

Triennial Review of IMF Surveillance

**IMF SURVEILLANCE IN EUROPE:
PROGRESS IN REFOCUSING**

Report by an External Consultant¹

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Executive Summary

Taking Europe as a case study, this report reviews recent surveillance experience – with special reference to its value added, focus, treatment of financial and cross-border issues, and format. It finds exceptional value added in some areas, especially the way that fiscal policy is treated in a consistent and integrated macroeconomic framework. There are now encouraging, but uneven, signs that financial issues are moving up alongside fiscal policy in this regard. But there is a need to strengthen further the focus on, and integration of, financial and external balance issues. Specifically, these issues are handled very well in a number of key emerging market cases (often facilitated by the integration of financial market experts in Article IV mission teams), and a first-order challenge is to generalise this best practice. Then, in terms of pushing the frontier, the priority is not really to “beat the market” in evolving ever more sophisticated financial analysis techniques. Rather, it is to deepen the analysis of macrofinancial linkages by tracing these more systematically through saving-investment and balance sheet analyses – thus building analytical links between shocks to the real sector and shocks to financial markets. In addition, global and regional spillovers deserve sharper analysis – including risk assessments relating to financial conditions in major currency countries or areas, because of their potential global impact. Surveillance formats also need some updating to achieve a more focused and concentrated effect.

To begin with the issue of “value added,” the strongest contribution of surveillance in Europe remains, at present, the Fund’s exceptional skill at placing fiscal policy in an integrated macroeconomic framework. The second greatest area of value added, recently, has been in the financial sector, where FSAPs systematically added value and in some cases triggered a stream of related surveillance work. Authorities also found analyses of structural policies valuable, notably when linked to macroeconomic goals. Worryingly, however, they cited contributions in the monetary and exchange rate field far less frequently. There is sharp criticism from a few authorities of Fund work on exchange rates – seen as over-emphasizing this instrument or relying unduly on methodologies that are inevitably somewhat fragile. There is also some unease about Fund assessments of monetary policy in the euro area – seen by some authorities as failing to pay sufficient regard to the ECB’s specific mandate. A few authorities also considered (as does the external consultant) that the Fund should explore in more depth the implications of any difference in monetary philosophy among the major currency areas. This somewhat mixed picture concerning the effectiveness of work on monetary and exchange rate issues is highly relevant to the challenge of achieving greater value added on financial and external adjustment issues.

Concerning “refocusing,” a reading of recent European Article IV reports, in conjunction with FSSAs, confirms that staff analysis is paying much greater attention to the topics of external balance and financial stability: this is widely appreciated by country authorities. Work on FSAPs and the Global Financial Stability Report has fostered a range of needed skills. But the penetration into bilateral surveillance remains uneven. This is clearly evident

in Europe, where the integration of financial work still varies widely. Some cases (notably key emerging markets) offer excellent examples of analysis, while others (especially some larger advanced economies) seem quite far from the refocusing frontier. Authorities in Europe have found the recent priorities in surveillance broadly appropriate, but they could typically support a somewhat more focused approach, if implemented flexibly – including that the analysis of structural issues not be dropped but slimmed and woven in through its relevance to macroeconomic assessments. In particular, financial issues still need to be more systematically integrated in surveillance. The analysis in staff reports should be further deepened in terms of strengthening macrofinancial diagnostics; embedding the analysis of financial linkages in an integrated macroeconomic framework; and, within budgetary constraints, supporting these priorities by including more financial experts in mission work.

The need to better capture financial market “spillovers” at the global and regional level is a further urgent priority – with “regional” here being interpreted broadly in terms of interconnections among economies, not just geographically. Authorities in Europe confirm that this would enhance bilateral surveillance in general, though regional work is definitely not viewed by them (or by the consultant) as a substitute for bilateral surveillance. In Europe specifically, the existence of the euro area – and the growing real and financial integration of catching-up economies in the east – warrant an especially strong regional component in surveillance. Here, the euro area missions have achieved high visibility among policy-makers, and are valued as a channel of two-way communication. The study of finance in the Nordic-Baltic region was widely appreciated. The second REOs was particularly impressive in tracking financial spillovers. Work on regional supervisory issues has been ambitious and suitably probing. But a countervailing concern is that, in bilateral country papers, the analysis of persistent imbalances and inflation divergences in the euro area have not been placed in a clear analytical framework and mapped convincingly to financial dynamics and adjustment capacity at the level of the euro area. A further question is whether the level of the formal surveillance dialogue with the euro area (not involving management participation) is suitable for the role it now plays in the world economy. A third concern relates to current account deficits in converging Europe, where the Fund has not seemed to project a forceful and consistent surveillance analysis.

As regards spillovers from the sub-prime crisis, country authorities do not claim to have been more far-sighted than the Fund, or suggest that it can anticipate every crisis. Its skills are seen to lie more in integrating economic and financial analysis, and in bringing others systematically “up to the curve,” rather than always being “ahead of the curve.” Nonetheless, in the view of some authorities and of the external consultant, there is a question whether the Fund showed sufficient risk awareness concerning the global persistence of easy liquidity, expanding credit and low risk premia during the past decade – and the pervasiveness with which a reversal of these trends could drive financial market spillovers, including in Europe. A priority, at all events, is to further extend work on regional and global spillovers.

Finally, in terms of “format,” the products of surveillance are not optimally structured to achieve a concentrated and tightly focused impact on key audiences in Europe. In the view of most country authorities (which may not coincide perfectly with the position of Executive Directors), and of the external consultant, the mission concluding statement is typically the most powerful vehicle for conveying surveillance assessments, while the Board summing up adds legitimacy and a broader perspective – but after a long delay. Post-mission work needs to be simplified to speed up the cycle. That could be helped by shortening Article IV Staff Reports somewhat, for example by structuring them on thematic rather than procedural lines. If a few well-targeted selected issues papers are prepared in advance of missions, for discussion with authorities, this in turn would not retard the process. In these ways, the form as well as the content of surveillance could be more fully effective.

The assessment in this Executive Summary, except where explicitly stated, broadly reflects the views of country authorities interviewed for the report, and it also emerges directly from analysis by the consultant of recent surveillance papers. Both of these elements are combined in the report, in line with the terms of reference. To avoid confusion, the report flags explicitly throughout where the views it expresses depart from the generality of views among authorities interviewed. Such departures are usually cases where the assessment of the consultant coincides with views held by only a minority of those interviewed. It should also be noted that views expressed by country authorities during the interviews may not necessarily accord precisely with positions expressed at meetings of the Executive Board.

A summary of key recommendations will be found in the final section of the report.

1. Introduction

This report reviews the Fund’s recent surveillance work on Europe, with a special focus on areas of “value added”; financial sector issues; spillovers and regional issues; and the format of surveillance. It seeks to assess the distance remaining between this experience and the frontiers identified in the 2007 Surveillance Decision and, more broadly, the refocusing exercise. It was not designed to perform an evaluation of the 2007 Surveillance Decision, however. In these respects, it aims to identify recent strengths and weaknesses in order to enhance implementation in the future (see: Terms of Reference, Annex I). The assessment in the report is based on recent surveillance papers and on consultations with authorities in selected countries, the ECB and the European Commission (see: List of Countries, Annex II). The interviews with country authorities were held during April-June 2008. The report was also informed by exchanges with authorities outside this group and with market participants. The report was designed in collaboration with Fund staff as a contribution to the Triennial Review of Surveillance. However, views expressed are independent of staff views.

There were only limited divergences between the typical views of country authorities and the assessment of the external consultant, which was based upon a reading of recent surveillance papers. Where the text simply expresses judgments, these may always be taken to represent views that are fairly typical among the authorities interviewed, and that are also shared by the external consultant. By contrast, the text flags explicitly those areas in which the external consultant’s assessment differs materially from the norm of comments received.

