase readership and hence impact.** Country officials interviewed by the external consultants noted that the readership and hence potential impact of the reports would increase if they were shorter and more sharply focused. Only one country official out of the 23 countries covered said the staff report for their country was too short. This viewpoint was echoed by key Fund-watching journalists interviewed in a conference call. Meanwhile, the internal review of staff reports found that while two-thirds of reports seemed of proper length given their focus, overly long reports were twice as common as excessively short ones. At a Board seminar on new formats for staff reports, many Directors concurred that greater efforts to make Article IV staff reports concise and focused would enhance the relevance of the Fund in the global environment.That said, in some cases audiences may desire more extensive surveillance information because alternative sources are limited, (e.g., in some developing countries).

- **Insufficient timeliness is an issue for some but not all audiences.** Only half of Executive Directors surveyed consider information to be timely in most staff reports. At the Board seminar on new Article IV report formats, Directors welcomed efforts to narrow the gap between the end of the mission and issuance of the staff report, while ensuring adequate time for staff to produce a high quality report. A number of authorities interviewed by the external consultants decried the long time lag between the mission and the summing up, and 72 percent of financial market respondents rate timeliness of country reports as a weakness. That said, some audiences seemed to appreciate that given the Fund's mandate, reports should have a relatively long shelf life, and therefore did not view timeliness as a major concern. Nor is lack of timeliness of staff reports always a major issue for journalists, who may have reported on the MCS. However, the media made it clear that timeliness affects the amount of coverage documents receive; as one respondent put it: "A story on a two-month old document is a hard sell to an editor." More generally, Fund surveillance information sometimes gets limited coverage because some of it, especially country forecasts and statistics, is available from other sources more promptly than from the Fund.

- **The clarity and persuasiveness of surveillance messages could be improved.** The review of staff reports judged that for 90 percent of all reports, the main conclusions of the surveillance exercise as provided in the executive summary and staff appraisal would be comprehensible to the average college-educated person. At the same time, frequent use of jargon or overly long sentences in these sections was judged to hinder communication quality in 36 percent of the reports. Whole reports were found clear and comprehensible in most cases by only 57 percent of Executive Directors.

Persuasiveness is still more elusive: the internal review of staff reports considered only half of the reports (54 percent) good or very good in terms of overall communication value.[106] Consistently, several officials told the external consultants that the language of staff reports sometimes had to be "revamped" in order to extract salient messages for senior policymakers in a form that would support impact on the policy debate. And only 43 percent of Executive Directors thought most reports were well-argued and convincing.

C. The Way Forward

136. **The vehicles of surveillance communications should be modernized,** in a manner that preserves the preeminence of the Board in surveillance but seeks to optimize the influence on external audiences, in particular via greater media coverage:[107]

- **The Fund should consider further promoting publication of an end-mission statement, ideally with a press conference, whenever the authorities agree,** perhaps by establishing a presumption. As long as the MCS is by far the most timely surveillance information release, it will retain its high impact, especially when it is accompanied by a press conference. To this end, the staff and authorities acting in coordination can draw on the two existing options of publishing either (i) the mission concluding statement in the same final version given to the authorities at the end of the mission or (ii) a press release at the conclusion of the mission, whose text is less prescribed. Better use of these two options might help find a better balance between the Fund's role as confidential advisor and the usefulness of communicating surveillance information to the public.

- **If significant progress could be made toward more timely and reader-friendly Article IV reports, the staff report could be paired with the end-of-mission statement as prime communication vehicles.**[108] Such releases could then act as "teasers" for a staff report released a few weeks, rather than months later, as currently.

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[106] Reviewers rated reports on overall communication quality according to the extent to which the reports were drafted with a clear story line; crafted around a relatively small set of specific questions, with important statements clearly substantiated with facts or data, and helpful use of data, charts, and boxes generally; and concise.

[107] While it is clear that the media are not the final audience of surveillance, they are a key link in the chain toward influencing the public's views. Media outreach therefore has a multiplier effect on the ability of surveillance to influence the domestic policy debate, and it makes sense to seek to exploit it as part of efforts to enhance the effectiveness of surveillance.

[108] Faster staff reports are not likely to fully supplant the MCS/press conference, as interviewed audiences indicate that the presence of the mission in the field associated with the "MCS/press conference" package accounts for a good part of its communication impact, though post-Board video teleconferences could be considered as a substitute.

