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BACKGROUND PAPER

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IMF Financial Surveillance in Action: Country Case Studies from Asia and the Western Hemisphere

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IMF Financial Surveillance in Action:
Country Case Studies from Asia and the Western Hemisphere

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ABBREVIATIONS

ABC	Agriculture Bank of China
AMC	asset management companies
AML	anti-money laundering
AMRO	ASEAN+3 Macroeconomic Research Office
ASEAN+3	Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam) plus the People's Republic of China, Japan, and South Korea
BCB	Banco Centro do Brasil (Central Bank of Brazil)
BIS	Bank for International Settlements
BNDES	Brazilian Development Bank
BNM	Bank Negara Malaysia
BOC	Bank of China
BOJ	Bank of Japan
BOT	Bank of Thailand
CADB	China Agriculture Development Bank
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CDB	China Development Bank
CDI	interbank deposit rate
CEIB	China Export-Import Bank
CFM	capital flow management
CIRC	China Insurance Regulatory Commission
CPI	consumer price index
CSRC	China Securities Regulatory Commission
ETF	exchange-traded funds
FCRG	financial crisis response group
FSA	Financial Service Agency
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSR	Financial Stability Report
FSSA	Financial Sector Stability Assessment
GDP	gross domestic product
GFC	global financial crisis
GFSR	*Global Financial Stability Report*
G-SIB	global systematically important banks
ICBC	Industrial and Commercial Bank of China
IOSCO	International Organization of Securities Commission
JGB	Japanese Government Bond
JSCB	joint-stock commercial banks
LGFV	local government financial vehicles
MAS	Monetary Authority of Singapore

MCM	Monetary and Capital Markets Department (IMF)
MOF	Ministry of Finance
MOU	Memorandum of Understanding
MSE	micro and small enterprises
NDF	non-delivery forward
NDRC	National Development Resource Commission
NFPS	non-financial public sector
OECD	Organization for Economic Co-operation and Development
PBC	People's Bank of China
PPP	purchasing power parity
QQE	Quantitative and Qualitative Easing
REIT	Real Estate Investment Trust
ROSC	Reports on the Observance of Standards and Codes
SELIC	Sistema Especial de Liquidação e Custodia
SFI	Specialized Financial Institutions
SIP	Selected Issues Paper
SME	small and medium-sized enterprises
SOCB	State-Owned Commercial Bank
SOE	State-Owned Enterprises
SSM	Single Supervisory Mechanism
STA	Statistics Department (IMF)
TJLP	Taxa de Juros de Longo Prazo
WEO	*World Economic Outlook*
WTO	World Trade Organization
YCC	Yield Curve Control

Chapter 1—IMF Financial Surveillance of Brazil

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EXECUTIVE SUMMARY

The IMF's financial surveillance of Brazil is generally regarded as of high quality and providing considerable value added, particularly the FSAP. The Brazilian authorities value the FSAP for providing an independent seal of approval for what is regarded as a sound financial regulatory and supervisory framework. Officials appreciate the detailed discussions FSAPs entail, and use the prospect of an impending FSAP as an opportunity to enact further improvements to the regulatory framework. Regulatory agencies outside the central bank also appreciate their only opportunity to interact with the IMF.

Officials appreciated the Fund's sober approach to financial surveillance in the Article IV, and close working relations on technical issues. Nevertheless, authorities view it difficult for Article IV staff reports to consistently add value to the more current and detailed analyses collectively contained in official and private publications within Brazil.

There is also a concern, expressed most forcefully in the private sector, that IMF financial surveillance was too slow in expressing concerns about wide fiscal deficits, the rapid growth in bank credit, and the situation of the public banks. According to this view, IMF advice following the crisis did not sufficiently incorporate financial conditions within Brazil, notably the high cost of government borrowing that persisted after the crisis. It also did not call vigorously enough for reining in the fiscal stance, implemented in large part through the expansion of lending by public banks, after the robust Brazilian recovery of 2010.

I. INTRODUCTION

1. This background study evaluates the IMF's financial surveillance in Brazil. It focuses on the period since the 2012 FSAP, although it also discusses IMF advice in the aftermath of the global financial crisis (GFC), given the strong views about this period that still prevail in Brazil. It is based on a review of recent Article IV consultations and the 2012 and 2018 Financial Sector Assessment Programs (FSAPs) for Brazil, interviews with Brazilian authorities, private sector economists and market participants, and IMF staff.[1]

II. CONTEXT

2. Following the GFC, Brazil's economy experienced a mild recession in 2009, which was followed by an initially vigorous recovery aided by expansionary fiscal and monetary policies in response to the crisis. However, the economy stagnated in 2014 and underwent its deepest recession since the 1930s in 2015–16, with real GDP falling cumulatively by about 7.5 percent, as wide-ranging corruption scandals, policy uncertainty, high inflation, and declining commodity prices undermined confidence and investment. The economy began to recover in 2017.

3. Expansionary policies were centered around expanded lending by public banks and rising primary expenditure. Public bank lending drove a sustained increase in the credit-to-GDP ratio, with the share of credit from public banks rising from about one-third in 2008 to about one-half by 2015.[2] In addition, the Brazilian Development Bank (BNDES) received substantial support from the Treasury to finance lending at subsidized interest rates.[3]

4. The combination of expansionary policy following the global crisis, and the recent recession put the fiscal accounts on a deteriorating path. The broadest measures of the public-sector deficit and debt in 2017 are estimated by the IMF at 7.9 percent of GDP and 84 percent of GDP, respectively, with public debt projected to continue on a rising path in the medium term.[4]

5. Brazil's financial environment was further complicated by large swings in the exchange rate against the dollar, as volatile capital flows responded to shifting views about Brazil's

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[1] Interviews with officials took place before the 2018 FSAP and 2018 Article IV consultation had taken place.

[2] Lending by public sector banks slowed since 2016, as fiscal transfers to public banks were curtailed. Moreover, effective from January 2018, the interest rate on new lending by public banks will gradually converge towards the market-based yield of 5-year government bonds, from the subsidized rate (TJLP).

[3] De Bolle (2015) reports that the post-GFC share of BNDES lending continued to target large firms after the crisis. Canuto and Cavallari (2017) indicate that the use of BNDES to supply subsidized credit among other fiscal and quasi-fiscal stimuli in response to the GFC was followed by a continued expansionary stance even as the economy started to show signs of overheating.