As a case study, Europe highlights several issues that are important for surveillance at the present time, and may be relevant in varying degrees for the Fund’s broader membership. Europe’s wide range of economies exhibits quite well the different ways in which fiscal, monetary, financial and external issues can come together in surveillance. The country cases selected here, for example, range across the United Kingdom, with its international financial role, and its mortgage market tensions; Spain, experiencing imbalances and an asset market cycle within a monetary union; Hungary, with its twin deficits and balance sheets risks; and Russia, with its energy-related external surplus yet potential vulnerability to shocks. Europe also raises quite sharply (those less representatively) issues of regional surveillance – from the functioning of the euro area to the challenge of interpreting the world’s largest current account imbalances in the converging region of eastern Europe. In Europe, too, the Fund is “competing” with a large number of other surveillance providers, public and private.

The remainder of the report is structured as follows. Section 2 reviews areas in which Fund surveillance has “added value” in the recent past. Against this backdrop, Section 3 discusses the evolving focus of surveillance. Section 4 probes how the Fund is performing in its analysis of external vulnerability and financial risks, with special attention to macrofinancial linkages. Section 5 explores spillovers and regional surveillance. Section 6 discusses the current effectiveness of surveillance formats in Europe. Section 7 concludes.

2. Value added in the recent past

The primary value added of surveillance has remained in the field of fiscal policy, due most importantly to the Fund's skill at placing this in an integrated macro framework.

Central banks found the Fund's fiscal advice particularly helpful, since it favoured risk-averse policies; and they have also appreciated missions' pursuit of "due diligence" work on fiscal performance, especially in emerging market contexts. Finance ministries also generally welcomed the Fund's input, despite periodic disagreements – finding its analysis valuable and seeing it as an ally when fiscal constraints are explained in wider political debate. There are some exceptions, where the Fund's position has been viewed as unduly risk averse. But in most cases, the Fund has been able to play a valued role of a "credible outsider" in fiscal analysis. Indeed, its analytical role is still appreciated in many countries that undergo peer-group surveillance in the EU, since Fund assessments are richer than EU surveillance in exploring macroeconomic linkages. Of course, EU members stress the key role of the EU's fiscal rules in supporting fiscal discipline. And Eurostat's work on fiscal notifications under ESA95 has, for them, replaced much IMF's due diligence on the accuracy of fiscal reporting.

The second area of strong impact recently has been the financial sector: FSAPs always added value, and in some cases they also triggered a stream of related surveillance work.

Micro and (especially) macro stress-tests are a concrete example of value added in an area that is relevant to surveillance. However, the links of FSAP work to surveillance are highly variable; and FSAPs are a voluntary activity. In some cases, especially larger advanced economies, their contribution has been rather independent from the activity of Article IV missions. In other cases – including most emerging market cases – the work flowing from them has become progressively more integrated with surveillance. The extent of integration has in part reflected the extent of financial vulnerabilities in a country; but in part it seems also a function of skills and personal chemistry on the side of the Article IV team. It is important, of course, that the stronger emphasis on financial work not detract from the existing well-established excellence of the Fund's fiscal analysis. Rather, the aim should be to deepen the interconnections between these two fields, for example by analyzing much more systematically than now the two-way interconnection between financial booms and fiscal performance.

By contrast, positive contributions in the field of monetary and exchange rate policies were cited significantly more rarely in the cases for special analysis reviewed in the present project. There were also more negative comments in this field. The issues concerning exchange rate and monetary policies, respectively, are to some extent distinct:

- On exchange rates, a few member countries, large and small, are highly critical of the Fund's work. They feel the Fund has relied unduly on fragile methodologies, and in certain cases has been unbalanced in arguing for use of the exchange rate instrument.

To be clear, the argument is not against the principle that the Fund should include exchange rate issues among those on which it focuses most strongly. Nor is it a view that there are other better methodologies available. It is about keeping assessments in a balanced perspective in terms of methodology, context, and the range of available policy options.² These comments do not come as a complete surprise following the recent assessment by the IEO.³

- A variant on this issue concerns internal trends in the euro area, where there are quite widely held doubts whether the present way of applying the CGER framework gives valuable insights into inflation differentials or adjustment dynamics in the euro area – or even whether current ways of discussing competitiveness in bilateral surveillance of euro area members are helpful at all (a topic further discussed in Section 5 below). Specifically, the CGER methodology, by design, deals with multilateral assessments vis-à-vis all trading partners, whereas intra-euro area movements in competitiveness need partly to be interpreted – and their policy relevance assessed – in terms of adjustment dynamics *within a monetary union*. The Fund has recently (in 2007) done valuable work on competitiveness issues within the euro area, as a region. But the bilateral country studies of euro area members so far typically fail to map competitiveness trends convincingly to intra-euro area adjustment dynamics. This is particularly important at the present time. Shifts in global market conditions are affecting euro area members differentially (depending in part on relative cyclical positions and asset market cycles). The adjustment strategies of these members in terms of policies in the national domain will be important for Europe’s contribution to adjustment ease and a resumption of balanced growth in the global economy.
- On monetary policy specifically, the Fund’s views on the conduct of euro area policy have aroused sensitivity among some in Europe – the concern being that the Fund’s frame of reference may take more account of growth (versus inflation) than the ECB mandate allows; and, in more absolute terms, that the Fund may underestimate the value of financial indicators in formulating monetary policy. Authorities holding this view consider 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 remain benign. Actual differences of view on the timing and scale of interest rate changes, it should be noted, were small; but the divide on frameworks and philosophies was not. One comment, also, was that the

² Two countries noted that the Fund was not invited to play an advisory role at the time they made changes in their exchange regimes in order to forestall actual or potential vulnerability (even though in one case the action was precisely in line with recent Fund views). These countries sought advice only from other central banks: this seems to have been mainly because of their direct operational experience in this field.

³ *IMF Exchange Rate Policy Advice, 1999-2005*, Independent Evaluation Office of the IMF, 2007

Fund has not explored the systemic implications of differing monetary philosophies in major currency areas. These are areas where further value could be added.

Some member countries have found staff analysis and mission dialogue on structural policies very valuable, especially when linked clearly to macroeconomic issues. The Fund's contribution has lain in part in identifying structural themes that are highly relevant to macroeconomic strategy, and exploring the linkages and trade-offs involved. The Fund's expertise in microeconomic analysis is typically not as strong as that of the OECD, but its value added in identifying and probing macro-relevant issues is prized. (Some implications of this are discussed further below.)

Partly as a spin-off from the Fund's fiscal role, the mission event has become established in some cases as a moment for strategic reflection on policy challenges and trade-offs. In member countries where that is the case, which include at least one G-7 euro area member, this catalytic role is a major value added of surveillance. The mission team has become, momentarily, part of the domestic policy process in a manner otherwise observed only in programme cases. In a sense, it also gives the international community a voice at the policy table. It seems to be the product of very favourable political opportunities and outstanding staff performance in terms of technical and communications skills. Whether such strong in-field performances by staff, which maximise the value added of missions, are adequately recognized by the Fund was a question raised by a few country authorities.

In each of the areas noted above, a further value added is the Fund's ability to swiftly identify the need for more technical expertise and get this rapidly into the field. This was cited by countries in areas such as monetary management, debt management and market liquidity, for example. This compared favourably with the response of many other agencies.

Several member countries pointed to the value added of Fund surveillance in terms of externalities in conducting analysis of other countries within the public sector. The use of the Fund's specialized skills resulted in major savings of time and resources as for member country authorities, and other multilateral institutions. They referred to official agencies' practice of internalizing (at times indeed, "cutting and pasting"), IMF macroeconomic judgements into their own reports, and depending on the Fund for data verification, especially in non-EU emerging markets. They particularly valued the relatively uniform and predictable frame of analysis in Fund documents, and the presentation of an integrated economic analysis, by comparison with market sources of analysis. Market participants themselves noted that they depended far less on the Fund than in the past for analysis, but that they still commonly check their assessments against it. And again, markets depend on it for verified data in many cases, especially in areas such as fiscal performance and vulnerability indicators.

Still, there is an underlying current towards higher and higher quality coverage of many economies by other institutions, and the Fund needs to play to its comparative strengths.

