INTERNATIONAL MONETARY FUND

BILATERAL SURVEILLANCE GUIDANCE NOTE

June 13, 2012

EXECUTIVE SUMMARY

This note aims to provide country teams with broad guidance on bilateral surveillance. For convenience and completeness only, it covers all aspects of bilateral surveillance. ***However, staff are not expected to comprehensively cover all the issues raised here as in a checklist.*** *Rather, selectivity in staff reports is critical, bearing in mind the overall focus on stability, and that the Board has identified a need for improvement in five areas defined as operational priorities for surveillance—interconnections, risk assessments, financial stability, external stability and traction. While guidance on these priorities is provided here, there is of course scope for staff to innovate and push the analytical content beyond current practices.*

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CONTENTS

LIST OF ACRONYMS

AML	Anti-Money Laundering
AREAER	Annual Report on Exchange Arrangements and Exchange Restrictions
CA	Current Account
CFT	Combating Financing of Terrorism
CGER	Consultative Group on Exchange Rates
DSA	Debt Sustainability Analysis
EPA	Ex-Post Assessment
EPE	Ex-Post Evaluations of Exceptional Access Arrangements
EREER	Equilibrium Real Effective Exchange Rate
EWE	Early Warning Exercise
EXR	External Relations Department
FCL	Flexible Credit Line
FSB	Financial Stability Board
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FSSGN	Financial Sector Surveillance Guidance Note
FTN	FSAP Technical Note
GFSM	Government Finance Statistics Manual
GFSR	Global Financial Stability Report
G-SIFIs	Global Systemically Important Financial Institutions
LOE	Languages Other than English
LCFIs	Large Complex Financial Institutions
MB	Macro-balance
MTDS	Medium-Term Debt Strategy
NEAP	Net External Asset Position
OFC	Offshore Financial Center
PLL	Precautionary and Liquidity Line
PSI	Policy Support Instrument
PRGT	Poverty Reduction and Growth Trust
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
RAM	Risk Assessment Matrix
REER	Real Effective Exchange Rate
REO	Regional Economic Outlook
ROSC	Report on the Observance of Standards and Codes
SIFIs	Systemically Important Financial Institutions
SIP	Selected Issues Paper
TA	Technical Assistance

TSR	Triennial Surveillance Review
UFR	Use of Fund Resources
VEA	Vulnerability Exercises for Advanced Economies
VEE	Vulnerability Exercises for Emerging Markets
VE-LIC	Vulnerability Exercises for Low-Income Countries
WEO	World Economic Outlook

INTRODUCTION

Following the introduction of an Integrated Surveillance Decision (ISD), the bilateral surveillance guidance note will be updated. In particular, an ISD will enable a better integration of multilateral and bilateral surveillance and spillover analysis.

1. This note provides guidance to staff on the conduct of bilateral surveillance, a core activity of the Fund.[1] Surveillance involves the continuous monitoring of members' economic and financial policies, and regular Article IV consultations. During these consultations staff holds pointed discussions with country authorities on the economic situation, the authorities' policies, and desirable policy adjustments. These discussions are then reported to the Fund's Executive Board for its consideration. The goal, through thorough analysis, candid discussions, and a peer-review mechanism, is to promote the domestic and external stability of members' economies and thereby the stability of the international monetary system as a whole.[2]

2. For effective surveillance (both bilateral and multilateral), the following qualities are essential and permeate all aspects of surveillance work:

- **Collaboration.** Surveillance is a collaborative process, based primarily on dialogue with country authorities, other stakeholders, and persuasion. While this dialogue should be a continuous process, particular value is seen in seeking the authorities' opinion on issues of their interest before the consultation (for example on areas where cross-country experience might be useful). In advising members on how to promote stability, staff should, to the extent possible, also take into account the member's other objectives. Staff should also draw on the expertise of other international institutions as appropriate.

- **Candor.** Effective dialogue requires candor, both in discussions with the authorities and in staff reports, including about risks.

- **Evenhandedness and regard to country circumstances.** Surveillance must be evenhanded, whether economies are large or small, advanced or not, and should pay due regard to countries' specific circumstances.

[1] This note replaces the Surveillance Guidance Note of October 2009 and the subsequent technical update in December 2010. It emphasizes the directions from the 2011 Triennial Surveillance Review (TSR) and its Operational Priorities. The note also reflects and is part of the efforts undertaken to follow up on the 2011 IEO report on performance in the run-up to the financial and economic crisis.

[2] While in accordance with Board guidance, the 2007 Surveillance Decision will be revised, in particular to better integrate multilateral and bilateral surveillance in the context of Article IV consultations, the present Bilateral Surveillance Guidance Note remains grounded in the existing Decision.

- **Practicality.** Staff's advice should be practical. It should be specific and take into account the authorities' implementation capacity.

- **Forward-looking.** Staff reports and discussions should take a medium-term view, including a discussion of medium-term objectives and planned policies, especially possible policy responses to the most relevant contingencies.[3]

- **Multilateral perspective.** Surveillance should discuss important spillovers, and draw from experience in other countries.

- **Selectivity.** While the Guidance Note presents the issues in a comprehensive manner, staff should not view it as a prescriptive list—reports should be focused and selective. Surveillance should focus on issues important for stability. Staff should use judgment in selecting the specific issues to cover in greater depth, and take a risk-based approach, leveraging the expertise of other institutions where appropriate. Guidance provided in Operational Priorities for Surveillance and Other Topics is intended to help staff in selecting topics. In terms of what to do less of, there is scope to cut back on issues that are not clearly at the core of the Fund's mandate and for fewer Selected Issues Papers (SIPs) focused solely on individual country issues (rather than with a cross-country perspective).

- **Timeliness.** To ensure that staff reports are fresh when discussed at the Board and subsequently published, staff should strive to minimize the time from the end of the discussions with the authorities to the Board discussion (it is expected that the lag should be within 65 days for most countries and three months for Poverty Reduction and Growth Trust (PRGT)-eligible countries).

- **Follow up.** To promote the candor and effectiveness of surveillance, country papers should follow up on past advice given in Article IVs and key FSAP recommendations and report on their implementation.

3. The note is organized around the following broad issues:

- **Focus on stability.** Stability is the organizing principle of surveillance. Article IV consultations should focus on the appropriate conduct of economic and financial policies pursued by members to promote present and prospective domestic and external stability.

- **Operational priorities.** The 2011 Triennial Surveillance Review (TSR) found that the overall quality of bilateral surveillance is generally held in high regard. However, it also identified areas for improvement. The TSR (together with the 2011 IEO report) informed the operational priorities to guide surveillance for 2011–14 (Box 1). To help ensure progress on the five operational priorities, a substantial part of this Guidance Note is devoted to them.

[3] For some issues, e.g. the macroeconomic impact of aging population, an even longer view may be appropriate.

- **Other substantive issues.** This note also covers other issues relevant to surveillance where specific guidance is available, as well as matters related to Article VIII and XIV consultations (relating to restrictions on payments and transfers for current international transactions and multiple currency practices).

- **Communication.** Good communication including outreach is key to effective surveillance, including with the authorities (to help staff's advice get traction), the Executive Board (to support effective peer pressure), and the general public (to help gain support for necessary policy adjustments). Surveillance messages need to be clear, concise, focused on a few key points, as well as timely and strategically targeted.

- **Process and formal requirements.** Article IV consultations are underpinned by a number of procedures, rules, and requirements that are summarized in this note.

Box 1. Operational Priorities for Surveillance, 2011–14

IMF surveillance will be guided through 2014 by the following operational priorities:

- **Interconnections.** Bring a multilateral perspective to surveillance. Regularize spillover analysis and promote more cross-country work and thinking;

- **Risk assessment.** Ensure systematic coverage and in-depth discussion of risks in bilateral and multilateral surveillance. Deepen understanding of risk transmission channels and their policy implications;

- **Financial stability.** Adopt a strategic agenda for the Fund's financial sector surveillance. Take further steps to mainstream financial stability analysis in bilateral surveillance. Strengthen understanding of financial interconnectedness and continue to address data gaps;

- **External Stability.** Improve consistency and transparency of exchange rate analysis and ensure discussions of external stability in staff reports extend beyond exchange rates; and

- **Traction.** Strengthen candor and evenhandedness of surveillance, ensure adequate coverage of macro-critical issues, and improve the effectiveness of communication. Encourage regular dialogue with members and engagement with other fora.

Management and staff are responsible for delivering on these operational priorities, subject to members' cooperation. A progress report on the implementation of the 2011 TSR will be sent to the Board in late 2012, and progress will be thoroughly assessed at the time of the next Triennial Surveillance Review.

4. **This note also serves as a portal to more detailed information.** It is accessible in web format and is supplemented by the websites on financial sector surveillance and exchange rates and external stability, which provide more information, tools, examples of good practices, and fora for discussions on these issues.