[4] These figures refer to the non-financial public sector (NFPS) overall balance (including net policy lending) and NFPS gross debt. The NFPS primary deficit in 2017 is estimated at 1.7 percent; the large difference between nominal and primary deficits reflects both high real interest rates on public debt as well as the large debt stock.

economic prospects and policy responses, as well as changes in the external environment, notably implementation of unconventional monetary policy in the United States.

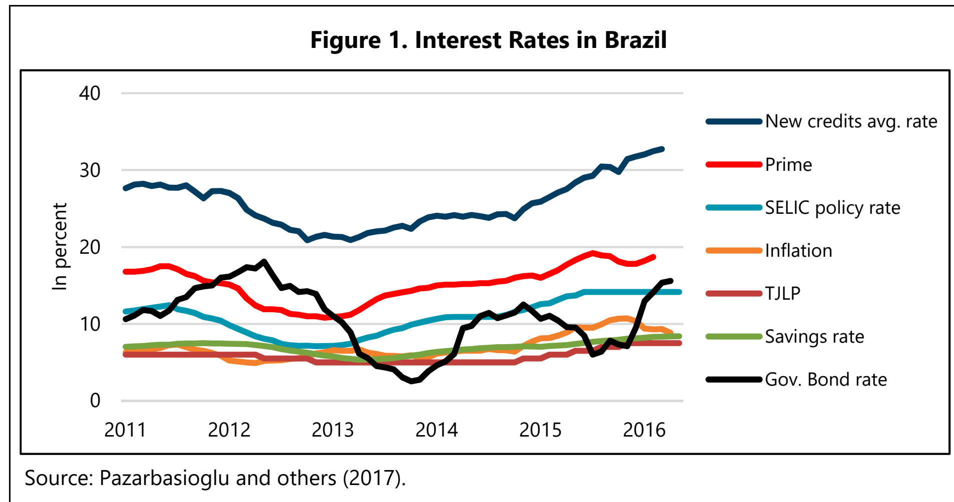
6. Notwithstanding concerns about fiscal sustainability and its potential impact on financial stability, the financial system weathered the global crisis, capital flow volatility and the recent recession. Following the GFC, the Brazilian financial system did undergo consolidation as a number of small banks under stress were merged with larger commercial banks, while the merger of Banco Itaú and Unibanco in 2008 created the largest bank in Latin America in terms of assets and market capitalization. Financial conglomerates, typically comprising commercial banking, investment banking, securities brokerage, asset management and insurance, control the bulk of financial system assets. The six largest banks, three private and three public, account for about 80 percent of banking assets.

7. Firm financial regulation and supervision are widely acknowledged to have played a key role in safeguarding the financial system. Banco Centro do Brasil (BCB) supervision is aided by a strong informational base and a willingness and ability to conduct intrusive supervision. Most large private banks are highly profitable, liquid, and already meet Basel III capital guidelines. Public banks have become an increasingly important segment of the banking system as their loans have increased rapidly in recent years. Despite significant corporate leverage amidst the recent recession, non-performing loans are relatively low, reflecting high write-off of delinquent loans due to strict regulatory requirements. Although proprietary trading is not restricted, market players generally show caution in investment and lending decisions, as directors and management face unlimited personal liability in case of bankruptcy of their institution. Disclosure standards are also high, including for hedge funds and mutual funds.

8. At the same time, credit markets are highly segmented, and interest rates for non-subsidized lending tend to be very high (Figure 1), reflecting several factors. The central bank's overnight policy rate (SELIC rate) averaged nearly 5 percent in real terms over the past decade, while the government itself faces high and volatile real interest rates for its borrowing.[5] Furthermore, spreads between lending rates and banks' cost of funds are also high, and have increased in recent years, even as credit growth declined in real terms. In addition to high interest rates, financial contracts are characterized by short durations. Most real-denominated debt contracts are indexed to the overnight interest rate, either the interbank deposit rate (CDI) or SELIC, reflecting, inter alia, a history of macroeconomic volatility and high intermediation spreads.

[5] Brazil ranks near the top of all countries in terms of both the real interest rate on government debt and interest payments on public debt as a share of GDP (Weisbrot and others, 2017). Nominal rates for government borrowing have fallen recently, however, aided by a decline in inflation to below 3 percent in 2017.

Figure 1. Interest Rates in Brazil



Source: Pazarbasioglu and others (2017).

III. IMF FINANCIAL AND MACROFINANCIAL SURVEILLANCE: AN OVERVIEW

9. The IMF has conducted three FSAPs in Brazil, in 2002, 2012, and 2018.[6] This section focuses on the main messages of the 2012 and 2018 FSSAs (IMF, 2012b; 2018a)—the IMF's summary document of the FSAP—together with pertinent macrofinancial surveillance in recent Article IV consultations on Brazil.[7]

A. FSAPs

10. **The 2012 FSSA** acknowledged the banking system's high levels of capitalization, profitability and liquidity, and found micro- and macroprudential oversight to be strong (IMF, 2012b). Bank supervision was characterized as risk-based, intrusive, and sophisticated. The central bank's strong informational base enabled it to access transactional information for each bank rapidly, conduct a wide range of stress tests, and monitor extraordinary trends. Enforcement powers were also judged to be broad, and BCB's handling of repercussions from the GFC was commended as swift, flexible, and successful. Stress tests conducted by the IMF for the FSAP indicated that on aggregate banks were well-positioned to absorb severe shocks—a result that proved robust.

11. The FSSA observed that prudent macroeconomic policies had provided Brazil ample fiscal space to mitigate the impact of the GFC (IMF, 2012b).[8] Among the policy responses cited as

[6] Following the GFC, Brazil was included in the IMF's list of 29 economies with systemically important financial centers for which mandatory FSAPs are supposed to be conducted every five years. The 2018 FSAP was discussed at the IMF Board in July 2018.

[7] Brazil was part of the pilot program to integrate macrofinancial analysis in Article IV surveillance during 2015–16.

[8] This was also the judgment of initial post-GFC Article IV consultations, although, as discussed below, Article IV staff reports were cautioning about overly expansionary fiscal policy by 2011 (IMF, 2011).

maintaining market stability and preserving confidence were fiscal and monetary stimulus, quasi-fiscal stimulus through the national development bank, and expanded lending by other public banks.

12. At the same time, the FSSA flagged rapid credit growth as a potential source of concern, while stressing various mitigating factors, including the low overall credit-to-GDP ratio, banks' ample capital, and very strong bank supervision (IMF, 2012b). Nevertheless, the FSSA pointed to signs of distress in parts of the household sector, while contrasting the corporate sector's improved resilience to shocks (IMF, 2012b).