There is a steady improvement in the quality of country analysis by market sources, and these cover a growing number of European economies. There is also some shift in the European Commission to embed its own country work in a richer macroeconomic context under the reformed Stability and Growth Pact – as implied, for example, by attention to the fiscal stance in “good times.” So there is no case for complacency. To maintain its pre-eminence, the Fund needs to develop more strongly its potential comparative strengths, including external balance issues and macrofinancial linkages. In this respect, it is of concern that views among country authorities are mixed not only on the question of exchange rate analysis but also on the assessment of spillover effects across global markets and within the European region. The following sections place these challenges in the context of the evolving focus of surveillance, and specific practices in key surveillance areas.

3. The evolving focus of surveillance

Member countries typically found the recent, sharper focus of surveillance appropriate, and support further progress in this direction if implemented with flexibility. A reading of Article IV reports confirms that surveillance has centered more on the “refocusing” topics, though cases vary, and some are quite far from the frontier. The Fund has always paid attention to external balance, especially in emerging market countries. Often, though, this was cast mainly in terms of the implications for fiscal policy, in an integrated macro framework; and it was part of a very comprehensive assessment of the economy. What has changed progressively is an effort, first, to focus more on financial sector dimensions of vulnerability; and, second, to move these elements towards centre stage alongside fiscal analysis, in the context of shorter and more selective reports.

Progress in focusing on financial vulnerability and external stability, however, has been gradual and uneven. Some recent reports still have a wide focus – delving deeply into micro aspects of structural policies while dealing with financial issues in a somewhat cursory fashion (a self-contained and sometimes quite short section in the staff report). FSAP work, meanwhile, has been very successful, but is unevenly integrated in mainstream surveillance. A range of favourable cases in economies as different as Spain (2007) and Serbia (2008) show major progress in terms of enhancing focus and integrating financial issues, although it must be recognized that a catching-up context does facilitate this.

Experience in the larger, mature economies seems rather mixed, even if the basic direction of movement is typically encouraging. Germany (2008) makes notable progress in drawing financial issues sector into the centre of the discussion, featuring different linkages. In the United Kingdom, it is clear that staff work recently has focused more strongly over time on core financial and external issues, including in the consultation cycle underway while this

report was being finalized. Judging from the 2008 UK Concluding Statement, there was in particular a stronger and potentially valuable emphasis on issues relating to external balance; but it is not clear whether advice to the authorities on the financial sector was as challenging and incisive as in the area of macroeconomic policy frameworks. (It is not possible to reach a fuller judgment until the papers for this consultation are issued.) The analysis of complex financial markets in advanced economies is recognised in the Fund as an area where there is still progress to make, and there is no clear evidence yet that the UK is an exception. Finally, the assessment of the consultant is that Italy (2007), which admittedly deals with a less tractable subject in this respect, still shows a refocusing gap, as further discussed below. It should be added that, in terms of traditional surveillance, Italy features high quality analysis.

The refocusing mandate, and the global trends driving it, require that financial issues be more systematically integrated in a macroeconomic framework than is currently the case.

This means a more consistently tight focus, which is the subject of this section, as well as a deeper probing of linkages and spillovers. The greatest challenges in terms of focus arise in euro area economies where financial vulnerability is not a concern and issues of external balance are not relevant at the euro area level. In such cases, what is the appropriate length of the report, and what should be the fulcrum for surveillance in a refocused Fund? The most recent staff reports on Germany (February 2008) and Italy (February 2007) illustrate these issues, and repay detailed consideration (Box 1), particularly when compared with Spain. The messages that emerge are to strive for greater brevity, especially where there is not a ready attractor theme for refocusing; to fully exploit financial linkages in an integrated manner; to subordinate micro analysis to the broader treatment of linkages between structural issues and the macro story; and to develop a more consistent framework for the analysis of competitiveness and adjustment issues in the euro area (further discussed below).

In such cases, moreover, there may be additional questions to tease out that are closely linked to financial spillover effects and questions of external balance and adjustment. Why has Italy not experienced the sharp ramping-up of domestic credit levels that is an almost universal feature of financial integration in Europe; and if this occurs, what would be the likely implications for competitiveness or the pattern and sustainability of growth? Why (to take a case outside the report sample) did Belgium not experience the boom-bust cycle of the Netherlands in the period following German reunification; and does it face such a cycle if its domestic structural conditions change? How far is financial integration in such economies supporting smooth adjustment to demand and supply shocks, in a monetary union with low labour mobility and cross-border fiscal smoothing? And what about the links into eastern Europe of banking groups in these countries, and spillover effects on financial stability? Again, what does the recent shift in sovereign risk premia signal, and at what point could it materially add to fiscal pressures? These seem legitimate topics for a surveillance that is focused on external and financial vulnerability, and on spillover effects.

Box 1: Experience with “Focus” in Germany and Italy

The most recent staff reports on Germany (February 2008) and Italy (February 2007) illustrate some of the dilemmas inherent in achieving focus in the context of larger euro area members, particularly when compared with Spain. There are some interesting lessons here :

- First of all, the report on Italy is roughly three times as long as that on Spain, whereas Spain seems the case where macrofinancial factors and external balance issues, even at the national level, take on an importance that need to be analysed in order to understand key issues of dynamics and external adjustment capacity at the level of the euro area. So, in a refocused Fund, should not a report such as Italy be much shorter? (One should note that Italy was finalized before the refocusing initiative was launched.)
- In Germany, again, the report is three times as long as that on Spain. But the impact of the sub-prime crisis provides a highly relevant surveillance theme, which is woven into a story of risks and challenges that “may interact in insidious ways”. Indeed, given the size of the German economy, questions of financial vulnerability raise obvious spillover risks. The financial stability and supervisory aspects of these questions add to this focus.
- In both Germany and Italy, structural issues and questions of competitiveness (in a broad sense) loom large. They are woven into a growth story of a traditional kind, with long-run fiscal ramifications. But there must be a question whether this micro story should remain a key focus in future, rather than being drawn in selectively to support other themes. (The 2008 cross-country selected issues paper on competitiveness in southern euro area economies is a fascinating study; but it poses the same issue of focus in an acute form.)
- There are, however, other dimensions to competitiveness and adjustment capacity that are potentially relevant to refocused surveillance. Notably, in Germany and Spain there is a strong argument for seeking to model better the dynamics of the underlying imbalances and their resolution *within the euro area context*. This topic is discussed further below.

In the case of emerging market countries, by contrast, it is usually clear how a sharp and relevant focus can be achieved, and this helps explain why the process of refocusing is typically more advanced in such cases. It would be hard to write about Hungary, Russia, Serbia or Turkey without focusing on such issues, and recent Article IV reports certainly do them justice: structural issues, moreover, are integrated in a particularly efficient and succinct manner. Austria and Sweden, meanwhile, are advanced economies; but in these cases their financial links to catching-up economies in the region provide an obvious attractor for focused surveillance, and have been successfully explored through various vehicles (such as

FSSAs and Special Papers⁴). This is not to say that the analysis of macrofinancial linkages and spillovers cannot be improved in such cases; but the issue of **focus** as such can be, and to a large extent has been, successfully addressed.

Of the above-mentioned cases, Spain is thus a particularly interesting case, being an advanced economy in the euro area, with mainly “internal” adjustment issues, yet an example of a short and highly focused report (about 7 pages of text). With its convergence process, credit boom and large current account deficit it is a “tractable case” for a focused report. But comparing it with the treatment of Portugal a few years ago suggests a much tighter surveillance focus, and an effort to highlight financial as much as fiscal linkages. Indeed, its tight focus both facilitates and enhances the innovative structure, which drops conventional partitions (such as “Policy Discussions”) and adopts a thematic treatment, thus minimising repetition. Moreover, in Spain, the relevance of the analysis to external balance at the euro area level is reasonably evident given the economy’s size and questions about its adjustment dynamics. This said, shortening can perhaps go too far: the Swedish Article IV staff report (2007), which drew elements of analysis together very skillfully and succinctly at a key moment for the authorities, was viewed by some as being too short in relation to the content – in a sense suffering from pressures for greater brevity.