If the current large "reader-friendliness" gap between the two documents were eliminated, the end of mission statement and the staff report would appear as natural progressions on a continuum, with one clearly foreshadowing the other. [109] This would help journalists understand and perceive their complementarities.[110] In addition, staff should strive for greater conciseness, admittedly a challenge at a time when stakeholders are simultaneously asking for greater coverage in key areas (e.g., cross country spillovers, macro-financial linkages). This puts more than ever a premium on effective writing skills and innovative presentation, and Executive Directors are looking forward to careful experimentation exploring new modes of presentation of Article IV staff reports.

- **There is a strong case for making better use of the information provided by the executive summary of staff reports and the summing up from the Board discussion.** An effective and simple approach would be to replace the option of publishing a PIN with the option of releasing the staff report executive summary and the summing up (together) on a country web page, or even only the summing up─to be augmented with the rest of the staff report when countries consent to its publication. To ensure that current background information on country economic and financial developments is available along with the summary documents, country web pages could provide factual background information on country developments (of the same kind as currently available in the background section on PINs), updated as needed. This approach would essentially eliminate the need for PINs, and would clarify the relationship between the different elements that may or may not be released to the public. Concomitant efforts to clarify the language of summings up would support greater effectiveness of communication.[111]

137. **There is also a need for a surveillance communications approach with clearer key surveillance messages that leverage multilateral and regional surveillance information** and are better tailored to specific external audiences. Bilateral surveillance communication should more systematically proceed from identifying the key messages that the Fund wants to communicate for a given country and making sure these messages come out clearly whatever the vehicle. In particular, staff reports could usefully highlight up front the three or four key messages of the consultation. When these messages are underpinned by

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[109] The reader-friendliness gap occurs because MCSs generally perform better compared to the average staff report in terms of clarity, length, and use of jargon; staff reports could also increase their readability through a more modern use of graphics.

[110] Interviewed journalists said that surveillance information would have much more impact if each new release on a similar subject made it clear what is different and/or new in the release compared to the last related document.

[111] If the Board saw merit in these changes, they could be taken up in the forthcoming review of the Fund's transparency policy.

or feed into major points from the WEO/GFSR or REOs, this could be incorporated to add context, weight, or resonance to the country-focused messages. In addition, the format for various audiences should be differentiated, as needed. The outreach section of surveillance agendas could be used much more effectively to this end.[112] A particular form of tailoring that could be pursued more routinely is publication in local languages. Most interviewed non-native English-speaking media said that even though they could handle Fund publications in English, having selected (notably, summary-type) information quickly available in languages other than English (LOE) made it appreciably more likely, all other things equal, that a release would be covered.

138. **The Fund should emphasize context over volume to help ensure the most important messages not only "make it into the headlines" but persist and resonate.** The vehicles that would make the greatest contribution in this area are audiences' access to "Fund experts;" more readiness to provide direct quotes on surveillance matters in response to evolving developments in core areas;[113] more background briefings on key topics; and more use of tailored vehicles, such as Fund staff participating in seminars organized by other bodies, rather than more Fund-centric outreach, as the former may help broaden the audience reached and help optimize the relevance of the timing. Implementation of the first two of these steps would likely require upfront training efforts and could involve large resource costs and risks. However, it could be managed in a way that minimizes both, for example by providing more access to "experts" and more direct quotes in a cautious and selective manner, strictly when the Fund finds it appropriate to do so in the context of a clear communication strategy for a country. This may include responding to unfolding events outside the cycle of Article IV consultations or staff visits. At the same time, many respondents noted that the Fund should preserve its credibility and independence by not becoming a pusher of commentary when it does not have something of critical substance to say, and a strategic reason for saying it.

139. **Finally, a few additional good external relations practices (rather than surveillance communication steps per se) could be instituted.** These include: providing pre-alerts when surveillance releases or other news are coming out; avoiding inconvenient timing of releases (e.g., late on Fridays or at similarly inconvenient times, when the timing is in fact under members' or the Fund's control); being less print-focused for certain audiences, e.g., in developing countries or for the iPod generation; innovations in press conference

[112] A review of the country-specific strategies presented in surveillance agendas found that they focus almost exclusively on process (e.g., "encourage the authorities to publish reports" or "(staff to) hold press conferences or seminars," but without specifying topics), and not on key surveillance messages.