13. Given its overall assessment of a generally sound regulatory and supervisory framework, the FSSA's (IMF, 2012b) recommendations focused primarily on legal and institutional reforms under the following headings:

- Macroprudential institutional arrangements and instruments
- Safety nets and crisis management
- Capital markets
- Insurance and pensions
- Consumer protection

14. **The 2018 FSSA** acknowledged that the financial system had been stable despite the deep recession, while supervision and regulation had strengthened further (IMF, 2018a). Nevertheless, it advocated a more robust reform agenda, including, inter alia, enhancing the supervisory, macroprudential and crisis management frameworks, improving financial intermediation efficiency, and reforming the role of public banks. The stronger reforms advocated in the recent FSSA (IMF, 2018a) appears to reflect deterioration in the domestic economy since 2012 and greater uncertainties in the domestic and external environments. In addition, the recent FSSA's assessment of risks also appears more broadly based, as it explicitly considered how financial sector risks could be amplified by the nexus with the sovereign, vulnerabilities in the household and corporate sectors, financial interconnectedness, and cross-border spillovers (IMF, 2018a).

B. Article IV Consultations

15. The 2012 and 2013 Article IV consultations reinforced the FSAP messages. The 2012 Article IV staff report included a section on the risks to financial stability from rapid credit growth, noting that household credit risk and rising house prices were of concern (IMF, 2012a). It further noted the need to avoid overly pro-cyclical lending by public banks if private credit was to rebound. In this regard, it suggested a strategic review of the role and size of BNDES, whose balance sheet had almost doubled to 14 percent of GDP between 2007 and 2011.

16. The 2013 Article IV staff report (IMF, 2013) included a box on the status of implementation of the key recommendations of the 2012 FSAP. Of the 14 main recommendations, three were listed as fully implemented, four as not implemented, and the remainder in various stages of implementation. Subsequent Article IV consultations, however, did not systematically update the status of the FSAP recommendations. The 2013 Article IV staff report (IMF, 2013) included a table of Financial Soundness Indicators, a practice continued in subsequent Article IV staff reports.

17. The 2013 Article IV staff report expressed heightened concern with the growing role of public banks, recommending that reliance on public banks for demand management and other quasi-fiscal operations should be wound down, as fiscal policy would be more effective when conducted transparently through the budget (IMF, 2013). This was in contrast to initial post-GFC Article IV staff reports (and the prior year's FSSA), which commended the government for its countercyclical response to the GFC, including the expansion of credit by public banks.[9] Appendices in the 2013 and 2014 Article IV staff reports also included, respectively, discussion of public banks' rapid credit expansion, and nonperforming loans in public banks (IMF, 2013; 2015). The 2014 Article IV staff report (which was issued in early 2015), raised sharp concerns about public banks beyond their fiscal impact, noting that: *"at times, lending by public banks has been at odds with the thrust of monetary policy, diminishing the latter's effectiveness"* and that *"the widespread use of subsidized lending weakens monetary policy transmission and distorts credit markets"* (IMF, 2015).

18. Article IV staff reports in recent years have included increasing discussion of macrofinancial topics. The 2014 Article IV staff report examined vulnerabilities in the non-financial corporate sector, concluding that Brazilian corporates were vulnerable to a worsening growth outlook as leverage had increased without translating to higher capital outlays (IMF, 2015). As the depth of the recent recession became more evident and corporate leverage rose, the IMF called for enhanced supervision and targeted micro-prudential measures, strengthening of the central bank's emergency liquidity assistance and modernizing the resolution regime, while also acknowledging that the banking system remained sound.

19. In the 2016 Article IV consultation, the IMF stress tested six major banks using publicly available consolidated data and the banks' financial reports. This work, conducted in the context of a Selected Issues Paper (SIP) assessing the health of the banking sector, used a baseline economic scenario consistent with the IMF's most recent projection for Brazil, and a stress scenario featuring a deep and long recession, with significant declines in asset prices and

[9] By 2011, however, the Article IV staff report was calling for withdrawal of the fiscal stimulus (IMF, 2011). The 2011 Article IV staff report also proposed a reduction in quasi-fiscal activities of the development bank (IMF, 2011).

increases in risk premia (IMF, 2016b).[10] It found that the banks would cope well under the IMF's baseline scenario, although some banks could fall below the regulatory threshold in a scenario characterized by a longer and deeper recession than envisaged at the time.[11] This finding led to proposals to bolster the resolution system and strengthen private restructuring frameworks with the aim of expediting the bankruptcy process.

20. In addition to the SIP on stress testing, an appendix to the 2016 Article IV staff report (IMF, 2016a) examined financial linkages across economic sectors by constructing a balance sheet analysis matrix, while another SIP on financial and business cycles assessed the importance of financial market developments for the business cycle (which, inter alia, found that offsetting the negative effects of a slowdown in private credit with an expansion in public credit can be costly and lead to inefficiencies that are difficult to unwind) (IMF, 2016b).

21. Although there was less discussion of financial sector issues in the 2017 Article IV staff report (IMF, 2017), the 2018 Article IV staff report (IMF, 2018b) referenced and summarized the 2018 FSAP, and included a useful discussion of high financial intermediation costs.

22. IMF staff acknowledged that the dedicated availability of Monetary and Capital Markets Department (MCM) staff and contributions from elsewhere in the Western Hemisphere Department (WHD), considerably enhanced the Article IV team's capacity to conduct macrofinancial analysis, noting that most country teams did not have access to such resources.

IV. EVALUATION OF IMF FINANCIAL SURVEILLANCE

A. Officials' Views

23. The FSAP is generally appreciated by a wide range of Brazilian authorities, who consider it an important instrument providing an independent assessment of the Brazilian financial system. FSAP recommendations were helpful to the reform agenda and implementing legal amendments. Moreover, the prospect of an FSAP—which officials prepare for well in advance—provides added impetus to review the regulatory and supervisory system, and assess whether improvements can be made to what is already regarded as a sound regulatory framework. Notwithstanding the cost in terms of their staff time, authorities are pleased with the FSAP process and outcomes. That said, some central bank officials indicated that an interval of 7-8 years, rather than 5 years, for the FSAP would be preferable for Brazil, reflecting not only the

[10] The scenario was somewhat more severe than the subsequent evolution of the economy.