A specific difficulty in terms of focus, bearing in mind the 2007 Surveillance Decision, concerns imbalances in small euro area economies: are these “relevant” for the Fund?

The 2007 Slovenia report provides an interesting perspective here. The staff highlight recent adjustment problems in Portugal, and point to potential risks following euro adoption in Slovenia, including through the authorities’ fiscal plans. This is a good example of cross-country learning. On balance, it seems relevant also in terms of refocused surveillance both to potential financial vulnerabilities and regional linkages; and it is important in shedding light on issues facing other catching-up economies outside the euro area, whose currencies are locked to the euro. But it cannot be said to affect the euro area’s external balance significantly: this results in a “grey area” in terms of relevance that deserves clarification.

Finally, while a sharper focus of staff reports would be widely welcomed in Europe, it is fair to add that some authorities are uneasy that structural policies may be left out of the picture unduly as a result. While accepting that the micro aspects of structural policies are not the Fund’s comparative advantage, some countries that also belong to the OECD still value highly the Fund’s work in this field. The key question, however, following the 2007 Surveillance Decision and the refocusing exercise, seems to be not whether such issues are

⁴ See, for example, “Financial Integration in the Nordic-Baltic Region: Challenges for Financial Policies”, S. Kal Wajid, Alexander Tieman, May Khamis, Francois Haas, Dirk Schoenmaker, Plamen Iossifov, Kalin Tintchev, IMF, 2007

important, but how far they are relevant to external balance and financial interdependency. Indeed, there are clearly several contexts in which this is the case (Box 2).

Box 2: The Relevance of Structural Issues – Some Illustrations

Three contexts may help highlight where there can still be a strong relevance of structural policies in refocused surveillance in Europe:

- **The multilateral consultation perspective:** In the case of Europe, structural policies were highlighted as being the key to the continent’s challenges in this exercise. More specifically, in terms of euro area adjustment, the sluggish and asymmetric response of prices and wages is a core concern as regards its adjustment to external shocks.
- **Catching-up in eastern Europe:** This is a region where many economies have impaired macrofinancial “brakes” at the national level (even countries with a floating exchange rate are experiencing quite rapid euroisation; and banks are mainly foreign-owned, so the impact of local regulations is qualified). In this environment, structural policies play a particularly crucial role in shaping the economy’s use of foreign savings (scale, allocation) and thus the path of net foreign assets; and they are also key as regards flexibility in adjusting to external shocks.
- **The grounding of macro advice in micro detail:** The point is made by some that a weakness of Fund advice in the past was a failure to explore the interaction between macro and micro, and to be credible in terms of the structural underpinning for macro goals (including those related to external balance). For example, is it credible to argue that structural policies should raise employment and thus enhance fiscal and external stability – or that the business environment is distorting credit flows and jeopardizing external stability – and just stop there? This context includes the case of countries designing an integrated programme to enhance growth and adjustment capacity. (Sweden is a recent example.) In such cases, the Fund’s ability to provide an integrated assessment of such programmes is highly valued. This reflects its capacity to integrate structural issues, assessing how they change incentives in ways that may exercise a profound impact at the macroeconomic level – potentially include the impact of structural policies on external balance and stability.

These contexts are examples of “hooks” on which a more selective treatment of structural issues in Europe could be hung.

A suitable approach, therefore, would be to treat structural issues in an integrated and streamlined manner, carefully tracing their links to macro challenges and especially external stability. Specifically, the challenge is to handle them in away that (a) highlights their integration; and (b) heavily streamlines needed work on the pure microeconomics. In both respects, recent practice suggests there is a way to go. But of course, one needs some in-

house expertise to have a valid dialogue. And there are gaps that must be filled pragmatically – e.g., among non-OECD members, and in emerging regions such as the West Balkans, though there is EBRD and World Bank work that potentially fills many such gaps.

If microeconomic analysis of structural issues is further slimmed back, this does leave a question how to mitigate the absolute loss of value to members that will result. Some well-targeted micro studies being done today (such as the recent extensive background study on competitiveness in the southern member states of the euro area) have been highly valued but perhaps can scarcely be done in the future. There will be an absolute loss of value for member countries. Can this be remedied? Clearly so. It seems important to identify more clearly at an early stage key areas where the Fund’s integrated analysis calls for a deeper understanding of a set of micro issues, and to seek to persuade other organizations to take over this work - or at least share in its execution according to their comparative advantage. There is scant evidence that synergies with the OECD and other agencies have been fully exploited in such ways. Refocused surveillance makes this urgent, if the Fund is to retain its role in presenting a fully integrated analysis.

4. External vulnerability and financial linkages

The analysis of these two topics – external vulnerability and financial linkages – is a key priority for the Fund in implementing the 2007 Surveillance Decision and more broadly in pursuing the Managing Director’s refocusing strategy. The two topics are closely related also, in that financial linkages may trigger problematic developments in terms of external balance, may amplify such problems, and may also transmit them across economies in a process of global and regional spillovers. So the analysis of these topics lies at the core of refocused surveillance in an increasingly capital-market driven world, and this priority has been evident in many respects since, at the latest, the Asian crisis.

In terms of skill development and technical advice, the time since the Asian crisis has certainly not been wasted: the Fund’s analytical capacity has advanced substantially. In this respect, the FSAP was a watershed: it is not a surveillance instrument in form, but it has created a huge surveillance opportunity for the Fund in terms of insights and credibility with country authorities. During this period, ICM also built up the capital market work of the Fund. These strands of work, while not always integrated, fostered key skills and an arsenal of techniques that are already enriching key areas of surveillance. In certain areas of financial analysis, the staff have indeed been ahead of the curve technically, as with the work in PDR on balance sheet analysis, and very recently indeed in MCM on Contingent Claims Analysis.⁵

⁵ See, for example, “Measuring and Analyzing Sovereign Risk with Contingent Claims”, Micahel Gapen, Dale Gray, Cheng Hoon Lim, and Yingbin Xiao, IMF Staff Papers Vol. 55 No. 1, 2008

Global market events since mid-2007 underscore that these strands of financial skill must now be linked up more systematically, and integrated fully in bilateral surveillance. The challenge is a horizontal one: to integrate such analysis more effectively, and especially to merge it into area department work on surveillance. This means, among other things, ensuring that surveillance missions identify the key sets of macrofinancial linkages in each case, and integrate these in a macroeconomic framework. Member countries would uniformly welcome increased contributions from the Fund in this area. Topics mentioned by member countries include a fuller diagnosis of such linkages; more sophisticated early warning systems; work on transmission channels of liquidity and other market shocks in bank-based (as opposed to “anglo-saxon”) financial systems; and generally a deeper analysis of the nature of country-specific transmission mechanisms for monetary policy changes and market-driven shocks. But several country authorities cautioned that the Fund could not, and need not, be “ahead of the curve” in every technical financial area. Its key contribution was to help bring countries “up to the curve” and also to apply its unique integrative skills in placing financial analysis in an integrated macroeconomic framework.

How to do this? A first guide for the future is to explore successful recent examples, and build on these systematically. In 2007-8, seven sets of consultation papers, among the member country cases selected for this study, merit attention in terms of their treatment and integration of macrofinancial linkages:

- In **Austria** (2008), a well-timed FSSA update visit occurred immediately before the Article IV Consultation discussions; staff explored the national and cross-border exposures of Austrian banks, as well as contagion and regional feedback linkages; the FSSA mission chief participated in the Article IV mission; and the Article IV mission included experienced former MCM staff. Among other issues discussed were indirect credit risk exposures (through unhedged borrowing by bank clients), and whether stress-tests might underestimate regional spillover effects. In the key mission recommendations, fiscal and financial issues received equal treatment.
- In **Hungary** (2007), issues of fiscal, external and financial vulnerability are well linked, in the context of staff concern about a possible future reversal in market sentiment; the assessment of exchange rate alignment is interestingly nuanced in light of the evolving EU entry context; and a balanced but critical view of the exchange regime is offered (including a check on the market underpinnings for such a change), and the recommendations corresponds to the subsequent regime change.
- In **Iceland** (2007), there is a full integration of fiscal, financial, exchange rate and structural linkages. The focus proved well-targeted in light of later market turmoil, and the selected issues topics were excellently chosen. Exchange rate overvaluation was clearly flagged. Staff were more concerned than the authorities (especially the

fiscal authority) about the need for policy strengthening. In the event, all parties were surprised by the scale of problems that later emerged. Notably, on the staff side, there is not a strong emphasis that the “greater understanding in international capital markets of Iceland’s unique circumstances” might be reversible; and staff endorsed a progressive shift underway in the focus of supervisory attention from funding to credit issues – which proved too sanguine, *ex post*. Importantly, a dialogue on linkages and policy options continued after the mission.