SCOPE OF SURVEILLANCE: FOCUS ON STABILITY AND RISKS[4]

5. Stability is the organizing principle for surveillance. At the level of individual countries this implies both an attention to the most likely scenario going forward, and a sufficient consideration of potential risks and their implications—including in seemingly quiet times. Staff should assess members' policies from that perspective, and discuss recommended adjustments. This would include an assessment of how exchange rates, fiscal, monetary, financial sector and structural policies and their interactions influence present or prospective domestic and external stability.[5] Other policies, for example those that promote higher rates of potential growth, should be examined to the extent that they significantly influence domestic or external stability (this could include structural reforms aimed at boosting competitiveness for economies that are currently generating a poor growth dynamic burdened by high debt levels and limited policy choices). In cases where the link of these policies to stability is not self-evident, it needs to be explained (not just stated). Macro-social issues (e.g., employment and income distribution) that pass the test of being critical to the assessment of macroeconomic stability should also be discussed in the report, drawing on the expertise of other institutions with relevant mandates (e.g. ILO, OECD, World Bank).

6. Staff reports should include a clear analysis and bottom line. All staff reports should include:

- **Developments and outlook.** A clear depiction of recent economic, financial, and where relevant for the economic analysis, political and social developments and policies and a candid analysis of the short- and medium-term outlook, including risks and vulnerabilities.[6] The assessment should always include an evaluation of developments in the balance of payments.

- **Policy discussion.** A substantive policy discussion, candidly reflecting both the staff's and the authorities' views.

- **Analysis and recommendations.** A pointed summary of staff's analysis and policy recommendations in a staff appraisal.

[4] In the remainder of this note, "surveillance" should be understood to mean "bilateral surveillance" unless otherwise noted.

[5] For help with the treatment of fiscal issues in surveillance, staff may refer to the Guidance Note on Presenting Fiscal Issues and FAD's Toolkit for Crisis Management. Staff reports issued after May 2011 should include presentations of the operations table in the GFSM 2001 format—expanded, if needed, to include key aggregates in the authorities' presentation. Deviations from the GFSM 2001 methodology due to data availability should be flagged in footnotes. (For more details, see Government Finance Statistics to Strengthen Fiscal Analysis).

[6] The Fund (and the staff reports) may not "advocate or promote, or pass judgment on the merits, of any political system," but may take into account a member's political situation to judge the member's capacity to formulate and implement economic policies.

Scope of surveillance in low-income countries

7. The set of issues that could be potentially relevant for surveillance in low-income countries is generally broader than for other countries. Surveillance in low-income countries should, as in other countries, focus on whether policies are contributing to domestic and external stability (as described in paragraph 5), but the potential range of relevant issues that could be considered as part of the Article IV Report is often broader than for other countries. Although not expected to be frequent, these issues may also in some cases be relevant for non low-income countries (e.g., Arab Transition countries).

- **Issues that often arise and could be covered.** These include:
    - General policies to support growth (e.g., policies to strengthen the business climate);
    - macroeconomic management of aid flows and management of natural resources;
    - financial sector reforms to promote financial deepening and to enhance the effectiveness of macroeconomic policies (e.g., to improve liquidity management and the transmission of monetary policy) or the economy's ability to absorb or respond to shock (e.g., through the development of hedging instruments); and
    - macro-critical social issues (such as progress in poverty reduction, priority spending, employment, income distribution).
- **Issues that might occasionally be relevant and could be covered.** These include sectoral policies to support growth; trade policy and regime; export diversification; and governance issues when these have a significant impact on macroeconomic stability and including through their impact on growth.

Scope of surveillance in currency unions

8. The scope of surveillance for members of a currency union is the same as for other members. For members of currency unions, the devolution of authority over a subset of economic policies to the union does not change individual members' obligations under the Articles of Agreement including with respect to surveillance and the provision of data to the Fund.[7] For effective surveillance, it is also important for the Fund to have discussions with the regional institutions responsible for devolved policies. Such a discussion ensures that there is an adequate context for the bilateral discussion with individual members. Surveillance with the union should consider the possibility that vulnerabilities in individual members of a currency union may have

[7] See Fund Surveillance Over Members of Currency Unions and Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview.

implications for the external stability of the currency union as a whole. Staff's assessment of policies should be made both:

- **In consultations held at the level of the union.** Surveillance should assess to what extent exchange rate policies and other policies implemented at the level of the union (monetary policy, fiscal policy frameworks, and financial sector policies) are promoting the union's external and domestic stability. An assessment of the union's real effective exchange rate should also be included.

- **In consultations held at the level of the individual member.** Surveillance should assess to what extent policies implemented at the level of the member are promoting the member's domestic and external balance and contributing to the stability of the union as a whole. Surveillance of individual members should always include an evaluation of developments in their own balance of payments and an assessment of their own real effective exchange rate, which can be cast in terms of either external competitiveness or the real exchange rate.[8] Vulnerabilities of an individual member country that could pose risks to the stability of the currency union should be flagged.

- **Integrated analysis.** In both cases, staff should consider the interactions between developments in individual countries and the union.

Scope of surveillance in program cases

9. Staff reports and discussions in program countries should address the same issues as in other cases. Article IV consultations and reports should be used to reassess the contribution of policies to stability independently of the program framework, and beyond the scope of program reviews. If an Ex-Post Assessment (EPA) or Ex-Post Evaluation of Exceptional Access Arrangement (EPE) has been carried out for a member since the last Article IV its results should feed into the discussion.

[8] See also paragraph 38 and Consultation with Members of Currency Unions.

OPERATIONAL PRIORITIES FOR SURVEILLANCE

As discussed in previous Board papers, under the current legal framework the discussion of outward spillovers from domestic economic and financial policies cannot be the primary focus of surveillance when the economy is either domestically stable or when the spillovers are not transmitted through the balance of payments channels.[9] The introduction of the Integrated Surveillance Decision will make policy spillover analysis a more central part of surveillance, including for spillovers that impact global economic and financial stability, and irrespective of the types of policies or channels of transmission that generate such spillovers.

10. This section provides guidance on the five operational priorities. The issues and topics listed below are intended to help staff in the conduct of surveillance; their actual coverage, including in staff reports, should reflect staff's judgment on what issues are the most important for stability given the country circumstances.

A. Interconnections

11. The propagation of the crisis and subsequent tensions have underlined the case for surveillance to consider the impact of policies in one country on another. This includes: (i) assessing linkages and spillovers across sectors and across borders, as well as the policy implications; and (ii) drawing lessons from cross-country experiences taking into account the interplay of global, regional and country developments (see Box 2 for good examples).

Macro-economic and financial linkages and spillovers across countries

12. Surveillance should in all cases assess how a country is or might be affected by developments and policy actions in other countries (inward spillovers). For members whose economies have a substantial impact on other countries, surveillance should also discuss the most significant outward spillovers. While not all such spillovers can be the primary focus of bilateral surveillance, the discussion could draw on the pilot Spillover Reports. The following questions can help staff think through these issues in both source and recipient countries:

- *For the most important spillover effects, what are the transmission channels?* An examination of the underlying drivers of critical balance of payments flows, and of non-exchange rate policies that may have spillover effects.

[9] See Review of the 2007 Surveillance Decision and the Broader Legal Framework for Surveillance and Modernizing the Legal Framework for Surveillance - Building Blocks Toward an Integrated Surveillance Decision.

- *How are these effects influenced by the global environment?* Risks identified in the Global Financial Stability Report (GFSR) and the World Economic Outlook (WEO) or by developments in specific other countries, may be helpful. Where appropriate, mission teams should also leverage the findings of the Fiscal Monitor, the pilot Spillover Reports, Regional Economic Outlooks (REOs), vulnerabilities exercises and the Early Warning Exercise (EWE).[10]

- *How might the effects transmit themselves to the domestic economy and affect stability?* Given the challenges in gathering reliable data and analyzing different channels, rigorous quantitative analysis may be difficult in some cases. Nevertheless, even qualitatively tracing out these linkages can be helpful (see C. Financial Stability).

- *What are the policy implications of the analysis of spillovers?* Is the policy framework flexible enough to address these spillovers? What are the specific policy options to reduce risks before they occur and to mitigate their impact if they materialize (see B. Risk Assessment)?

Distilling lessons from cross-country experience

13. Surveillance should focus on highlighting lessons from similar experiences in other countries, in support of clear and concrete policy conclusions. While this can include comparison with peers, quantitative analysis, and qualitative case studies, the TSR suggests that authorities place a particularly high value on the discussion of relevant policy experiences in other countries when assessing or making recommendations about their own economy. In addition, country teams should make maximum use of Fiscal Monitor, GFSR, REOs, WEO, Vulnerabilities Exercises and the EWE's cross-country analyses in discussions with the authorities and, where useful, reference publicly available reports in the staff report. Functional departments should support this effort, including through collaborative cross-country policy work, the FAD repository of cross-country experience on fiscal operations, and tools (such as on cyclical-adjustment of fiscal balances, and, on multipliers), and through the review process.

Box 2. Good Examples in Coverage of Spillovers and Cross-country Analyses

The coverage of spillovers varies greatly across countries. Examples of reports with a substantial coverage of inward spillovers are the 2011 staff reports for Turkey (inward spillovers of trade and sovereign risk) and Jordan (trade linkages and business cycles links with the GCC and Emerging Asia). The 2010 report for Germany and 2011 report for Russia stand out for covering outward spillovers as well.

- *Germany (2010)* the report discusses spillovers of Germany's discretionary fiscal policy into the Euro area (Box 6 and ¶44). As regards inward spillovers, it discusses the impact of changes to global trade and the foreign exposure of German banks (Box 8 and ¶s6, 7, 42).