[11] Results for individual banks were not published, however.

significant preparation the FSAP entails, but the preparation required for the Financial Stability Board (FSB) Peer Reviews.[12]

24. Central bank officials generally supported the trend towards greater focus of FSAPs on financial stability, whereas supervisory officials from other agencies (e.g., pensions, insurance, capital markets) tended to favor the continuation of more comprehensive coverage, since greater focus on financial stability could limit their interaction with the IMF; for some supervisory agencies, the FSAP is their only opportunity to interact with the IMF. The lack of follow up with the IMF between FSAPs is considered problematic for some agencies that do not interact with the IMF outside the FSAP process, and who would welcome more frequent contacts with the Fund.

25. Although interaction with the FSAP team is valued, officials expressed reservations about the expertise of some FSAP consultants. For example, authorities indicated that misinterpretation of International Organization of Securities Commission (IOSCO) objectives and principles led the 2012 FSAP to conclude—erroneously in the view of authorities—that Brazil was out of compliance with IOSCO.[13] In the example cited, the disagreement was with a World Bank consultant, but the authorities did not distinguish between agencies, signifying the potential for reputational risk to the IMF from the joint FSAP. In cases where the authorities and the FSAP team cannot resolve their differences, it was suggested there should be recourse to the relevant global authority with the expertise to adjudicate the matter.

26. Financial surveillance in Article IV staff reports elicited more mixed support from government officials. Some officials commended the IMF for taking "sober" views, for not trying to create waves and for being respectful of the government's views, while suggesting that the reports could give a better sense of the debates between the government and the Fund. Others appreciated the close working relations between the government and Article IV teams on technical issues such as stress tests and debt sustainability analysis. Still others, however, stressed that it was difficult for Article IV staff reports to add value to the greater depth and more current analyses contained in official and private sector publications within Brazil.[14] A few officials noted that there have been too many SIPs in recent years, which tend to be supply driven in their

[12] The recent FSB Peer Review of Brazil, completed in April 2017, focused on two topics relevant for financial stability in Brazil: trade reporting and its use in systemic risk monitoring, and the regulation and supervision of investment funds (FSB, 2017).

[13] The disagreement concerned the legal structure of certain investment funds in Brazil, and the power provided to the investor versus investment managers.

[14] This critique was directed at the overall analysis in Article IV staff reports, not specifically at financial surveillance.

choice of topics.[15] At the same time, officials indicated that macrofinancial issues selected for coverage in Article IV consultations should continue to be determined by the Fund's area department and not its functional departments, since it is the country team that is best able to assess the relative importance of issues for Brazil. That said, this should not preclude Article IV staff reports from providing more comparable data across countries, with the Financial Soundness Indicators serving as an example of this.

B. Private Sector Views[16]

27. As a backdrop to their views about IMF financial surveillance, private sector interviewees emphasized their concern about Brazil's fiscal sustainability, and its potential repercussions for financial stability. By contrast, they considered prudential regulation and supervision in Brazil to be sound and conducive to a stable financial system. The problems in the financial system were said to stem from forced savings and subsidized lending, whose expansion after the GFC was considered excessive, especially after the economy had recovered in 2010, and led to waste and abuse.

28. Viewed from these perspectives, the IMF was considered to have been too encouraging of the government's fiscal expansion after the global crisis, not critical enough of the way in which stimulus was provided through public sector banks and credit subsidies, too slow to call for a retrenchment, and, according to some, not appreciative enough of Brazil's resilient financial system.

29. IMF statements about the need for fiscal stimulus following the GFC—at the G20 level and in dialogue with Brazilian authorities—did not differentiate enough between cases where fiscal expansion would be most and least effective. Brazil was said to fall in the latter category since real interest rates for government borrowing remained high following the GFC, indicating that additional government borrowing would tend to crowd out private borrowing and spending rather than substitute for the collapsing private demand observed in other countries. Some interviewees supported the initial stimulus, including through the use of lending by public banks, given the uncertainties prevailing at the time, but concurred that the IMF was late and not forceful enough in calling for a curtailment of such lending after the robust recovery in 2010.

30. These private sector observers argued that although the initial fiscal stimulus may have limited the downturn in 2008–09, the prolonged expansion of subsidized lending by public

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[15] The last three Article IV cycles (prior to 2018) contained 20 SIPs totaling 369 pages. In 2018, no SIPs were produced in line with the Fund's recent policy but were replaced by working papers. (None in the financial sector.)

[16] Although Article IV staff reports on Brazil were not published until 2012, private sector interviewees were familiar with their content. Moreover, some interviewees in the private sector were former senior officials in the government or central bank.

banks, much of it to favored corporations that retained access to market sources of funding, was detrimental to efficient capital allocation, and undermined monetary policy effectiveness. The IMF's concerns about the scope and impact of expanded public bank lending came too late, whereas it should have been a focus of the 2012 FSAP and earlier Article IV consultations.[17]

31. The IMF was said to have become the victim of a cookie cutter approach on financial surveillance. It tried too hard to look for fragilities despite the regulatory system's vigor; one interviewee characterized the IMF's financial sector work as searching in vain for the equivalent of the next subprime lending crisis in Brazil. For example, before the recent recession, the IMF was concerned that household credit growth was too high; yet, despite a 10 percent decline in Brazil's per capita income over three years (2014–16), the financial system remains resilient.[18]

32. These private sector observers stated that the IMF should have focused less on the prudential framework and more on the chronic features of the financial system characterized by high real interest rates and the factors explaining them, and the inefficiencies in resource mobilization and allocation stemming from expanded public bank lending in such an environment.

V. Concluding Observations

33. Recent FSAPs and Article IV consultations have provided a wider range of analysis of macrofinancial issues in Brazil, and indeed Brazil is one of the few countries for which stress tests of individual banks have been conducted in the context of Article IV consultations since 2016. Such analysis has raised the quality of macrofinancial surveillance and appears to have strengthened the IMF's understanding of financial and macrofinancial risks. The FSAPs in particular have been appreciated by officials in providing an independent assessment and supporting the reform agenda.

34. While these strengths should be acknowledged, there are a number of aspects of Brazil's experience that could have received more attention. First, the IMF could have done more to comprehensively address the nexus of issues that have long plagued the Brazilian macroeconomy and financial sector, which include: high real interest rates for government borrowing and the very high interest rates on non-subsidized loans to the private sector, which in turn reflect unusually high spreads over the banks' cost of funding.[19] Public bank lending has traditionally been used to counter the adverse impact of high real interest rates, but in the process may have undermined the development of the capital market and monetary policy

[17] Government officials also did not recall the IMF being overly concerned about public bank lending in the initial years after the GFC.