[113] The correspondent of a major Fund-watching media organ said: "The number of Fund economists I know, I can count on the fingers of one hand, and it's very hard to get to talk to anyone." Several journalists suggested that resident representatives, while proactive and generous with their time in providing off-the-record information, are greatly constrained in providing quotes on country surveillance issues.

styles, notably more regularly providing access at the conference to the key Fund economists on a “hot” topic or country; better organization of material on the website, including on country pages; and an improved website search engine. Closer coordination between area departments and EXR could facilitate mainstreaming of these practices, thereby helping ensure that the Fund’s key messages make it “into the lead” and reverberate.

Background on Surveillance Communications

To communicate bilateral surveillance messages, the Fund uses a number of vehicles, prepared for the authorities and the Executive Board and recycled for other audiences. The main vehicles for communicating surveillance messages to the authorities are the mission concluding statement (MCS) and the Summing Up, and to the Board, the staff report. These vehicles are recycled for external audiences via publication, if the member agrees (possibly with deletions). They are produced for every member in the course of surveillance.[114] Alongside these vehicles for bilateral surveillance communication are regional surveillance communication tools, centered around Regional Economic Outlooks. In addition, ad hoc tools tailored to external audiences are used in specific circumstances, including press conferences, interviews with management or senior staff, seminars, resident representative communication and other outreach efforts. And, an important development in surveillance communications is the strategic publication of documents in languages other than English (LOE). Box 12 provides usage/volume statistics on the various surveillance communication vehicles.

[114] Publication in general and publication in languages other than English (LOE) impact the communication value of the core vehicles. Under the transparency policy, publication of all major surveillance documents is up to the member in question. In practice, the vast majority of members agree to the publication of Board surveillance documents, but only 32 percent of members consent to the publication of the MCS—a non-Board document. Deletions, allowed for highly market-sensitive or premature policy information, do not seem to have had a major impact on the communication value of publication (See *Review of the Fund's Transparency Policy* (5/24/05)).

Box 12. Surveillance Communication Policies, Vehicles, and Activity Indicators

Guiding surveillance communication are the Fund's communications strategy, the transparency policy, and departmental outreach plans. Extensive information on the first two of these is available elsewhere (See the 2005 *Review of the Fund's Transparency Policy* and 2007 *Review of the Fund's Communication's Strategy*). Departmental outreach plans, along with the outreach strategy section that appears in country surveillance agendas, were advocated by the 2004 BSR and the MTS as an informal means of helping to ensure that communication is built into the Article IV process. Following are some activity indicators for surveillance communication vehicles.

Vehicles	**2007 Activity Indicator (percent)**	
Article IV Consultations	138	
Article IV Mission Concluding Statements published	44	(32)
Article IV Staff reports published	114	(83)
PINs	125	(91)
Press conferences at the end of Article IV Missions	54	(39)
Post-Board meeting Article IV press conference calls	14	(10)
Published articles in external media focused on country surveillance	80	(n.a.)
PINs translated into LOE	14	(10)

Sources: The first four data observations are from PDR's transparency database and relate to Article IV consultation discussions held by the Board from November 1, 2006 through October 31, 2007. The last four pieces of data are estimates based on information provided by EXR.

The 2004 BSR focused on two aspects of Fund surveillance communications: the general dissemination of surveillance information to the public at large, and the publication of country documents through the Fund's transparency policy. Box 13 summarizes findings and recommendations of the 2004 BSR, and progress against them.

Box 13. Main Findings and Recommendations of the 2004 BSR and Progress Against Them

Main findings: Active dissemination efforts had raised the visibility of surveillance in recent years, but public understanding of surveillance remained limited, even in countries that publish Fund documents. Surveyed external audiences reported coded language, obscure structure of staff reports, and information overload.

Recommendation	Progress
Staff to develop outreach programs and enhance contacts with local think tanks.	Area departments focused more on outreach efforts and indicated outreach plans in surveillance agendas, including outreach to local think tanks; most area departments developed outreach plans; EXR enhanced outreach to think tanks.
Members encouraged to use of the "right to reply."	Publication of the Executive Director's Buff has risen somewhat, to 60 percent of Article IV consultations in 2007, up from 53 percent before 2004; however, use of a specific "right of reply" statement by country authorities is very rare.
More active internal dissemination of best practices and innovations in the modalities of Article IV consultations and further experimentation with staff report formats and style	Experimentation began with streamlined consultations and an innovative subheading format (see e.g., the Indonesia and Belgium 2006 Article IV Consultation staff reports), and the Board discussed new possible formats for Article IV staff reports in July 2008.