- *Russia (2011)* The report analyzes the implications of an intensification of the Euro area (EA) debt crisis from the 2011 EA spillover report and discusses spillovers from Russia to its fellow members of the Commonwealth of Independent States (Box 2 and ¶9).

[10] Teams may use, in whole or in part, the PowerPoint presentations on the essential findings of the WEO and GFSR accessible from EXR's communications toolkit website.

Cross-country analyses

Country authorities reported that they would like to see Article IV consultations drawing policy lessons from cross-country experience. The 2010 reports (reviewed for the 2011 TSR) on Cambodia, Cyprus, Finland, and Jordan draw policy conclusions from relevant cross-country experiences.

- *Cambodia (2010)* report provides a cross-country analysis of the productivity of the VAT/tax system showing that there is significant scope to improve revenue mobilization, including by taking measures to bring the productivity of Cambodia's VAT to levels comparable with other Asian LICs (Box 1 and ¶s10 and 11).

B. Risk Assessment

14. **The assessment of risks is important to provide members with early warning and to promote policy responses, for purposes of both prevention and contingency planning.**[11] While teams are best placed to think through idiosyncratic risks, the assessment should leverage the analysis of risks conducted at the multilateral or regional levels ((WEO)/(GFSR)/(REOs)). Staff are also encouraged to seek input from the functional departments at an early stage (well ahead of the policy consultation meeting). Staff's dialogue with the authorities should include an explicit and thorough discussion which should also be reflected in the staff report. As part of this assessment, staff should consider:

- **Risks to the baseline.** Staff reports should discuss risks around the baseline scenario and policy implications. The report should set out the macroeconomic and financial sector risks and transmission channels, an assessment of their likelihood (e.g. high, medium, low), their potential impact—and staff recommendations for possible policy responses. Staff should consider policies both to reduce the probability that risks materialize or attenuate their effects (insurance) and to deal with the consequences should the risks materialize (contingency planning).

- **Tail risks.** Staff are also encouraged to explore tail risks—low-probability events with serious negative implications—even if their probability is unquantifiable. Although the authorities may be sensitive on these points, exploring tail risks with them is important, so as to draw their attention to the possible macroeconomic impact and discuss how to insure against them through adjustments in policies. In general, staff should ask themselves "what if" questions, while exercising judgment over which risks to highlight. Staff reports should be candid about risks, bearing in mind that the transparency policy allows for deletions of highly market-sensitive material before publication.

[11] The paper on Initial Lessons of the Crisis also discusses the importance of analyzing risks.

15. Risk analysis should build on the following inputs where relevant:

- **Vulnerability assessments, the EWE and other multilateral surveillance.** A variety of quantitative and qualitative information inputs could be drawn upon including from the vulnerability exercises for advanced economies (VEA), emerging markets (VEE) and low-income countries (VE-LIC) and the broader early warning exercise (EWE), as well as the downside scenarios used in the WEO and the GFSR. Staff are encouraged to present alternative scenarios (including using stress tests) and to use the balance sheet approach.

- **Debt sustainability analysis (DSA).** Article IV reports should undertake debt sustainability analysis (DSA) in line with relevant guidance for market-access (MAC) and low-income (LIC) countries and could draw upon the Medium-Term Debt Strategy where available. The framework for public debt sustainability analysis for MACs has been modernized and revised guidance to staff on implementing the new risk-based framework is forthcoming. While a reasonable level of standardization will be maintained, teams will be expected to customize their analysis including alternative scenarios. Teams will also be expected to use templates developed for these purposes. A good practice for the interim period would be to bring in relevant elements of the new framework into the DSA particularly for countries facing public debt vulnerabilities.[12] More in-depth discussion of risks to debt structures (i.e. maturity, currency, interest rate composition and investor base) may be warranted for particular high debt cases. The framework for LIC debt sustainability framework has also been reviewed

- **Medium-Term Debt Strategy (MTDS).** For countries with an up-to-date MTDS, staff should explore the recommendations in the strategy and use them to explore the extent to which interest rate, maturity and exchange rate mismatches would increase debt and fiscal vulnerabilities.

- **Risk Assessment Matrix (RAM)**. Although not required, staff are encouraged to use a RAM similar to those already included in FSSAs as a focus point for the discussion of risks. The RAM provides a structured framework for analyzing risks and their possible impact and is now a standard feature of the Financial System Stability Assessment (FSSA) reports.[13] For Article IV reports RAMs would cover both macroeconomic and financial sector risks. RAMs attempt to ask and answer "what if" questions and help: (i) identify key risks; (ii) assess the broad probability of realization of each (low-medium-high); and (iii) assess the economic impact should these risks materialize (low-medium-high). The design of the RAM is flexible and staff are encouraged to innovate (see Box 3 which includes good examples from 2011 Reports).

[12] Elements of the new framework, such as assessment of realism of projections and customizing shocks, have been reflected in a few recent DSAs.

[13] See for instance Table 4 in the Philippines 2009 FSSA report as a good example of a standard RAM. See also Box 3.

Box 3. Good Examples in Risk Assessment

The findings of the 2011 TSR suggest that focus on risks has improved in recent years. At the same time, more is needed to ensure systematic in-depth coverage of risks over time including in good times. The 2011 staff reports for Norway, Qatar and Turkey include discussion of risks using a Risk Assessment Matrix (RAM).

Norway (2011) staff report and the RAM discusses five potential risks—a collapse in property markets, intensification of Eurozone crisis and global double dip, the inability of banks to meet refinancing needs on foreign wholesale funding markets, a drop in oil prices, and rapid appreciation resulting from safe haven inflows. For each risk the RAM assesses the likelihood of the risk and its expected impact if realized. The report also discusses the potential for a number of these risks to be realized simultaneously.

Qatar (2011) report and the RAM suggests that despite softening of global growth the likelihood of a large and prolonged decline in hydrocarbon prices in the next three years is low, with a low to medium impact on the Qatari economy if the risk materialized. Other risks highlighted in the RAM include a worsening of global liquidity and financing conditions, financial contagion to sovereign risk, inflation risk, and fiscal risk. Qatar was the first country in the region where the findings of the RAM were reported in the media and it proved to be a useful communication tool with authorities.

Turkey (2011). The RAM looks closely at domestic and international developments in the financial and non-financial sectors and identifies four main risks—namely, external funding risks, recapitalization needs in euro area banks, delayed, but aggressive policy tightening, and a decline in euro area demand. It identifies the transmission channels and the vulnerable sectors. It highlights the sectoral weaknesses that could become a source of systemic instability and outlines potential impact. It pinpoints mitigating factors and identifies issues for further analysis, particularly, for financial sector surveillance.

C. Financial Stability[14]

16. Financial sector surveillance is a key component of bilateral surveillance. The focus should be on financial stability, the cross-border transmission of risks and two-way linkages from the financial sector to the real economy. Article IV consultations should systematically incorporate such analysis as they are the Fund's primary instrument for surveillance of the financial sector in individual countries (see Box 4 for good examples).

17. The Financial Sector Assessment Program (FSAP) should underpin the more continuous surveillance of Article IV consultations.[15] The FSAP provides comprehensive and in depth, but lower-frequency assessments. For 25 countries with systemically important financial sectors, FSAPs have become mandatory and FSAP stability assessments are formally part of Article IV

[14] For more detailed discussion of possible approaches, analytical tools, data sources, and 'best practice' examples, please refer to the Financial Sector Surveillance Guidance Note (FSSGN) and the FSSGN website. See also Financial Sector and Bilateral Surveillance—Toward Further Integration). See also the Financial Surveillance Group (FSG) cross-departmental website for material on discussion on topical issues and of mission relevance. The IMF's Financial Surveillance Work Agenda can also be used as a guide to key topics.

[15] The FSAP, a joint IMF-World Bank initiative launched in 1999, undertakes comprehensive evaluations of countries' financial systems at multi-year intervals. Formally, FSAPs are technical assistance provided by the Fund at the request of members on a voluntary basis and is not a surveillance activity. Following a FSAP, however, a Financial System Stability Assessment (FSSA) is normally submitted to the Board together with the Article IV staff report.

surveillance. When available, staff should draw on the FSAPs' analysis, in particular as reflected in the Risk Assessment Matrix, and integrate the findings into the Article IV staff report. Staff should also follow up on the implementation of relevant FSAP findings and recommendations in Article IV staff reports in the years following an FSAP. When staff are of the view that a member's participation in the FSAP should be of high priority, staff should say so in the Article IV report, irrespective of the authorities' intentions.[16]

18. Country teams should seek up-to-date information on the financial sector. This includes: (i) the size, structure, soundness/performance, and cross-border exposures of banks and non-bank financial institutions and financial markets, and characteristics of the investor base when relevant; and (ii) institutional, regulatory, and policy frameworks both for crisis prevention and management (e.g., systemic liquidity arrangements, cross-border arrangements, and macro-prudential framework).[17]

19. Staff reports should present a clear analysis of financial stability and identify policy measures to address any related concern. The assessment of financial stability in Article IV consultations should focus on the stability of the system as a whole, not of individual institutions, unless they have systemic implications.[18] It should pay particular attention to cross-border issues, including, where relevant, off-shore and off-balance-sheet (e.g. shadow banking) transactions.