[18] The 2017 Article IV staff report indeed acknowledged that household balance sheets had begun to improve, even though the economic recovery from the deep recession had barely begun (IMF, 2017).

[19] These issues were addressed in the 2018 FSAP, which built on an IMF working paper by Segura-Ubiergo (2012) that focused on this issue.

effectiveness. Some IMF staff indicated that in the division of labor between the IMF and World Bank, public bank lending was to be addressed by the World Bank—and the World Bank has indeed addressed this issue in depth. Nonetheless, since such lending has fiscal repercussions, and has also undermined monetary policy effectiveness (as acknowledged in Fund surveillance), it is difficult to defend the IMF's lack of in-depth focus on this issue.

35. Second, the IMF is perceived in Brazil as having been too encouraging of fiscal stimulus following the GFC, and not sufficiently forceful in urging a reversal of the fiscal stance following the 2010 recovery. The 2012 FSAP commended both the post-GFC fiscal expansion and use of public bank lending to implement the expansion. Although the 2011 Article IV staff report (IMF, 2011) called for withdrawal of fiscal stimulus, the IMF's earlier encouragement of fiscal stimulus in an environment of high costs of government borrowing, coupled with the tone of the 2012 FSAP, appears to have contributed to the view that the IMF could have been more forceful in calling for restraint on fiscal expansion and the lending of the public banks. Since then, IMF surveillance has addressed these topics, in the process reversing its earlier stances on fiscal policy and public bank lending. But until the recent FSAP and Article IV consultation, discussion of the high interest rate conundrum appeared somewhat piecemeal, rather than comprehensive.

36. Finally, the factors that contributed to the resilience of financial institutions to both the GFC and recent deep recession warrant close attention having in mind potential lessons for the IMF work in Brazil and beyond. The factors that might have contributed to this resilience included a sound regulatory and supervisory framework; the high profitability of Brazilian banks, which itself appears to stem from institutional factors such as market dominance by a small group of large banks; a history of macroeconomic volatility that has imbued caution into private lending and investment decisions; and incentives that appear to instill further caution in risk taking—such as unlimited personal liability for management and Board directors in case of institutional bankruptcy.

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Chapter 2—IMF Financial Surveillance of China

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EXECUTIVE SUMMARY

The IMF has been the leading outside player analyzing financial stability issues, making recommendations and providing technical support to Chinese officials tasked with financial regulation and supervision. The 2011 and 2017 FSAPs and the Article IV consultations in this period documented progress and identified additional reforms that were still needed. IMF surveillance provided analysis and options that clearly influenced China's financial reform. But its main value has been sharing international experience and bringing a toolkit that can be applied to China. Chinese officials want to learn the toolkit, so they can apply it themselves, and hear IMF recommendations as one set of options to consider in designing reform.

Overall, the IMF was more influential in the micro dimension of financial regulation and supervision than in the macro dimension. Since at least the 2011 FSAP, the IMF has been warning that the growth of credit was too rapid and that the build-up of debt-to-GDP was worrisome. Yet, given China's characteristics, the authorities assessed the risks to be less severe. Credit continued to grow rapidly but has stabilized in the past year as authorities took steps to rein in the growth of credit, especially in shadow banking. The IMF recommended that monetary tightening be complemented with state-enterprise and fiscal reform. While reform has been slow in these areas, the IMF's recommendations may resonate in the future.

The IMF's financial surveillance of China has strengthened over time. The Chinese authorities learned a lot from the first FSAP, but the exercise suffered from problems of lack of data—either because it was not compiled, or data sharing was subject to confidentiality constraints—and from the IMF team's lack of familiarity with China. Both problems have diminished over time. The Fund has built up more expertise on China, and data availability has improved.

While overall the Fund should get high marks for its financial surveillance of China, there are still areas for improvement. An interesting point of convergence is that both mid-level officials and Fund staff indicated that they would prefer more regular contact. One suggestion from several Chinese officials was that the FSAP should be more focused and that there could be a formal, mid-term review about two years after the FSAP to measure progress and update recommendations. Some of the FSAP assessors could join the Article IV team for that year and make the Article IV something of a mid-term review. There are still problems with data availability and the communication of China's financial policies. Authorities would prefer if the *GFSR* and other flagship reports were more closely coordinated with them, or at the very least negative messages shared with them in advance. While they welcome the Fund's honest assessment, they do not like to be surprised by criticism that they have not seen before.

There could not have been in all of history so rapid a development in a functional financial system, and in particular of banking institutions, as in China over recent decades.
—Paul Volcker, preface to *China's Emerging Financial Markets*, 2009

I. INTRODUCTION

1. China's economic and financial development in the past few decades is truly a remarkable story without precedent in economic history. This case study examines the IMF's role in this transformation, in particular by evaluating the Fund's financial surveillance of China starting with the FSAP carried out during 2010–11, a succession of Article IV consultations, and the 2017 FSAP. Section II provides background on economic and financial reform in China. Section III describes and evaluates the main IMF products. Section IV assesses the influence of the IMF's work on China's reform program, and shares some views from the authorities, the private sector, and academic economists. To gauge the reaction of key regulators, interviews were conducted in Beijing from July 3–7, 2017. The basic story is a very positive one, with IMF analysis and advice helping shape the transformation of China's financial system. The authorities did not always follow Fund advice, but it was a critical input into their deliberations and decision-making. Still, there is room for improvement and the concluding section offers recommendations to improve financial surveillance in China and in general.

II. CONTEXT

2. Since launching its reform and opening *(Gaige Kaifeng)* in 1978, China has turned in a remarkable growth performance, averaging nearly a 10 percent growth rate for four decades. At the heart of reform was a gradual shift from a nearly totally planned, collectivized economy, to a mixed system in which private household agriculture, foreign investment, and a dynamic domestic private sector were keys to rapid capital accumulation and productivity growth. Alongside this private sector, there continues to be a large state-owned enterprise (SOE) sector. The centrally-owned enterprises are in heavy industrial sectors such as oil, minerals, and chemicals, as well as in modern services such as banking, insurance, telecom, and transport. But enterprises are also state-owned at the local level, and these tend to be in a much broader range of sectors. An important recent development is the emergence of local government finance vehicles (LGFVs) which were set up to invest in infrastructure but in practice often engage in a wider range of development activities, including real estate.