- In **Russia** (2007), there is a clear analysis of links between monetary policy, exchange rate expectations, capital inflows, banking governance weakness, and the interaction of these factors with a pro-cyclical fiscal cycle. The risks are discussed, on the eve of the sub-prime crisis, that a favourable external environment might mask underlying financial system vulnerabilities.
- In **Serbia** (2008), the staff report analyses clearly key macrofinancial linkages and challenges, with a pointed diagnosis how to counter them – highlighting the links between structural issues and this macrofinancial nexus. The Executive Summary bears re-reading as a crisp and jargon-free model in this regard. The selected issues paper covers a range of issues, but all of these seem well-targeted. While the staff report text is quite long, it is not easy to imagine how the linkages and their context could have been analysed credibly in a paper that was (say) half that length.
- In **Spain** (2007), the focus is right on the mark in highlighting asset price and saving linkages as a key concern for growth; evaluating financial stability and external adjustment in light of this; and embedding the discussion of structural policies in the context of foreseeable adjustment challenges.⁶
- In **Turkey** (2007), the focus is again on the mark in terms of macrofinancial linkages and resulting vulnerabilities. There is a strong analysis of the interplay between monetary, fiscal and financial factors (including the dynamics of risk across the sectors of the economy, including firms and households). This analysis leads to a clear and consistent set of policy messages, which embraces complementary paths to resilience such as the role of fiscal and monetary rules, and of financial buffers in

⁶ The interpretation of strong, but perhaps transient, fiscal performance during a financial boom is admittedly not developed fully in the Article IV papers, but it was an important topic of discussion with the authorities. This link is a subject that typically deserves fuller consideration under refocused surveillance. For a comparison on Spain, see for example “*Asset Booms and Tax Receipts: The Case of Spain 1995-2006*,” C. Martinez-Mongay, L.A. Maza Lasiera and J. Yaniz Igal, European Economy Economic Papers, November 2007.

public sector balance sheets. Structural challenges in the public finances and real economy are embedded thematically in this architecture of financial linkages.

Another promising example is the stylized application of the contingent claims approach to Bulgaria in [WP/07/236](#). Moreover, earlier staff work on Latvia also explores macrofinancial linkages in an enlightening way.

The financial issues and linkages highlighted in the surveillance papers on these countries present good models to build on. Most importantly, they go far towards overcoming an intrinsic challenge in financial analysis: the sheer number of indicators, and the wide range of linkages that could transmit shocks or fail under stress. In these reports such elements have been welded into a unified and credible surveillance perspective, albeit there is always scope for deepening such analysis in the future.

The challenge is to generalise this and other “best practice”, so that surveillance achieves systematically a high degree of integration in the case of financial issues. The key learning areas seem to fall into three categories: developing a mission toolkit for macrofinancial diagnostics; embedding the analysis of financial linkages in an integrated macro framework; and supporting both these priorities by integrating experts in mission work:

- ***Identifying the key issues is the essence of focused surveillance, so what lessons can be learned in terms of macrofinancial diagnostics?*** This deserves a specific study, but three lessons of experience are: first, to analyse the incentives for agents flowing from current policies as well as spillovers from regional and global markets; second, to explore the key drivers of asset price and capital flows, and implications for financial sustainability; and third, to analyse stock and flow vulnerabilities and adjustment rigidities in each of the sectors, and their linkages.
- ***Embedding this analysis in a macro framework is a core challenge, calling for the integrative capacity that is a great Fund strength.*** In this, probing financial feedback between sectors will be key, as will the assessment of adjustment costs (on different policy options) that take into account financial linkages – such as balance sheet risks. As in some national financial stability reports, these issues may best be explored through medium-term quantified risk scenarios, which also provide a bridge to embed this analysis in an integrated macroeconomic framework.⁷ With experience, the diagnostic techniques that flow from work in cases, including macro stress tests, can be disseminated in a simplified form. In the view of the external

⁷ Work in the Financial Stability Reports of Hungary and the Czech Republic in 2006 and 2007 is interesting to consider in attempting to build consistent risk scenarios to integrate stability analysis, as is work underway in Croatia, with Fund support, to adapt DSGE modelling techniques to capture financial sector linkages.

consultant, three specific areas of technical analysis deserve a priority. The first is the extension of DSGE models to incorporate a well-articulated financial sector – allowing, for example, the modeling of leveraging and deleveraging in the economy under the impulse of risk premium shocks. The second is to map more systemically the shock transmission channels across sector balance sheets (including negative feedback effects to shock variables); and to cross-check a monetary (or balance sheet) analysis of these shock routes to a parallel analysis in terms of the conventional national income accounting framework of sector saving flows, which is the familiar and workhorse framework of desk economists.⁸ The third is a wider application of contingent claims analysis, in which the Fund has already done path-breaking work.

- ***Ensuring an integration of skills through mission composition and staff mobility is essential for progress.*** Experience in recent years makes clear that major advances can be achieved where MCM staff and other experts are rotated onto surveillance missions, or work for a period in area departments. Country authorities repeatedly commented on the benefits of this in terms of deepening mission expertise. It also provides feedback to MCM on the issues of surveillance value, and on possible dilemmas in implementation. Incentives for area departments need to reinforce this trend; but there are also constraints in terms of specialist staff resources. Within an overall tight budget, this is a priority that every effort should be made to respect.

5. Spillovers and regional coverage

Better capturing spillovers, especially financial spillovers, is a priority; and there is also a continuing need to identify valid comparators in bilateral surveillance. This is a typical assessment of the challenge, as seen by member countries in Europe. There are indeed examples of surveillance in Europe being highly successful in both these respects, which are discussed below. As regards the Fund’s approach to its member countries in general, however, a specifically *regional* emphasis in surveillance received only qualified support. Countries cautioned that regions are one, but only one, source of spillovers and comparators. Moreover, “regional” should be not be understood in a narrow geographic sense, but in the broader context of economic connections among countries. Also, there was no support for displacing work on bilateral surveillance by regional studies – except, of course, in connection with the conduct of monetary policy at the euro area level.

⁸ Traditionally, in surveillance, the key nexus ran from the public finances to the balance of payments and back. One core analytical intuition was to visualise these dynamics through the complementary prisms of monetary and national income accounts, and use this to flag risky trends or inconsistencies. The analogous challenge now is to evolve a clear financial stability approach, intuitively obvious to macroeconomists, and probably driven by a similarly sector-based analysis as well as by a cross-analysis from monetary to national income accounts.

At the same time, Europe has specific features that make some regional approaches truly a core element in surveillance. These features include, first, the creation of the monetary union; and, second, the expansion of the EU and the associated rapid growth of financial links with catching-up economies in eastern Europe. Both these developments heighten the case for regional surveillance, especially in the financial domain.