20. The analysis should be based on an assessment of financial sector risks and vulnerabilities and their potential impact on stability, subject to data availability. Staff should distinguish between potential risks to the financial system—events or developments that might trigger a crisis—and the underlying vulnerabilities that expose the system to such risks, and determine their likely two-way impact on and from the real economy (e.g., taking into consideration the possible implications of economic agents' balance sheets for financial stability, the inter-linkages between financial and sovereign and balance sheets, and how restoring financial stability could impact growth and policy responsiveness).

21. Staff reports should also identify if there are key data limitations that may impede financial stability analysis. Article IV reports should report these data limitations and evaluate the extent to which they hamper proper financial stability analysis with the help of relevant functional departments.

[16] See the "Q&As for Mandatory FSAPs" for detail and Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance (Supplements 1 and 3).

[17] IMF. 2011. Macroprudential Policy—An Organizing Framework and Progress Report to the Group of Twenty—Macroprudential Policy Tools and Frameworks

[18] Members have no obligation to provide information on individual institutions under Article VIII, Section 5, but many do provide this information. Please refer to the guidance note on transparency policy for the handling of confidential information and of highly market-sensitive material in staff reports as they are prepared for the Board and as they are published.

22. The following questions can be useful to help identify and prioritize financial stability concerns. The FSSGN provides more detailed guidance.[19]

- *What are the main sources of risk?* Emanating both from the financial system itself and from the real economy, at home or abroad.

- *What is the likelihood that the identified risks materialize?* This judgment can be informed, for example, by estimates of probability of default or distress; the extent of asset price misalignments; concentrated exposures; early warning models for assessing the likelihood of specific crisis events underlying the Fund's vulnerability exercises.

- *What are the main vulnerabilities of the financial system and how would the system be affected by a particular risk event?* The analysis could be guided by stress-test results, including scenario analyses.

- *What policies are needed to address these concerns?* Article IV reports should indicate, when relevant, staff's views on supervisory and regulatory policies, macroprudential policy and priority areas for standards assessments (including views from Financial Stability Board (FSB) peer reviews).

- *Do the authorities have adequate safety net and crisis management capacity?* Given the vulnerabilities arising from an interconnected world, particular attention could be paid to cross-border arrangements and resolution frameworks.

23. The analysis of real-financial linkages should focus on whether the financial sector is a potential source or amplifier of instability. The following questions can help staff think through these issues:

- *What are the critical channels of interaction between the macro-economy and financial markets and financial institutions (cross-border and across domestic sectors)?* Data permitting, staff should seek to integrate balance-sheet effects and stress testing in macroeconomic scenarios to help assess the impact of the scenarios on financial solvency and viability and in turn the potential impact of financial balance sheets on sovereign balance sheets.

- *How do changes in financial conditions affect economic activity across domestic sectors?* Discuss whether prudential, supervisory and regulatory "fault lines" have significant macroeconomic implications, (e.g. ramifications of subprime mortgage lending on consumers channeled through shadow entities linked to banks).

[19] There is no single, widely-accepted methodology for assessing financial stability. However, there is a broadly shared view among regulators on the range of issues that such assessments need to cover. These issues are discussed in more detail in the FSSGN (also, see the external Financial Stability Webpage for examples of approaches used by financial regulators in different countries to assess financial sector stability). The Financial Sector Surveillance Work Agenda sets out the current key priorities and a more detailed Strategic Plan for Financial Sector Surveillance is forthcoming.

- *How does the financial sector affect the conduct of macroeconomic policies?* For example, the role of the financial sector in the monetary transmission mechanism and policies, the composition of the investor base and its implications for public debt management, the risks of contingent liabilities and implications for macro-prudential policies.

- *How might problems in the financial sector potentially cause or amplify external instability?* (For example, by triggering a reversal in capital flows and a balance of payments crisis).

- *For countries with important financial sector links to other countries, what are potential spillovers from real or financial sector developments and policies?* For example, data permitting, an understanding of financial interconnections and cross-border exposures, including through global systemically important financial institutions (GSIFIs) would be useful.[20, 21]

Financial sector development

24. Financial sector development issues should be covered in Article IV consultations when relevant for stability. Fostering financial development, while managing attendant risks, can help in strengthening an economy's resilience and capacity to cope with shocks and can help support inclusive growth. Financial development matters for stability for example by strengthening the transmission channels of macroeconomic policy tools and by widening the range of policy options. Additionally, financial development can affect growth by increasing access to credit for productive sectors of the economy by reducing the cost of capital. Financial sector development is more likely to be relevant in low-income countries.[22]

Box 4. Good Examples in Financial Stability Analysis

Stakeholders saw an improvement in the Fund's financial sector surveillance since the pre-crisis period (2011 TSR). Nevertheless, better integration of macro and financial sector issues in surveillance, greater follow up and specificity of policy recommendations; greater capacity building through coordination of TA and FSAP; and bigger focus on LCFIs and filling data gaps, were suggested. Good examples include:

Nepal (2011) assessed financial vulnerability and its implications for contingent fiscal cost and debt sustainability by drawing on cross-country experience. It relies on authorities' stress tests, and the mission's assessment of balance sheet and financial soundness indicators, evaluated against the economy's fiscal space and reserve buffers. The report recommends strengthening supervisory, regulatory and corporate governance environments and establishing a crisis management framework.

[20] See Quarterly Report on Systemically Important Financial Institutions (SIFIs), produced by the Monetary and Capital Markets Department (MCM).

[21] IMF. 2010. Understanding Financial Interconnectedness and Supplementary Information; IMF, 2012. Enhancing Surveillance - Interconnectedness and Clusters).

[22] IMF, 2012. Enhancing Financial Sector Surveillance in Low-Income Countries—Financial Deepening and Macro-Stability, Overview, Background and Case Studies).

Iceland (2010) thoroughly reviewed recent developments in the financial sector and progress on private debt restructuring. It highlighted three key medium-term challenges: (i) the need to generate conditions to grow out of the large post crisis debt; (ii) adjustment measures to stabilize public debt; and (iii) the need to overhaul the policy framework. A selected issues paper looked at external debt sustainability and the nature of interest and exchange rate risks, focusing on the structure of corporate debt and sovereign risk. A contingent claims approach examined how variations in fiscal consolidation path, Icesave outcomes, and contingent liabilities from public enterprises might affect sovereign spreads.

Korea (2010) discussed how the intensification of pressures in Greece had led to an increase in risk-premia for Korea-related exposures. Indirect risks to Korean banks, heavily reliant on wholesale funding, were noted and the potential knock-on effects on the corporate sector, given potentially large dollar-denominated rollover needs. Amending the inflation targeting framework to explicitly account for asset prices was discussed.

Peru (2010) discussed the challenges posed by sustained large capital inflows and policy responses in a highly dollarized economy.

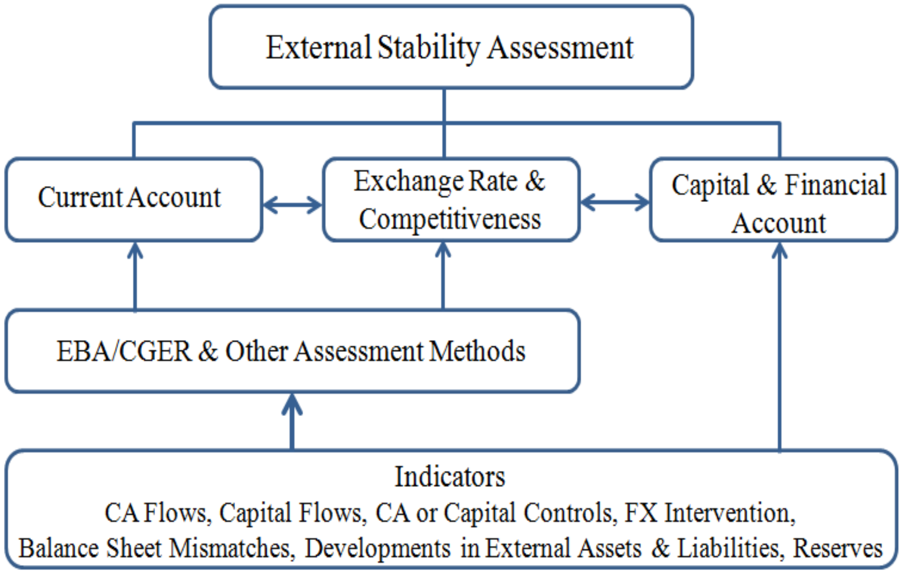
Cameroon (2010) discusses the risks posed by excessive concentration of bank exposures and by inadequate supervisory standards. Remedial policy actions are recommended.

D. External Stability

25. External stability is at the core of bilateral surveillance. To ensure comprehensive coverage of the relevant issues, staff reports are expected to provide a clear assessment of: (i) the current account (CA) and the exchange rate level/competitiveness; and (ii) developments arising from the capital and financial account that could lead to external instability for the member or its trading partners, including from the composition of inflows and balance sheet mismatches and intervention policies where relevant (see Figure 1 and Box 5 for good examples). An assessment of external stability is broader than an assessment of the exchange rate, and of exchange rate policies. Nonetheless, exchange rate issues are a crucial part of surveillance, as the Articles give the Fund a unique responsibility in this area. The Principles for the Guidance of Members' Exchange Rate Policies in the 2007 Decision (see Attachment I) support this analysis.[23]

[23] The Principles provide guidance to members for the conduct of their exchange rate policies and to the Fund in conducting surveillance over these policies.