3. China's success has propelled it to a point where it is the largest economy in the world in purchasing power parity (PPP) terms, the second largest at market exchange rates, the largest trading nation, and probably soon the largest international net creditor. Hence, it is easy to forget that its financial institutions are relatively young. While the People's Bank of China (PBC) was established shortly after the founding of the People's Republic, it was placed under the Ministry of Finance (MOF) and carried out both the function of a central bank (monetary policy) and the role of a commercial bank (taking deposits and making loans). Soon after, three

specialized banks were created under the PBC to finance agriculture, foreign trade, and construction, respectively: Agriculture Bank of China (ABC), Bank of China (BOC), and China Construction Bank (CCB). With the launching of reform, the role of the central bank was transformed. The BOC and ABC were separated from the central bank and established as state-owned commercial banks (SOCBs). This development shifted China to a two-tier banking system. A fourth state-owned bank, Industrial and Commercial Bank of China (ICBC), was started in 1984.

4. Still today the four SOCBs dominate commercial banking in China. At their formation, these banks focused on their respective sectors: agriculture, industry, construction, and foreign trade. However, subsequent competition among them has blurred these distinctions. City-owned commercial banks and joint-stock commercial banks (JSCBs) have also been established. Foreign banks up to today have only been allowed a small scope for participating in China's commercial banking sector.

5. In the planned economy era, banks such as CCB lent at the direction of the government, in line with the plan. Since the shift to a market economy, these banks were supposed to make loans based on commercial considerations of credit-worthiness and financial viability of investment projects. The state still had some legitimate interest in directing credit to certain purposes, so in 1994 three policy banks were established, namely China Development Bank (CDB), China Export-Import Bank (CEIB), and China Agriculture Development Bank (CADB). The purpose of the move was to separate directed credit from commercial credit. In 1995, China's National Assembly passed two key laws to promote banking reform: the Law on the People's Bank of China defined the role of PBC as the central bank, and the Law on Commercial Banks established the four SOCBs as commercial banks. At the same time, China separated the banking, securities, and insurance industries.

6. While the idea of separating central banking from commercial banking is clear, in practice it proved difficult to get the big four SOCBs to lend commercially. It was natural for them to continue to lend to their traditional clients, large SOEs in the sectors to which they were dedicated, and it was difficult to quickly develop the new skill of assessing risk (Naughton, 1998). Lending to any state enterprise in the mid-1990s probably looked relatively risk-free. However, many state enterprises produced poor economic results. This tendency was exacerbated by the East Asian financial crisis which hit China primarily through its exports. By 1998 it was clear that the SOCBs were developing large non-performing loans, which peaked at 20 percent of banking assets. It was also difficult for the PBC, only recently given a central banking mandate, to develop the staff and skills to supervise the banks properly. China's banking crisis was a bitter experience that cost an estimated 18 percent of GDP (Laeven and Valencia, 2012), which was used to cover bad loans in the SOCBs and to recapitalize them before their IPOs. Strategic foreign investors were brought into each major bank as minority partners to help strengthen their management before going public.

7. In 1999, four asset management companies were established under the auspices of the MOF and PBC, with $20 billion in financing, to address the bad debts of SOCBs. Several years

later, in 2003, China established the China Banking Regulatory Commission (CBRC) to supervise and regulate commercial banks. That freed up the central bank to focus on monetary policy and financial stability. The establishment of CBRC has not only allowed PBOC to focus on monetary policy execution, it also enabled CBRC to develop the specialized staff needed to supervise commercial banks effectively.

8. This background is important because it is a reminder that the key financial institutions in China are relatively young and that the banking crisis of 1998 was a costly experience that made China's leaders cautious about the pace of financial sector reform. During the late 1990s, many key structural reforms were carried out: loss-making enterprises were closed; millions of workers shifted from state enterprises to the private sector; fiscal reform re-centralized revenue collection and ensured that the government had adequate resources for public services; the urban housing stock was privatized; and China liberalized foreign trade and joined the World Trade Organization (WTO) in 2001. These reforms set the stage for a golden age of Chinese growth in the first decade of the new millennium. China's exports grew rapidly, at more than 20 percent per year, and this stimulated the expansion of the manufacturing sector, which became the engine of growth for the larger economy.

9. The global financial crisis in 2008–09 was a large shock for China, primarily working through its export sector. China's exports dropped by one-third within a few months and the government estimated that 20 million workers were thrown out of work. GDP growth in 2008 slowed to 9.6 percent as the effects of the crisis began to be felt. China responded to the shortfall in external demand with a massive domestic stimulus. The stimulus was mostly aimed at investment and mostly carried out through credit, not on-budget financing, despite contrary advice from the IMF. It was during this period that the LGFVs increased dramatically in number and size. In the years prior to the crisis, the debt-to-GDP ratio in China was quite stable. But, with the stimulus program, the growth of credit rapidly shot up above 30 percent and the debt-to-GDP ratio started to rise. The GDP growth rate in 2009 declined only a small amount from the year before, but the composition was very different. The decline in net exports subtracted 3½ percentage points from growth. But the growth of investment accelerated from 10.8 percent in 2008 to 19.2 percent in 2009. The investment boom was concentrated in local government infrastructure, real estate, and the heavy industry sectors that contribute to construction. This investment boom essentially made up the shortfall in demand from net exports.

10. Starting in 2010, China began to gradually withdraw the stimulus; but the growth of credit was still around 25 percent that year and real investment growth moderated but was nevertheless high at 12.0 percent. Real GDP growth accelerated to 10.4 percent. Over the next few years, GDP growth gradually slowed as investment growth decelerated. The growth of credit continued to be higher than the growth of nominal GDP throughout, with an increasing share coming from an opaque shadow banking sector, that provided ways to channel credit to parts of the economy with limited access to the formal sector, often bypassing regulation that attempted

to control credit allocation. This was the context in which the IMF stepped up its financial surveillance of China starting in 2010.

III. EVALUATION OF IMF FINANCIAL SURVEILLANCE

11. The IMF's heightened financial surveillance began with the first FSAP for the country in 2011. Financial stability issues were also covered in annual Article IV staff reports from 2012 through 2017. An updated FSAP was undertaken during 2017, with a main mission in the field in the middle of the year and an assessment published in December (IMF, 2017c). In addition, because of China's growing importance in the global economy, the country's financial stability received significant attention in the IMF's global reports, notably the *GFSR*, but also the *World Economic Outlook (WEO)* and Spillover reports. These are discussed in turn below.