There have been some striking recent successes in regional surveillance in Europe, and these hold out an example of ways in which such activities can be effective. The cumulative impact of these is impressive and belies any suggestion that the Fund has failed to grasp EU developments at the regional level:

- Most obvious are the flagship *euro area Article IV consultations*, which have achieved high visibility among policy-makers in Europe and are valued as an important channel of two-way communication with the international community. This is an innovation driven by necessity, as monetary and exchange rate policies moved to this level; but its execution has been impressive in many key respects – including extremely relevant studies on EU financial regulation and supervision.
- The recent *study of financial links in the Nordic-Baltic region*, referred to above, is widely praised, even though it is not strictly a surveillance exercise. Indeed, a parallel initiative in southeastern Europe would have many attractions given the similar degree of financial integration among mature and catching-up economies.
- The first *European REO* was viewed as well targeted on the financial sector, and the second (which had not yet been assimilated at the time of the country interviews for this study) seems even more impressive in keeping a finger on the pulse of spillover effects, and blending the skills of area and functional departments: this is a high-water mark in regional surveillance of financial sector linkages.⁹

These latter documents successfully establish the role for a REO, but the work plans for this will need to be carefully co-ordinated *ex ante* with those for the euro area report, the GFSR and the WEO, in order to avoid duplication and exploit comparative advantage. The latter principle may suggest exploiting particularly in the REO the mezzanine layer of surveillance between bilateral and regional, with special emphasis on financial and real interconnections of the euro area and the EU, respectively, with the non-member economies in Europe.

One countervailing concern, however, is that the bilateral surveillance of euro area member economies has not situated national divergences in inflation or intra-area imbalances in a clear analytical framework. Member countries do not necessarily point to

⁹ See “Regional Economic Outlook – Europe: Strengthening Financial Systems,” World Economic and Financial Surveys, IMF, November 2007; and “Regional Economic Outlook - Europe: Reassessing Risks”, World Economic and Financial Surveys, IMF, April 2008.

an obvious frame of analysis, but there are degrees of restlessness, sometimes intense, in seeing these national developments described as if endogenous dynamics within the euro area are a second-order feature. As noted earlier, this feeling is strongest as regards developments in competitiveness, despite the recent work by the Fund in this area. Some authorities stress in particular that it is not useful to base assessments of policy challenges in individual euro area members on their real effective exchange rates vis-à-vis all trading partners.¹⁰ The point underlying these concerns is that two separate mechanisms are at work: (1) the operation of adjustment mechanisms within the euro area as a monetary union, in which competitiveness fluctuates in part as a result of country-specific shocks, and which deserve self-standing analysis; and (2) factors that drive the real exchange rate of the euro over time. The changes in competitiveness of Germany or Spain (to take two striking and symmetrical examples) need to be understood first in the former context. Then links must be traced to see how far this is relevant to the external balance, and conceivably financial vulnerabilities and regional or global spillover effects, at the level of the euro area.

The Fund has recently (2007) done valuable work on competitiveness analysis in the euro area; but in bilateral staff reports, as noted above, competitiveness analysis is not yet squarely placed in the framework of dynamic adjustment within a monetary union.¹¹ In terms of focused surveillance, the relevance of these regional adjustment mechanisms and spillovers within the euro area also need clarifying. Certainly, a key example is to be found in the price and wage developments in Germany: these developments need to be analysed in terms of a long, country-specific adjustment cycle that has straddled entry to the monetary union. (If this dynamic were misunderstood, it could trigger inappropriate wage patterns in other euro area economies, complicating the task of area-wide monetary policy and potentially affecting the area's contribution to the resolution of global payments imbalances.) More generally, though, the weak responsiveness to output slack of prices and wages in some large and small euro area economies, evident following recent shocks, is also relevant to the area's adjustment process in a world of shifting payments imbalances. Here, the additive effect of small economies in a similar relative cycle position, and of spillovers within the monetary union, could be telling. Finally, the relevance of differential impacts of risk premia shocks in the current global setting was already discussed in terms of "Value Added" above.

¹⁰ It is fair to add that these concerns are not uniform in their starting assumption: some monetary officials would preclude not only use of the multilateral CGER methodology, and indeed terms such as "intra euro area real effective exchange rate," but also the use of terms such as "competitiveness changes" as a proxy for the latter concept. Given the state of real and financial integration in this monetary union, and the nature of its adjustment mechanisms, this latter position seems analytically an outlier.

¹¹ One example of work in moving forward in this area is the European Commission's 2006 EU Economy Review: "[Adjustment Dynamics in the Euro Area](#)," although this represents only a first building block in such analysis by exploring certain country specific shocks and the role of adjustment mechanisms (including the competitiveness channel) within the euro area as a system. A disclaimer is in order here, however, in that the external consultant was co-editor of the study in question.

A second concern about surveillance in the field of spillovers and regional surveillance relates to the current account deficits of catching-up economies in eastern Europe. These have been large, persistent, and accompanied by very rapid credit growth. The degree of vulnerability inherent in these imbalances is not easy assess in the distinctive perspective of EU Accession. As noted, the 2007 Article IV report on Hungary makes this point well in its analysis of the equilibrium exchange rate.¹² Nonetheless, the sharp slowdown in growth now underway in the Baltic economies underscores continuing risks of a “hard landing” in catching up economies in Europe.

Overall, there has been some weakness in the Fund’s regional surveillance over these catching-up economies in Europe. The importance of the imbalances has certainly been flagged by the Fund: the April 2007 WEO, for example, contained a detailed and valuable analysis. But widely differing schools of thought within the staff were not resolved in a distinctive message about these imbalances. That would have needed to include a clear framework of analysis, according due prominence to the driving force of financial integration as well as the differential nature of adjustment challenges, reflected in formal surveillance documents. And it would also have resulted in a clear judgment about policy urgency that encompassed multilateral and bilateral surveillance in a consistent manner. The missing and unresolved elements transpire when one reads and contrasts the analysis in various Working Papers, Occasional Papers, the WEO, and the GFSR over time.¹³ Indeed, messages about these imbalances conveyed by senior staff at official meetings, such as consultations with the European Commission, and multilateral ministerial meetings, have signaled sharply different perspectives on the risks. In most cases, such papers and statements did not formally convey views of the Fund as an institution, and a diversity of views in analytical work is an absolutely healthy sign. But it would have been valuable if a deeper and unified surveillance analysis could have been developed from this ferment. Latterly, several Working Papers have indeed begun to offer innovative ways of placing these imbalances in new perspectives, helping to resolve some earlier analytical tensions – but the surveillance conclusions remain to be fully drawn, while the signs of reversal in many economies are already evident.¹⁴

¹² Those who considered that converging Europe would be “the first shoe to drop” in any financial turbulence (in part because of common creditor bank effects that bear a resemblance to Asia in 1997) have been discomfited. Indeed, the most seriously affected economy in Eurasia (Kazakhstan) experienced external financing stresses in part because of the *small* role played by foreign banks.

¹³ See, for example, the serious worries raised in “Vulnerabilities in Emerging Southeastern Europe – How Much Cause for Concern?”, Piritta Sorsa, Bas B. Bakker, Christoph Duenwald, Andrea M. Maechler, and Andrew Tiffin, IMF Working Paper WP/07/236, 2007

¹⁴ See “Finance and Convergence: What’s Ahead for Emerging Europe?”, Rudolf Bems and Philip Schellekens, IMF Working Paper WP/07/244, 2007; “International Finance and Income Convergence: Europe is Different?”; Abdul Abiad, Daniel Leigh, and Ashoka Mody, IMF Working Paper WP/07/64, 2007; and “Current Account Developments in New Member States of the European Union: Equilibrium, Excess and EU-

Turning to global spillovers following the sub-prime crisis, the main thrust of discussions with country authorities was not strongly critical of the Fund, but some important questions were raised. Authorities stressed in general that they (and, a fortiori, their banks and rating agencies) were not more foresightful than the Fund. A typical comment was “Well, neither the Fund nor we saw this shock coming; and that is the nature of a shock. It is not a fair litmus test of surveillance.” However, a vocal minority questioned some aspects of the Fund’s surveillance. First, whether staff had subjected the financial system of the United States to scrutiny as deep and rigorous as in the case of many non-systemic countries, taking account of its potential importance for global financial spillovers, including in Europe. Second, whether the Fund showed a sharp enough risk awareness concerning trends in money, liquidity and risk premia in major economies in the years preceding the turbulence.