Figure 1. Structure of External Stability Assessment



26. The following are expected of external stability assessments in staff reports and policy notes:[24]

- **Clear bottom line and recommendations.** Policy notes should include the staff's preliminary assessment, and staff reports should include a clear analysis and bottom line view (while mindful of the inherent analytical uncertainties), of whether the current account and the exchange rate are broadly consistent with medium-term fundamentals and desirable policies. The assessment should be fully integrated into the broader assessment of stability and the overall policy mix, and support clear policy recommendations. When there are no prima facie concerns, the discussion can be brief.

- **Exchange rate estimates.** Numerical estimates should be included in staff reports (drawing from the pilot External Sector Report (ESR), the External Balance Assessment (EBA) where available, and Consultative Group on Exchange Rates (CGER) and/or CGER type estimates) except for countries with serious data limitations, where the assessment may be largely qualitative.[25] For countries in the EBA exercise, staff should form their assessment of the current account and exchange rate using all the available methodologies— EBA/CGER, their own estimates and judgment. For transparency purposes, staff are encouraged to report both

[24] Additional guidance can be found on SPR's Exchange Rate and External Stability Assessment and RES's CGER Exchange Rate Analysis websites and on the EBA methodology. Another useful resource is RES's How to Apply CGER Methodologies to Non-CGER Countries: a Guide for Desk Economists. Appendixes I and II of "Chapter I—Exchange Rate and External Stability Assessments" in the 2011 Triennial Surveillance Review—Background Studies discuss the technical challenges for exchange rate analysis in non-CGER countries and recent developments in exchange rate analysis for CGER countries.

[25] Note that the Bilateral Surveillance Guidance Note will be updated again to more fully reflect the External Balances Assessment/External Sector Report when available.

estimates and the reasons for differences. For economies included in the forthcoming Pilot External Sector Report (ESR), staff should ensure that the assessments of external stability are consistent between the Article IV and forthcoming pilot ESR with each reflecting updates that have occurred over the time period since the previous assessment. Staff is encouraged to use the Article IV to elaborate on the external stability assessment provided in the forthcoming Pilot ESR.

- **Consistency and country-specific circumstances.** Teams are encouraged to check for consistency in assessment over time by checking past assessments, while taking account of changing circumstances.
- **Transparency.** Information on key assumptions should be transparently provided. This would include: (i) the results of exchange rate assessments; (ii) what, if any, adjustments have been made to standard assessments methods (e.g. high remittance countries, aid recipients, oil exporter); and (iii) why, if relevant, the bottom line assessment diverges from what would be expected from the exchange rate estimates. Staff should also indicate uncertainties that may arise in the assessment.

Elements of an external stability assessment

The external stability assessment should include an analysis of exchange rates, the current account capital and financial account including balance sheet mismatches, reserve and intervention policies.

Current account and exchange rate

27. Staff should assess whether the current account and equivalently, the real effective exchange rate are broadly consistent with medium-term fundamentals and desirable policies. The current level of the real effective exchange rate (REER) should be compared to the level that would be consistent with the "underlying" CA being in line with the medium-term fundamentals and desirable policies. The "underlying" CA is the current account stripped of temporary factors, and assessed on the basis of the current REER and established non-exchange rate policies (those in place, as well as policies announced that are, to the best judgment of the team, likely to be implemented). The CA in line with medium-term fundamentals and desirable policies is one that leads the net external asset position to evolve in a manner consistent with the economy's structure and fundamentals and appropriate non exchange rate policies relative to other countries, and subject to a multilateral consistency constraint. Note that even if the current account can be explained by fundamentals and existing policies , if the country has inappropriate macroeconomic policies the current account could be found to be out of equilibrium (e.g. if fiscal policy is too loose, then the current account may be weaker than fundamentals and desirable policies suggest).

28. If an under- or overvaluation is considered to be temporary, this should be made clear. This could happen, in particular, in the following cases: (i) if the current level of the REER is affected by temporary factors such as tight monetary policy; (ii) if the economy is considered to be in transition to a new long-run net external asset position, so that the current account is expected to be temporarily out of line with fundamentals; and (iii) if the authorities' established exchange rate policies would remove the under- or overvaluation over the medium term.

29. Recognizing the inherent uncertainties in the analysis of equilibrium exchange rates, the assessments should draw on all pertinent information, including notably:

- **The indicators in the 2007 Decision** (see Attachment I).

- **Where relevant, assessments and other information provided by the new EBA and the CGER.** The Decision and both CGER and EBA use the same conceptual framework. Of the three methodologies, the current account approach (which compares the underlying CA with a measure of the CA consistent with medium-term fundamentals and desirable policies) can be most directly related to the framework of the 2007 Decision. The equilibrium real effective exchange rate (EREER) approach (which relates the REER directly to fundamentals) can provide helpful additional insights. The external sustainability approach additionally illustrates the external position consistent with stabilizing the net international investment position. Where available, EBA results are likely to provide useful input for assessing exchange rates under the Decision, including through the provision of multilaterally consistent assessments. The EBA builds on CGER and additionally includes "policy gaps" which may help in explaining the policies that may need to be adjusted to reduce an imbalance.

- **Other relevant information.** This could include the evolution of the real effective exchange rate, purchasing power parity estimates, export and import trade shares, and structural competitiveness indicators, among others.[26]

30. In countries with serious data limitations, the assessment may need to be largely qualitative. It may be based on a discussion of recent and prospective balance of payments developments, DSA, reserve adequacy, and other factors.

Capital and Financial Account

31. Staff should assess whether developments in the capital and financial account raise concerns about external instability. This may happen even when the current account and exchange rate levels do not raise concerns. First, temporary fluctuations in the capital account may cause liquidity problems, even if the current account is at a level consistent with medium-term fundamentals. Second, a country's external financing structure may create vulnerabilities which could unwind abruptly. Frequent sources of such vulnerabilities are mismatches in the currency or maturity composition between asset and liability sides of external balance sheets, concentration risk, or reliance on short-term funding. In individual cases, concerns about instability emanating from the capital and financial account may well be much more important than any arising from an under- or overvalued exchange rate.

[26] Please note the labor component of the World Bank's Doing Business Indicators is being revised and should not be included in Staff Reports.

32. The evaluation of developments in the capital and financial account should include an assessment of: the size and sustainability of capital flows, against the background of the member's reserves; the size and composition of external assets (other than reserves) and external liabilities; and the access to international capital markets. Work is underway to develop a balanced and flexible approach to managing capital flows to help countries reap the benefits of capital mobility while limiting the risks, and a series of papers has already been presented to the Board. The results will help the design of an approach to policies affecting capital flows.[27]

Reserves and Intervention Policies

33. The adequacy of reserves is often a critical element in the assessment of external stability. In analyzing the adequacy of reserves, staff should consider a range of approaches, while taking into account particular country characteristics and vulnerabilities. Going beyond the traditional reserve adequacy indicators such as ratios of reserves to imports, short-term external debt (remaining maturity), and broad money, staff are also encouraged to make use of the new metrics for emerging market and developing economies proposed in the IMF paper "Assessing Reserve Adequacy," while taking into account country-specific considerations. Staff are also encouraged, where relevant and feasible, to explore other approaches and indicators (such as ratio of reserves to gross external liabilities) and use scenario analysis to gauge the level of reserves needed to cushion the impact of a sudden stop in capital flows and other extreme balance of payments shocks.[28]

34. Staff reports are expected to cover intervention activities to the extent they are important for external stability. Where relevant, coverage would normally entail a description of past intervention episodes stating their objectives and analyzing their effectiveness, including whether they were coupled with sterilization. Intervention includes outright purchases/sales of foreign exchange or foreign exchange derivatives by the central bank, the ministry of finance, or others working on behalf of these.[29] Staff should assess in particular whether there are protracted large-scale interventions in one direction in the exchange market.

35. The analysis and policy advice on intervention policies should be tailored to country-specific circumstances and avoid an overly prescriptive approach. The assessment should be made against the background of the de facto exchange rate regime and the adequacy of the member's reserves. Staff's advice regarding the use of intervention to influence the exchange rate should be guided by the following: particularly that intervention should be used to counter

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[27] See "Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework," February 2011, "Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework—Supplementary Information," March 2011, "The Multilateral Aspects of Policies Affecting Capital Flows," October 2011, and "Liberalizing Capital Flows and Managing Outflows"; March 2012.

[28] For additional information, see IMF Assessing Reserve Adequacy. See also Guidance Note for Fund Staff on the Treatment and Use of SDR Allocations (paragraph 18 in particular).

[29] See "Classification of Exchange Rate Arrangements".

disorderly conditions in the exchange market, and should not be used to manipulate the exchange rate to gain an unfair competitive advantage, nor in such a way as to result in external instability (for instance, a significantly over- or undervalued exchange rate).

Box 5. Good Examples in External Stability Analysis

Considerable advances have been made in exchange rate assessments but more is needed to ensure that they go beyond a narrow discussion of the exchange rate level and are integrated more fully with overall policy discussions (2011 TSR). Listed below are a few good example cases that take this broader direction in recent Article IV discussions.