A. 2011 FSAP

12. The 2011 FSAP was launched by a letter from the Premier indicating that financial regulators and relevant ministries should cooperate with the exercise. China prepared carefully for the exercise with training in advance for relevant officials. The key participating agencies, aside from the central bank, were the CBRC, the China Securities Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC). The 2011 FSAP involved about 400 meetings in China, with the main work during the second half of 2010. The assessment was completed in June 2011 and published in November 2011 (IMF, 2011).

13. The 2011 FSAP was the most comprehensive assessment of the Chinese financial system up to that point. On the one hand, it gave China relatively high marks for financial stability. The resulting report, the Financial Sector Stability Assessment (FSSA), complemented the country for "remarkable progress in its transition toward a more commercially-oriented and financially sound system" (IMF, 2011). Stress tests on the largest 17 commercial banks found the banks to be largely resilient to isolated shocks. The shocks considered were a sharp deterioration in asset quality, a correction in real estate, shifts in the yield curve, and changes in the exchange rate. On the other hand, the FSSA found various deficiencies in financial supervision and regulation and made a host of recommendations. One of the key issues in the first FSAP was data. The FSSA notes prominently on page 1: "A full assessment of the extent of these risks and how they could permeate through the economic and financial system, however, was hindered by data gaps, the lack of sufficiently long and consistent time series of key financial data, weaknesses in the informational infrastructure, and constraints on the FSAP team's access to confidential data" (IMF, 2011).

14. The FSSA had 29 recommendations, of which 11 were deemed high priority:

- Continue to advance the process of interest rate and exchange rate reform, while ensuring that appropriate credit risk management practices in financial institutions are in place;

- Empower the PBC and three supervisory commissions with focused mandates, operational autonomy and flexibility, and increased resources and skilled personnel, and strengthen inter-agency coordination to meet the challenges of a rapidly evolving financial sector;

- Ensure that beneficial ownership and control information of legal persons is adequate, accurate, and readily accessible to competent authorities;

- Improve information sharing and coordination arrangements among the PBC and other agencies on anti-money laundering and other supervisory issues;

- Establish a permanent committee of financial stability, with the PBC as its secretariat;

- Build a macro prudential framework for measurement and management of systemic risk; this should include increasing the resources and capacity of the PBC and regulatory agencies to monitor financial stability and to carry our regular stress tests;

- Enhance the sterilization of structural liquidity through market-based instruments and manage systemic liquidity spillovers via indirect monetary policy instruments;

- Introduce reserve averaging to facilitate liquidity management and enhance stability and efficiency;

- Start targeting a short-term repo rate on a pilot basis, as a trial of indirect liquidity management, and commence daily open market operations;

- Continue to improve bond issuance strategies between the MOF and PBC to help improve the existing market-making across all maturities of the yield curve; and

- Review existing government programs to determine their effectiveness in promoting rural and micro and small enterprise (MSE) finance and formulate an integrated and coherent rural and MSE finance strategy.

15. The first two of these recommendations are fairly general, but the other nine are admirably specific. They aimed to strengthen the capacity of the regulatory agencies, improve coordination among them, and enhance the functioning of specific financial markets.

16. It is interesting and appropriate that the IMF cautioned China about not moving too quickly to a fully open, market system. The final paragraph of the executive summary warns: “Certain pre-conditions have to be made before broader acceleration of financial deepening, liberalization of interest rates, and, finally, full liberalization of the capital account. Such pre-conditions include putting in place a well-functioning legal, regulatory, supervisory, and crisis management framework; improving the corporate governance in banks; early absorption of the current liquidity overhang in the financial system; and greater reliance on market-oriented

monetary policy instruments" (IMF, 2011). In the next few years in China there would be quite a few voices calling for rapid opening of the capital account as something that would propel the more general reform and opening. The IMF has correctly been a voice of caution about such a path. The heart of the first FSAP was to identify a range of structural and institutional reforms that were needed before there could be a fully open, market-based financial system.

B. Article IV Consultations, 2013–17

17. In the years following the FSAP, Article IV consultations generally followed up on the issues and recommendations from the financial assessment. Naturally, the Article IV consultations had more of a macro focus, but still covered financial sector issues. The June 2013 Article IV staff report noted in its opening sentences: "Since the global crisis, a mix of investment, credit, and fiscal stimulus has underpinned activity. This pattern of growth is not sustainable and is raising vulnerabilities" (IMF, 2013). The first three policy recommendations of that report all concern the financial sector:

- In the near term, a priority is to rein in broader credit growth and prevent a further build-up of risks in the financial sector […];
- Accelerated financial sector reforms are needed to secure a safe transition to a market-based financial system. This will combine allowing greater room for market forces (such as liberalizing interest rates in the "traditional" banking industry) with strengthened oversight, governance, and investor accountability […]; and
- The post-2008 expansion in quasi-fiscal activity needs to be gradually unwound. Key reforms to this end should include a comprehensive revamp of local government finances, including SOE dividend payments to the budget, and continuing tax reforms…

18. The reference to "quasi-fiscal activity" is important. A key institutional feature of China is that local governments in general have not been allowed to borrow directly, at least until some recent experiments with bond issuance. When a large stimulus was needed in response to the global crisis, the Chinese authorities found a work-around: local governments set up "corporations" that could borrow and finance infrastructure. There were a lot of pent-up infrastructure needs circa 2008 and it made sense to have much of this managed at the local level, where needs in urban transport and water supply and sanitation could be better assessed by local rather than central authorities. The problem with this work-around is that it created opacity in municipal finance and real activity. China's consolidated, central-local budget showed only a modest increase in fiscal impulse in 2009. The general government budget deficit went from about 1 percent of GDP in 2008 to 3 percent in 2009. However, there was a surge of borrowing and investment from LGFVs.

19. The 2013 Article IV staff report introduced the concepts of "augmented fiscal deficit" and "augmented public debt," which IMF staff regarded as providing a more accurate picture of

China’s fiscal health and are widely cited by analysts who follow China. IMF staff estimated how much of the corporate borrowing and debt corresponded to infrastructure financing through these local vehicles. This augmentation provided a very different picture of the fiscal situation. The augmented deficit was much larger: in 2008 it was an estimated 7.5 percent of GDP, and in 2009 it doubled to about 15 percent. China’s central government debt was and remains small at about 20 percent of GDP in 2008 and stable in subsequent years. Local government debt, on the other hand, jumped significantly from about 20 percent of GDP in 2008 to nearly 30 percent in 2009. This contributed to in-depth dialogue between the authorities and IMF staff on an important issue. At the same time, the IMF recommendation cited above, to “gradually” unwind the quasi-fiscal stimulus, reflected a recognition that the quasi-fiscal activity was central to China’s growth and employment objectives and needed to be addressed with care.