The complex factors contributing to an extended period of low inflation, real interest rates and risk premia discourage any black-and-white answer to such questions. However, given the Fund’s now more complex views on monetary policy and asset prices, in the April 2008 WEO, it perhaps seems somewhat behind the curve in questioning its earlier positions.¹⁵ It is also interesting to compare BIS, ECB and IMF global assessments in recent years, to which some authorities referred. Both the BIS and ECB stood out from the crowd in stressing the need for peripheral vision as regards developments in financial aggregates, and in some cases asset prices, during this period. Indeed, from 2002-3 onwards the BIS underscored that low risk premia, while partly reflecting benign fundamentals, might be masking not tail risks but major endogenous risks in the working of financial systems; and it raised probing questions about the adequacy of monetary and prudential policy regimes in this setting. It can be noted that some speeches by the Fund’s then Economic Counsellor also picked up this theme for a while in mid-decade.¹⁶ Again, the BIS and the ECB were perhaps faster, in 2006-7, in

Phoria,” Jesmin Rahman, WP/08/92. Some similar lines of analysis also emerged in the European Commission, as in “Growth and Economic Policy: Are there Speed Limits to Real Convergence?” Istvan P. Szekely and Max Watson, European Economy Economic Papers No. 294, European Commission, December 2007.

GG¹⁵ There are examples of papers by R. Rajan, when Economic Counsellor, that issue warnings on these points, but they do not seem to have found a full expression in the formal surveillance documents of the Fund, which tended to regard the long period of unusually low risk premia and high liquidity simply as “benign”.

¹⁶ The interaction between monetary policy, liquidity, risk-taking and financial stability was indeed notably explored in a speech to the Bank of Spain Conference on Central Banks in the 21st Century, on June 8, 2006 by the then Economic Counsellor to the Fund, Raghuram Rajan. At the BIS, milestone publications on this topic (in the second and third cases, reflecting only the views of the researchers, of course) date from as early as 2002 and 2003 - with, for example, Crockett, Andrew, 2003, in “Monetary Stability, Financial Stability and the Business Cycle: Five Views,” BIS Papers No. 18; Borio, Claudio and Philip Lowe, 2002, “Asset Prices, Financial and Monetary Stability: Exploring The Nexus,” BIS Working Paper No. 114; and Borio, Claudio, 2003, “Towards a Macroprudential Framework for Financial Supervision and Regulation?”, BIS Working Paper No. 128. At the OECD also, recent staff work has explored, in various advanced economies, how monetary policy may have contributed to setting the stage for asset price exuberance and reversals. Work by Ansgar Belke, Walter Orth and Ralph Setzer, using OECD data, has reopened a question familiar in the Fund from the 1980s, as to whether aggregate developments in money or liquidity at the level of the G-7 (or the G-7 plus China and Russia) are of value in interpreting global trends in output or prices. In a world of open capital accounts and substitutable currencies, the intuition here is fairly clear and deserves further consideration.

shifting from a focus on global imbalances to concern about market linkages (the ECB Financial Stability Reports of December 2006 and June 2007 voice strong warnings in this regard). But these elements are present also in the April 2007 GFSR. Indeed, the April 2006 GFSR probed tellingly the issues and risks in structured credit ratings. And, of course, no agencies came near to foreshadowing the degree of market shock that has taken place. So one is talking about nuances, albeit important nuances as pointers for future surveillance.

For the future, a key priority in Europe is to build on recent efforts to identify the drivers and spillover effects of rapid financial integration at the global and regional level. This is important within the euro area, and also vis-à-vis EU member states and candidates in eastern Europe. Highlighting such issues seems strongly consistent with refocusing and streamlining the Fund's surveillance of Europe, including by embedding structural and financial issues more firmly in an open economy macro setting. In today's global markets, moreover, it is hard to imagine a more promising route to engage analytically the economic leadership in Europe and to help shape its interaction with the international community.

6. **Format**

A final question is whether the surveillance process, in terms of formats and procedures, is efficient and well targeted towards audiences that can promote desirable policy change. Whether such policy change is triggered, of course, on the issues of analytical focus and value added discussed above; and, more fundamentally, on political opportunity and a setting of adequate institutions. It depends also on the leverage that results from the discipline exerted by global capital market conditions. So the question here is only one building block in surveillance effectiveness; but it is important. It concerns surveillance formats, and in particular whether these end up bringing the Fund's analysis to bear efficiently, vis-à-vis audiences that matter, with the added leverage of broad international endorsement.

The short answer of many country authorities and of the external consultant is "No": from concluding statement to PIN, the process seems too long, and there is too much duplication in the outputs. For almost all countries, it is the mission concluding statement (CST) that is the most powerful vehicle for conveying surveillance assessments. Its freshness, immediacy, and fine-tuning to local audiences are widely praised. The assessment by the Executive Board adds legitimacy, and at times a broader perspective. But, in a world of fast-moving markets, this endorsement comes after a long delay, and in an apparently very duplicative form. Degrees of discomfort with this situation among member country authorities vary. Some authorities are mainly concerned with the paperwork that they themselves have to process – from exhaustive questionnaire to the reading of lengthy selected issues papers that are not always focused on key issues. Other authorities go further than this, and point to the costs in terms of transparency and endorsement that result from time elapsed between CST and PIN. So the present process could helpfully be improved in terms of conveying a prompt and focused message that is not diluted by a lengthy set of

procedures. There was quite wide support for this among country authorities, but these views may differ, of course, from nuances in positions taken in the Executive Board.

The primary audience of staff reports has been and remains the country authorities and the Executive Board. But the fact is that, at a second-order level, target audiences have widened: some current formats and procedures work well in this new world, while others do not. The concerns cited in the previous paragraph are amplified, in the view of the external consultant and of some authorities, when one layers in this secondary audience. In a world where expectations are key, markets are swift, and transparency is prized, it is not surprising that the most immediate audiences for surveillance in Europe should include the public, the financial markets, and of course local policy-makers at the moment of current decisions. Indeed this process got underway informally through the release of CSTs well before PINs were created. Most, but clearly not all, country authorities in Europe seem quite sympathetic to more outreach by missions. In more than one case they cite staff testimony to parliament – for example on the introduction of medium-term budgetary framework in Austria – as especially helpful; and contact with labour unions and NGOs has been valued.

For this and other reasons, countries do not typically favour a major shortening of missions, or a cycle of less than once a year. The length of missions was seen, on the whole, as a comparative advantage that allowed the Fund to “get inside the system” more than most other agencies. But many authorities favour shorter questionnaires with an upfront identification of key issues, where this is not already the case. So, in the process up to mission completion, the key elements for member countries in Europe are substantive missions, at least once a year, and clear closing statements.

In some respects, the procedures after a mission still work as if the main audience of the Article IV process is only the Executive Board, impairing its clarity for outsiders. This is most evident in the length of time between CST and PIN. Improvements can certainly be imagined. Those raised in the interviews for this report typically centred on streamlining the post-mission process. The Article IV staff report itself is in need of further shortening, mainly through removing duplication. One approach would be to structure it thematically, instead of in procedural sections as at present. However, it is crucial not to eliminate key elements of analysis. Views of the authorities also should be included where these are valuable for an informed treatment of the themes – and several member countries and market participants stressed their value (though not necessarily in a dedicated section of the text).¹⁷ If well-targeted selected issues papers are prepared in advance of missions, for discussion with

¹⁷ The development of tightly focused reports, which integrate the financial sector as organically as fiscal policy, is a highly specialized skill: it may be one that merits more specific and case-study based training than is currently available to mission chiefs.

authorities, this would benefit and accelerate the process. This said, flexibility is needed. Sweden was cited above as a case where pressures to shorten may have been overdone; and Serbia was noted as a case where length seems quite well-used in terms of the analysis of macrofinancial linkages (and low or no coverage by sources such as banks and the OECD).

The staff report and selected issues paper would thus mainly present the analytical assessment of the staff. In counterpoint, other Board documents, including the authorities' buff statement and the PIN, could seek to juxtapose the views of the staff, the country authorities and the international community, reinforcing themes that are key in terms of global resonance.