Singapore (2010) contains a clear bottom line assessment of the real exchange rate and reserve accumulation. It presents numerical estimates from all three CGER methods. The discussion mentions factors such as aging of the population, Singapore's role as a financial center, and net foreign asset position. Staff acknowledges uncertainties in the analysis in both the text, Box 4 of the Staff Report and staff appraisal. The discussion of the current account and exchange rates are related to fiscal and monetary policies. The report also discusses broad developments in other aspects of external stability including the balance of payments, capital flows, foreign exchange intervention, and reserve accumulation. The authorities' points of view and disagreements on these issues are clearly presented.

Jordan (2010) has a clear bottom line and presents estimates from all three CGER methods. Other measures of external competitiveness are also discussed, including trends in exports of goods and services and tourism-based real effective exchange rates. A chart for the macro-balance approach shows the contributions of each fundamental variable to the current account norm.

Croatia (2010) presents all three CGER methods. The main text discusses the balance sheet implications of exchange rate policy. Moreover, given constraints to more exchange rate flexibility, the report discusses issues related to structural competitiveness and other measures such as market shares, tourist arrivals, and unit labor costs, productivity, and wages.

Bangladesh (2011) presents a clear bottom line and compares Bangladesh's exchange rate with comparator countries. The analysis notes the importance of remittances. It provides both a remittance adjusted estimate along with standard estimates under the macro-balance approach.

Free Floaters, Currency Unions, and Dollarized Economies

36. **Staff should assess the real exchange rate level in all cases irrespective of the exchange rate regime.** Thus such assessment should also be undertaken for members who have a freely floating exchange rate (and hence no exchange rate policies), and those who do not have their own national currencies.

37. **Under a floating exchange rate regime, as in other regimes, the real exchange rate can be under- or overvalued.** This may happen as a result of non-exchange rate policies, as a result of other countries' policies affecting the exchange rate of the country at issue, or because of market imperfections such as a bubble (which may burst in a disorderly way). Thus, even fully market-determined exchange rates can result in disruptive adjustments.

38. **Currency unions.** In currency unions, the real exchange rate and current account should be assessed both at the level of the union and at the level of individual members and there should be

an assessment of any vulnerabilities in individual members that may affect the stability of the union as a whole.

- **At the level of the union**. Union-level staff reports are expected to provide a clear bottom line assessment of whether policy frameworks are adequate, the extent to which exchange rate policies and other policies implemented at the level of the union (e.g. monetary policy, fiscal policy frameworks and financial sector policies) are contributing to the union's stability and should include a bottom line assessment of the real exchange rate level, and associated exchange rate policies.

- **At the level of the member.** Staff reports for individual members are expected to assess to what extent policies implemented at the level of the member are promoting the member's domestic and external balance and contributing to the stability of the union as a whole. Reports should present an analysis of the country's real exchange rate and balance of payments. The discussion can be phrased in terms of external competitiveness or the real exchange rate, including whether the REER is over- or undervalued.

  - Staff reports on individual members should not include statements suggesting that the *nominal* exchange rate is over- or undervalued (unless this is the case at the union level).

  - If the real exchange rate of an individual member is found to be over- or undervalued, the staff report for that member should refer to whether the union exchange rate is considered to be over-or under-valued. This helps clarify why policy adjustment in the individual member is or is not recommended. If the misalignment at the member's level mirrors one at the union level, policy adjustment would be recommended at the union level. Otherwise, policy adjustment would be recommended at the level of the individual member.[30]

  - Significant vulnerabilities apparent at the level of the member should be flagged in both the report of the individual member and in the report of the currency union.

39. Dollarized economies. For members that use the currency of another member as their sole legal tender ("dollarized economies"), staff reports should still include a real exchange rate assessment. The exchange rate discussion can be phrased in terms of external competitiveness or the real exchange rate, and it should include a bottom line assessment including whether the REER is over- or undervalued. Where this is the case, the report needs to discuss the recommended adjustment in policies.

Coverage of exchange rate regimes in Article IV reports

40. Staff reports should identify the de facto and de jure exchange rate regimes. The de facto exchange regime should be understood as a backward-looking description, as assessed by staff, of the approach followed de facto by the authorities in the conduct of exchange rate policies.

[30] See also paragraph 8 and B. Consultations with Members of Currency Unions.

The description should be as elaborate as necessary to enable the reader to understand how exchange rate policies have been conducted in practice, and should include a classification of the de facto regime using MCM's definitions and categories, as used in the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER).[31] (This does not mean that the last classification published in the AREAER should necessarily be used, as staff will take a fresh look at the issue during the Article IV consultation process and explain any difference in classification.) Staff reports should also specify the de jure regime—namely, the regime that the authorities have reported to the Fund and typically also the publicly announced regime—at least in the Appendix on Fund Relations. If the de facto and de jure regimes coincide, both can be referred to simply as "the exchange rate regime." Where applicable, reports should discuss changes in the authorities' forward-looking policy intentions.

41. Reports should also provide a view regarding the adequacy of the de facto regime for maintaining stability. Staff should examine the consistency of the exchange rate regime with the policy mix, which can be more important for external stability than the regime itself. This may include where relevant a discussion of the appropriateness of the fiscal stance, the monetary objectives, and the financial sector regulatory framework. Discussion of alternative regimes should reflect the authorities' views, and advice to alter the regime should take into account readiness and adequacy of the implementation capacity.

E. Traction

42. The ability to influence policy making—or traction—is the cornerstone of effective surveillance.[32] Policy debate and changes are shaped by many factors, of which Fund surveillance is only one. Traction for the Fund can be understood to have two dimensions: the extent to which the authorities engage with the Fund on its analysis and recommendations and more broadly, the value Fund surveillance adds to the policy debate including all stakeholders that may also influence policy; and the extent to which Fund advice is reflected in policy action. To enhance traction, staff should ensure for all countries the candor and evenhandedness of reports, and should use outreach where appropriate to help reach a wide audience and influence the public debate.

- As part of this process, at an early stage in the cycle, staff are encouraged to exchange views with the authorities on analytical topics for discussion. This needs to be done without compromising staff's capacity—and obligation—to raise relevant and at times difficult issues.

- Macro-social issues which pass the test of being critical to the assessment of macroeconomic stability should be discussed, drawing on the expertise of other institutions with relevant mandate (e.g., ILO, World Bank,).

Reports should include an assessment of the authorities' responses to staff's advice on key issues raised in previous Article IV discussions.

[31] See Attachment II for further details on the categories.

[32] This is particularly challenging for systemic countries (2011 TSR).

OTHER TOPICS

A. Issues within the Mandate of Surveillance

43. Inadequate data provision. Comprehensive, timely, and accurate data are critical for surveillance, and staff should be familiar with the Guidance Note on Data Provision to the Fund for Surveillance Purposes.[33] Staff reports and Policy Notes are required to identify the adequacy of data provision for surveillance purposes in a Statistical Issues Appendix. When data provision has serious shortcomings that significantly hamper surveillance—including data deficiencies that hamper an assessment of financial stability—staff reports should discuss:

- Deficiencies. The nature of the deficiencies (coverage, quality, periodicity, timeliness or other aspects of data quality).
- Implications. The implications of the data shortcomings for the analysis, in particular policy conclusions that are subject to significant uncertainties.
- Remedial measures. In those cases where staff have had to construct key data based on limited information (either because of lack of, or long lags in, official data), specific and prioritized remedial measures, possibly including increased resources to ensure durable progress and proper assimilation of technical assistance.
- The extent of discussion of these issues would depend upon the extent of the shortcomings.

44. Reports on the Observance of Standards and Codes (ROSCs).[34] The Fund and the World Bank have endorsed 11 international standards and codes of good economic and financial practice in 12 policy areas; including anti-money laundering and combating the financing of terrorism (see guidance on AML/CFT). Staff should seek information on the observance of those standards that are relevant to country circumstances. Resources permitting, ROSCs, including those carried out in the context of FSAPs, are the preferred means of obtaining this information. The ROSCs' findings relevant for stability should inform surveillance and be discussed in Article IV documents. In addition, Article IV reports should indicate when relevant staff's views on priority areas for standard assessments, independently of the authorities' perceived willingness to volunteer for such ROSCs.

45. Trade issues. Coverage is only expected: (i) where serious trade distortions hamper prospects for stability; (ii) where balance of payments are vulnerable to trade developments; or (iii) in systemically important countries when trade policies have substantial impact on others (see

[33] This note also provides guidance on dealing with possible breaches of Article VIII, Section 5.

[34] ROSCs are a summary of detailed assessments of standards and codes.

paragraph 12). The possible impact of trade restrictions in services (including financial services) should not be forgotten.

46. Governance issues. When relevant for stability, staff should discuss governance issues and reforms with the authorities (see The Role of the IMF in Governance Issues).

47. Political and social developments. Article IV reports should include information on political and social developments when they are relevant for analysis of economic policies.