It is important, in making such changes, not to weaken the analytical quality of staff reports, and not to undermine their comprehensiveness and or comparability. But the issue here is substance, not superficialities of format. Comprehensiveness is not adequate at present. Important macrofinancial linkages, or two-way connections between financial and fiscal performance, are not systematically exploited. Comparability has not necessarily been achieved in the degree with which some major economy financial systems have been probed. These are both points made by several country authorities in the interviews for this report. In the assessment of the external consultant, there is major room for further refocusing, and for some selective shortening of staff reports, while improving on balance both comparability and, in many cases, the comprehensiveness with which financial and macroeconomic interactions are captured.

In addition to these issues related to the standard surveillance process and its formats, there is a final, specific point, related to the euro area as such, that deserves flagging. This is the level and prominence of dialogue at the euro area level. Some officials in Europe argue that the Fund has not moved up to speed in treating the euro area as an established monetary union with a major world currency. They query why top Fund management does not participate directly in formal surveillance meetings with the euro area. They also suggest that two rounds of surveillance a year at a senior level contrasts with treatment of, say, the United States – even though they see the case for a monetary conditions update as a background to ongoing bilateral consultations with euro area members. Of course, there are two ways in which such an asymmetry in consultation cycle could be resolved. In the view of the external consultant (in this case unsupported by expressed views of country authorities) the case could at least as well be made that there should be six-monthly surveillance of both the major currency blocs, given their unparalleled influence over global trends in the real and financial economy.

At a more general level, this procedural unease about the way the surveillance of Europe is conducted blends with the policy unease of some authorities, noted above, concerning the Fund's assessments of monetary policy in the euro area. These concerns are potentially important for the surveillance of Europe. If they continued to deepen, they could see a

weakening in the present quality of dialogue and depth of understanding between the euro area and the Fund.

7. Conclusion: the way ahead

Major progress has been made in refocusing the surveillance of Europe, although the degree of advance varies considerably across country cases. This concluding section does not repeat the evaluation in the body of the report in this regard, but seeks to bring together the main suggestions about priorities in the immediate future as this progress is extended.

The core challenge is to integrate financial and external adjustment issues more deeply in macroeconomic analysis. In the first instance, it is to achieve more uniformly the best practice evident in a number of European emerging market cases in terms of a deeper and more interlinked focus on these issues; and to bring the analysis together in the kind of parsimonious and thematic treatment achieved, for example, in Spain (2007).

In terms of moving beyond this best practice and pushing the frontier, the issue is not mainly sophistication in financial techniques. It is the need to deepen the Fund's capacity to diagnose macrofinancial linkages. This is recognized to be a difficult area, in which progress is likely to be steady rather than dramatic. But over time, analysis of the financial market nexus needs to become as rich and embedded in surveillance as are, today, the interconnections of fiscal policy and performance with all sectors of the economy.

A key aspect of this, transcending country cases, is the treatment of global and regional spillovers. This needs strengthening, including through a deeper analysis of sophisticated financial markets in the major economies and currency blocs, which are key in assessing spillovers in their regions and in the global economy. It is thus a challenge that affects both bilateral and multilateral surveillance instruments, including the Fund's developing regional work on Europe – where cross-border interconnections are now critically important as financial integration continues very rapidly and contributes to some large imbalances.

One priority in terms of spillover analysis is to explore more deeply the dynamics of the catching-up (or "real convergence") process in the EU and its neighbouring economies, including the macroeconomic and financial drivers of "external" imbalances in the region. Recent work is moving towards a deeper analysis of these imbalances, and the adjustment issues they raise under different monetary regimes. This should find expression in a clearer framework and a more differentiated view of country risks and policy responses.

A second priority regarding spillovers is to place shifts in competitiveness within the euro area squarely in the context of adjustment dynamics in a monetary union. Current CGER methodology is not designed to do this, nor is it adequate to assess the policy implications of

competitiveness changes in these economies. The challenge is in part a modeling one. It is to diagnose the interaction of policy and market shocks, and explore where competitiveness shifts (or their absence) should ring alarm bells as the adjustment process to such shocks works through under a common monetary policy. This question is relevant to Europe's interactions with the global economy, and never more so than today as real and financial shocks in world markets exert, inevitably, differential effects on euro area members.

In the opinion of the consultant and of some authorities interviewed for this report, a third aspect of spillovers that needs deepening urgently is a risk assessment of the medium-term impact of monetary policy in key anchor economies – not neglecting how this influences liquidity, credit growth, asset markets and imbalances. In this connection, the implications of any difference in monetary philosophy in the main currency areas deserve analysis. This, again, is highly relevant in the surveillance of Europe at the present time.

To counterbalance more analytical work in these fields, a cut back in microeconomic work on structural policies (but not in monetary or fiscal analysis) seems inevitable. And in terms of working to the Fund's comparative advantage, this is desirable. But the implications of structural factors in shaping financial flows and in responding to external shocks remain crucial: indeed these linkages deserve even more focused and integrated attention. It is clear that there will be adjustment stresses in shifting staff resources over time, especially with tight budget constraints. But ultimately such changes need to include an even wider participation in area department missions of staff with FSAP experience, to mutual benefit.

Against this backdrop, the surveillance format need some updating to arrive at a more concentrated and focused message. One component would ideally be more thematically structured and (on average) somewhat shorter staff reports, circulated to the Executive Board soon after consultation missions. In addition, it has for many years been desirable to enforce systematically the best practice of preparing a few well-targeted selected issues papers ahead of missions – for discussion with the authorities and prompt publication thereafter. How to design a consistent set of changes to surveillance documents, however, goes beyond the remit of this report, because it interacts with wider questions about Executive Board procedures.

Terms of Reference for External Consultant for the 2008 Triennial Surveillance Review

Purpose

To provide an independent view on how some key aspects of surveillance, as presented in Article IV staff reports and related outputs, could be improved.

The consultant will aim to answer such questions as:

1. Where lies the value-added of reports on Article IV consultations for countries where Fund surveillance has many competitors; what are they better and worse at than key competitors (e.g. the OECD, BIS, prominent think-tanks)? Are these strengths and weaknesses in line with the Fund's mandate? Is the Fund consistently ahead or behind the curve in certain areas?
2. What should these reports do differently to better analyze spillovers across highly integrated economies? Is the current balance in emphasis between bilateral and regional focus right? How should bilateral and multilateral vehicles of surveillance be best used and integrated for greatest effectiveness on these issues?
3. What should surveillance reports do differently to provide a better analysis of linkages between the real and financial sectors (both nationally and across borders)?

In answering these questions, the consultant should pay attention to any incident insights on whether improving performance on the above points requires a different way of conducting surveillance (e.g., periodicity, outputs, modalities and scope of engagement with domestic authorities and other stakeholders).

The analysis will focus on Europe. This region was chosen given its globally systemic and highly integrated nature, its diverse mix of countries, including a currency union, and the ample supply of analysis by “competitors”, for assessing value-added.

Expected activities and output

The expert would form a view on the above questions by carrying out the following activities:

- Review staff reports (and associated FSSAs) for a sample of highly integrated economies (around 12 countries, selected in consultation with PDR) subject to third party surveillance, the Euro-Area report and the European Regional Economic Outlook.
- Gather views from country authorities by holding discussions with the authorities from a subset of the countries studied. The choice of key questions will be made in consultation with PDR staff.
- Produce an interim report of around 10 pages conceptualizing his early findings, and discuss these findings with designated staff by end-April.

Produce a final report of around 20 pages summarizing his findings and recommendations, and discuss these findings with designated staff by mid-June. The final report may be edited by staff for the purpose of preserving confidentiality of sources and of country-specific information.

List of Country Cases for Special Study in the Project

Austria

Germany

Hungary

Iceland

Italy

Latvia

Russia

Spain

Serbia

Slovenia

Sweden

Turkey

United Kingdom

The euro area as an aggregate