B. Matters Related to Article VIII and XIV

48. Article VIII and XIV issues. The Surveillance Decision provides that, in principle, Article IV consultations should include consultations under Articles VIII and XIV. Staff reports should indicate when a member has in place exchange restrictions or multiple currency practices subject to Article VIII or that are maintained under the transitional arrangements of Article XIV, Section 2. If the member does maintain such restrictions or multiple currency practices that are subject to approval under Article VIII, Section 2(a) and 3, the staff appraisal should include an explicit recommendation concerning Board approval of the restrictions.[35] Missions should inform members that their failure to seek the Fund approval or to notify the Fund for the imposition or the maintenance of exchange restrictions or multiple currency practices represents a breach of their obligations. Staff should encourage members who have not yet done so to accept the obligations of Article VIII, Sections 2, 3, and 4, following the relevant guidance to provide such encouragement. In addition, the appendix on Fund Relations should note any exchange restrictions imposed for security reasons and required to be notified to the Fund under Decision No. 144-(52/51).

COMMUNICATION

49. Communicating well and candidly with all relevant audiences is key to effective surveillance. The 2011 TSR underscored that surveillance messages need to be concise, focused on a few key points, as well as clear, timely, and strategically targeted. It also emphasized the need to communicate more boldly about risks, while recognizing—and accepting—that this will mean sometimes being proved wrong. It is important to provide clear and candid messages without (unduly) undermining confidence and triggering adverse market reaction.

[35] The Fund approves the imposition or maintenance of exchange restrictions subject to Article VIII, Section 2(a) provided that the restrictions are imposed for balance of payments reasons, are not discriminatory, and that their use will be temporary while the member is seeking to eliminate the need for them. Restrictions imposed solely for the preservation of national or international security are subject to a different procedure: a member must notify the Fund of the imposition of such restrictions; following this notification, the restrictions are approved unless the Fund informs the member within 30 days that it is not satisfied that the restrictions are imposed solely for security reasons (see Decision No. 144-(52/51)). For multiple currency practices, the criteria for approval are specified in Decision No. 6790-(81/43).

50. To strengthen communication, area departments are encouraged to develop outreach programs as part of mission planning and in active consultation with EXR.[36] Outreach can play an important role in communicating and building support for the Fund's advice. To be effective, outreach should be tailored to match messages and medium to the target audience. In addition, Article IV press conferences at the end of missions and/or Board meetings should be routine, unless departments see specific reasons to hold off (e.g., the authorities do not consent). Staff—as "ambassadors of the Fund"—should also aim to present the global and regional outlooks, and the main global messages of the Fund, to country authorities and to the public, as appropriate.

51. Staff should encourage all members to publish Public Information Notices, Article IV consultation staff reports, and background documents.[37] The Fund's transparency policy provides a framework for the publication of these documents, which is voluntary but presumed. The transparency policy allows for deletions and corrections that meet certain criteria. [38] It also gives authorities a "right of reply." Publication in languages other than English (LOE) is also encouraged as appropriate (see the Guidance Note on Translation of Documents for Publication in LOE).

52. As part of the transparency policy framework, the following guidelines have been established:

- **No sharing of draft reports.** Staff should not share draft staff reports (or portions of reports) with country authorities or EDs, with the exception of some specific documents.[39]
- **No negotiated documents.** Staff reports must not be negotiated with the authorities.

[36] EXR has prepared guidance on outreach with civil society, legislators, the media, and the general public, and is maintaining a communications toolkit to help staff in its outreach. The institution's willingness to engage and listen to the views of key external stakeholders will over time help in achieving better public understanding of Fund policies and programs. EXR has staff assigned to each department to serve as a liaison officer to facilitate effective communications, see link, EXR Departmental Teams List.

[37] The PIN consists of a background section with factual information on the economy of the member (including a table of economic indicators) and the final version of the Summing-Up with the deletion of the first sentence (which indicates the EDs' endorsement of the thrust of the staff appraisal) and the last sentence (on the consultation cycle). Where a report has been issued on a LOT basis the Executive Board Assessment is the Staff Appraisal. The first sentence of the PIN should read " In concluding the [year] Article IV consultation with [country], Executive Directors endorsed staff's appraisal as follows:" The Executive Board's Assessment in the PIN should follow the staff appraisal verbatim, with the exception of changes to accommodate corrections or deletions permitted by the Fund's transparency policy.

[38] To avoid undue delays in publication, the transparency policy specifies that requests for deletions and corrections are expected to be communicated to the Fund no later than two days before the Board meeting (or the date of lapse-of-time decision) takes place. See guidance note on transparency policy for details on which corrections and deletions are acceptable under the policy and for the procedures to be followed. Appendix II in the guidance note has a table with main deadlines in the publication process of Board documents.

[39] Exceptions are drafts of mission concluding statements, selected issues papers, ROSC modules, EPA and EPE reports, FSAP aide-memoires and FTNs, OFC assessments aide-memoires, detailed assessments, and TA reports. If staff wishes to confirm in writing their understanding of the authorities' views, they may provide the authorities with a minute of the relevant meeting(s) for comment.

- **Candid and comprehensive assessments.** The authorities' publication intentions should not affect the candor and comprehensiveness of staff's papers.

In addition, to avoid unnecessary difficulties with country authorities, staff are encouraged to:

- **Accurately characterize counterparts' views.** The counterparts' views should be properly characterized as official views of authorities, views of institutions, or personal views.

- **Avoid politically sensitive language.** Staff should avoid formulations that may be considered insulting or divisive in the member country, though without shying away from candid assessments of relevant political economy issues.

- **Avoid discussing publication intentions in staff reports.** The publication intentions should be addressed only in the cover page issued by SEC for internal circulation.

Do not include information provided by the member on the understanding that it will remain confidential to the staff. In the case of doubt, staff should clarify with the authorities whether the information is meant to remain confidential within staff/management, or whether it can be shared with the Board and/or with the public.[40]

[40] See paragraph 13 of the guidance note on transparency policy.

SURVEILLANCE PROCESS AND REQUIREMENTS

A. Consultation Cycles[41]

53. Consultations for countries without an arrangement are normally expected annually. Consultations in countries that do not have an arrangement (other than FCL or PLL) or a PSI with the Fund are normally expected to take place annually (with a three-month grace period).[42] The Executive Board may decide to place a member that is not under a Fund arrangement or a PSI on a longer cycle, not exceeding 24 months, unless the member: (i) is of systemic or regional importance; (ii) is perceived to be at risk, or is facing pressing policy issues of broad interest to the Fund membership; or (iii) has outstanding Fund credit exceeding 200 percent of quota. The Fund may only place a member on a longer cycle with its consent and after consulting with its Executive Director. To enhance the Fund's policy dialogue with a broad range of economic stakeholders, Article IV consultation cycles should be tailored to national policy timetables, such as budget cycles, to the extent feasible. When a member's Article IV consultation has been delayed by more than 12 months, following the end of any applicable grace period of conclusion of its Article IV consultation, formal steps to address prolonged delays are initiated (see Decision No. 15106-(12-21) February 29, 2012).[43]

54. Members that are granted a Fund arrangement or a PSI, with the exception of FCL or PLL arrangements, are automatically placed on a 24-month consultation cycle.[44] In cases where a program review under an arrangement is not completed by the date specified in the arrangement, the next Article IV consultation should be completed by the later of (i) 6 months after the date specified in the arrangement for completion of the review, and (ii) 12 months, plus the 3-month grace period, after date of completion of the previous Article IV consultation, unless a review is completed before the later of these dates, in which case the consultation reverts to a 24-month cycle (i.e., should be completed within 24 months of the previous consultation).

55. Remaining on a 24-month cycle. Except for FCL or PLL arrangements, members that have completed a Fund arrangement or a PSI (i.e., the arrangement or PSI ended "on track") may remain

[41] This section reflects the new rules adopted by the Executive Board on September 28, 2010 (see Decision on Article IV Consultation Cycles (Decision No. 14747-(10/96))). Consultation cycles for individual members will be set based on these new rules at the time of completion of their first Article IV consultation following the adoption of the Decision or in the context of a Fund arrangement or a PSI.

[42] The periodicity and "deadlines" for the completion of individual consultations with members are expressed in terms of an "expectation" rather than an obligation. Except where a member is automatically placed on the 12- or 24-month cycle in the context of a Fund arrangement or PSI, the consultation cycle for members is established by the Executive Board at the conclusion of each Article IV consultation, or at the time of the last program or PSI review, or if necessary, on an ad-hoc basis. The 3-month grace period applies only to consultations that take place on the standard 12-month cycle.

[43] The formal steps to address serious delays are: (i) sending a letter from the Managing Director to a member with a delay more than 12 months; (ii) publishing a list of members with delays more than 18 months; and (iii) holding an informal session to brief the Board on the economy of a member with a delay of more than 18 months.

[44] A calculator for Article IV consultation deadlines in program countries is available online.

on the 24-month cycle if they do not meet any of the criteria described in ¶53 above. At the time of the final review under the arrangement or PSI, staff should assess whether the consultation cycle should be shortened back to 12 months, based on the above criteria. When this is the case, the staff report for the final review should seek the Board's approval of such shortening of the cycle through a recommendation in the staff appraisal (to be reflected in the summing up).[45] If an arrangement expires with undrawn amounts or is cancelled by the member, or if a PSI expires with uncompleted reviews, is terminated, or is cancelled by the member, the member will remain on the cycle it was on, unless the Board determines that a different cycle should apply (which could be done through an ad-hoc decision that the Board could consider on a lapse-of-time basis).[46]

56. Members that are granted an FCL or a PLL arrangement are automatically placed on the standard 12-month consultation cycle. For members that, prior to the approval of an arrangement were on a cycle longer than the standard 12 months, the first Article IV consultation following the approval of the arrangement is expected to be completed by the later of (i) six months following the approval of the arrangement, or (ii) 12 months plus a grace period of three months, after the date of completion of the previous Article IV consultation. At the end of an FCL or a PLL arrangement, that member will remain on the 12-month cycle, unless the Executive Board determined that a different cycle should apply (which could be done through an ad-hoc decision that the Board could consider on a lapse-of-time basis).

B. Consultations with Members of Currency Unions[47]

57. Consultations for members of currency unions should comprise the following:[48]

- **Individual members**. The frequency of Article IV consultations for individual members is determined by individual country circumstances (e.g. whether or not they currently have a program or PSI in place).

- **Discussions with regional institutions.** Yearly staff discussions should be held with regional institutions responsible for common policies in the currency unions. The discussions are held separately from the discussions with the individual member countries of the currency unions, but are considered an integral part of the Article IV process for each member. These discussions focus on policies under the aegis of the regional institutions and, as relevant, other policies of regional importance.

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[45] In case the Board decides to shorten the consultation cycle back to 12 months, the first Article IV consultation after the end of the Fund arrangement or a PSI should be concluded no later than 12 months (plus the 3-month grace period) after date of completion of the previous Article IV consultation, or six months after the end of the arrangement or PSI, whichever is later.

[46] Such a decision could be adopted by the Executive Board based on a proposal by management made upon cancellation (termination) of the arrangement or PSI.

[47] See also Scope of Surveillance: Focus on Stability and Risks and paragraph 38.

[48] See Fund Surveillance Over Members of Currency Unions—Proposed Amendments to Existing Modalities for background and further details.

- **Reports and summing ups at the union level**. An annual staff report on the discussions with the regional institutions is prepared followed by a Board discussion, which are both considered an integral part of the Article IV consultations with individual member countries. Each union level summing up should include language to the effect that the views expressed by Directors in that union level summing up will form part of their discussions in the context of the Article IV consultations for individual currency union members that take place before the next annual Board discussion for the currency union.

- **Informal reports at the union level**. A second round of staff discussion with the regional institutions and an informal report to the Board may be needed to provide adequate context for bilateral consultations with the currency union member countries that do not coincide broadly with the annual Board discussion on the currency union's policies.

C. Process and Documentation

58. The documentation requirements and review process for Article IV consultations are set out below. For more details on the latter, see "Combined Guidelines for the Review Process" on the review process website. Also see the working with eReview website for country review work.

- **Policy Note.** This note (3–4 pages, plus charts and tables) should be prepared ahead of the consultation to lay out the key diagnostics and proposed focus of the consultation and policy advice. It should include background; macroeconomic outlook; policy line on key issues, including surveillance priorities; supportive charts and tables; and note any divergences of views among departments that arose from the policy consultation meeting (see below).

- **Policy Consultation Meeting**. This meeting between the area departments and reviewing departments should be held 2 to 3 weeks before the mission to discuss and agree on the content of the Policy Note, before it is sent to management for clearance.

- **Board discussion.** Article IV staff reports are expected to be discussed by the Executive Board within 65 days of the end of the discussions for most countries, and within three months for PRGT-eligible countries. These should be understood as outer limits as staff are expected to finalize staff reports as quickly as possible after the end of discussions.

Staff report requirements. The requirements for staff reports are listed in Attachment II.

- **Background documentation.** Background documentation for Article IV staff reports may be produced, in the form of papers covering selected issues and statistical annexes, i.e. comprehensive sets of historical data tables. The choice of selected issues papers (SIPs) should be guided by their centrality to the discussion and each SIP should begin with a description of how the papers fit in the consultation discussions. There is scope to cut back from delving into issues that are not clearly at the core of the Fund's mandate and those solely on individual country issues (rather than with a cross-country perspective). Staff has great discretion on whether or not to produce comprehensive statistical annexes and is expected to make this decision in consultation with country authorities. Statistical annexes need not be produced when data are freely available from other sources, which is increasingly the case.

- **Summing Up.** With the exception of when Article IV reports are considered on a lapse-of-time basis (see below), the Executive Board's conclusion of an Article IV consultation will be reflected in a Chairman's Summing Up of the discussion, which will be communicated to the member concerned.

- **Lapse-of-time procedure.** The lapse-of-time (LOT) procedure will be proposed for Article IV consultations where the following conditions apply: (i) there are no acute or significant risks, or general policy issues requiring Board discussion; (ii) policies or circumstances are unlikely to have significant regional or global impact; (iii) in the event a parallel program review is being completed, it is also being completed on a LOT basis; and (iv) the use of Fund resources is not under discussion or anticipated. The LOT procedure should not be used when: (i) the last Article IV consultation was concluded on a LOT basis; (ii) more than 24 months have elapsed since Board discussion of an Article IV consultation; or (iii) the member is on a 24-month consultation cycle. On the basis of these eligibility criteria, the Managing Director, with the approval of the Executive Director for the member concerned, would propose completion of an Article IV consultation on a LOT basis at the time the staff paper is circulated to the Executive Board. The Executive Director for the member concerned may also propose the completion of an Article IV consultation by LOT no more than two business days after the staff paper is circulated to the Executive Board, and preferably as soon as possible after the staff paper is circulated.

- **Combining reports.** There is usually scope for combining Article IV and UFR papers (requests and reviews), though some may prefer to follow a "two-papers" approach. Under either approach, it is critical that the Article IV coverage remain comprehensive and deal with all relevant issues.

- **Clustering.** While recognizing there is often scheduling constraints, teams are encouraged to coordinate Article IV consultations to facilitate Board discussion of clusters of interconnected countries (e.g., countries tied together through financial, trade or other links or exposed to a common set of issues).

59. Informal country matters sessions offer opportunities to inform the Board about significant developments between Article IV consultations. Where warranted, the Board may also be kept apprised of economic developments in a member and of staff's assessment of these developments through issuance of a report in between Article IV consultations (e.g., following a staff visit). Regular provision to creditors or donors of staff assessments of a member's policies can be done through assessment letters, which are delivered upon request. Assessment letters should only be provided when an up-to-date PIN or Chairman's statement is not available.[49]

[49] Such assessments do not constitute an endorsement of the member's policy program or a statement that it meets a particular standard. Assessment letters are typically produced in response to requests from multilateral or bilateral donors or creditors, in particular the World Bank and other international financial institutions. In some instances, the request for an assessment letter may come directly from the member country that is approaching these entities for financial assistance. Generally, assessment letters should only be provided when the most recent PIN/Chairman's statement is more than six months old or when there has been a material change in the country's macroeconomic situation since its issuance. In cases where the most recent UFR review was concluded on a lapse of time and there is no Chairman's statement, an assessment letter can be prepared based on the report's staff appraisal.

ATTACHMENT I. 2007 SURVEILLANCE DECISION: PRINCIPLES AND INDICATORS

Principles for the Guidance of Members' Exchange Rate Policies[1]

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.
B. A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized inter alia by disruptive short-term movements in the exchange rate of its currency.
C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.
D. A member should avoid exchange rate policies that result in external instability.

The Exchange Rate Surveillance Indicators

In its surveillance of the observance by members of the Principles above, the IMF shall consider the following developments in a country's economy as among those requiring thorough review and might indicate the need for discussion with a member:
(i) protracted large-scale intervention in one direction in the exchange market;
(ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;
(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or (b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;
(iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;
(v) fundamental exchange rate misalignment;
(vi) large and prolonged current account deficits or surpluses; and
(vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

[1] Principle A constitutes an obligation under Article IV, Section 1, while Principles B—D constitute recommendations rather than obligations of members.

ATTACHMENT II. FORMAL REQUIREMENTS IN ARTICLE IV STAFF REPORTS

Article IV staff reports should always include the following elements (those marked with an asterisk can be included in the informational annexes):

- A classification of **data adequacy for surveillance**, as per guidance, into adequate (A), broadly adequate (B), or significantly hampering surveillance (C) (see paragraph 43 for case C countries). If adequacy is considered (C), this should be discussed in the main text of the staff report.*

- **A Statistical Issues Appendix and Table of Common Indicators Required for Surveillance** (see Data Provision guidance note, section II.D and attachments I and II).*

- A brief **assessment of the authorities' response to the policy recommendations** on the key issues raised in previous Article IV consultations.

- An accurate description of the **de facto exchange rate regime**, along the following categories: exchange arrangement with no separate legal tender, currency board arrangement, conventional pegged arrangement, pegged exchange rate within horizontal bands, crawling peg, crawling band, managed floating with no pre-determined path for the exchange rate, and independently floating.*

- A reference to proposed consultation cycle.

- A reference to **Article VIII and XIV status** (see paragraph 48).

- Fund Relations Appendix, Bank-Fund Collaboration Appendix.*

- Staff reports for PRGT-eligible countries should include a table on the Millennium Development Goals.

- The background section of the Public Information Notice.

- The following are indicative **word count limits** for staff reports:[1] 5,000 words for stand-alone report for non-systemic countries and 8,000 words for stand-alone report for systemic countries.

[1] Word count limits include everything except tables (contents, acronyms, data), figures, proposed decisions, and Debt Sustainability Assessments appendices. Also excluded are informational annexes (which, in the case of routine annexes to country papers are issued separately).