20. The IMF has also played a leading role in providing data on shadow banking and in analyzing the associated risks. The 2014 Article IV staff report noted that “shadow banking emerged as an important source of funding for sectors involved in the post-crisis stimulus (real estate, local government infrastructure projects, and SOEs). It became the fastest-growing segment of the financial sector, reflecting in large part regulatory arbitrage….” (IMF, 2014).

21. In 2015, the Renminbi depreciated against the U.S. dollar by about 4 percent over two days, a move which though small in scale sent shock waves around the world. After a long period during which the yuan was either climbing gradually against the dollar or stable (during the height of the global financial crisis), there was suddenly great uncertainty about the direction of the Chinese economy and its currency. This initiated a period of large net capital outflows and downward pressure on the currency, even though China still had a large current account surplus and the Fund judged the current account to be moderately stronger than consistent with fundamentals. The 2016 Article IV staff report provided useful analysis and recommendations concerning this episode. It argued that the authorities needed to provide better high-frequency data and communicate its policy intentions more clearly.

22. Reading through the Article IV staff reports from 2013 to 2017, it is clear that Chinese authorities moved on many of the structural measures recommended by the FSAP. For example, the central bank began to convene regular, high-level meetings of the regulators; deposit insurance was introduced; the securities regulator began site visits to the stock exchanges; and many more steps are documented in the 2017 FSSA, as discussed below.

23. However, despite the warnings in the 2011 FSSA and a succession of Article IV staff reports, the growth of credit continued at a rapid pace, attracting intense attention from the Fund. The 2016 Article IV staff report introduced a version of this figure, based on Bank for International Settlements data.

24. Figure 1 shows total credit to the non-financial private sector as a percent of GDP. The dotted lines indicate the trend. In earlier financial crises of Japan, Thailand, and Spain, credit ran substantially ahead of trend in the run-up to the crisis. Prior to the global financial crisis, this ratio in China showed no upward trend; in fact, it trended down modestly. But then with the

stimulus program in response to the global financial crisis there was a large jump in credit to GDP. After a brief pause, the credit-to-GDP ratio continued to rise and the "credit gap" between actual and trend widened. The 2016 Article IV staff report highlighted the level of the credit gap and the associated risk of financial crisis.

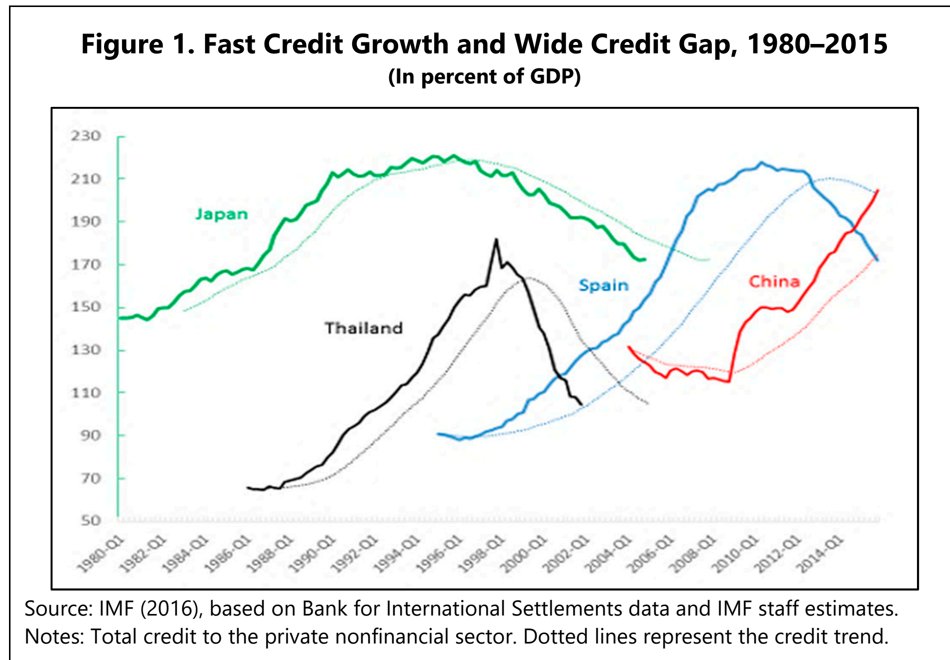

Figure 1. Fast Credit Growth and Wide Credit Gap, 1980–2015
(In percent of GDP)

Source: IMF (2016), based on Bank for International Settlements data and IMF staff estimates.
Notes: Total credit to the private nonfinancial sector. Dotted lines represent the credit trend.

25. The tone of Article IV staff reports over this period became successively more alarmist. One theme of the 2011 FSSA and the Article IV staff reports that immediately followed was that China had adequate buffers to deal with financial risks but that reform was needed to ensure stability in the medium to long term. Article IV reports document substantial progress on some of the structural reform agenda, but also highlight the continuing build-up of risks. The 2016 Article IV staff report noted that "[b]uffers, while still adequate, are shrinking fast, calling for urgent action to address these rising risks" (IMF, 2016).

26. Article IV consultations up through 2016 took as a baseline the assumption that the authorities would accept somewhat slower GDP growth, start to rein in credit growth, and move to stabilize leverage. However, staff took a different view in the 2017 Article IV consultation . The 2016 Article IV staff report projected a leveling off in the total non-financial debt relative to GDP; the 2017 Article IV instead projected a nearly linear increase continuing in the debt-to-GDP ratio, reaching close to 300 percent in 2022. Embodied in this projection was the notion that the authorities would broadly maintain the high levels of infrastructure investment and not substantially consolidate the augmented deficit.

C. 2017 FSAP

27. The 2017 Article IV consultation was followed a few months later by the second FSAP. The exercise started with an informal visit in June 2016, during which some of the team traveled together with PBC staff to six provincial cities. This gave the team a good picture of reality on the ground, including the fact that instructions from Beijing were not necessarily followed at the local level. Local branches of the financial regulators tended to be in the sway of local government officials.

28. The 2017 FSAP was a big effort that involved 550 meetings. Once again, a key element was stress tests for commercial banks. Data continued to be an issue. The situation was handled more smoothly than during the 2011 FSAP. In particular, the stress test team was able to work in a "data room" at the central bank. Staff described the data that it received as "marginally enough." The authorities explained that some of the requested data did not exist. In addition, PBC may not have received some of the relevant data from other agencies.

29. The stress tests considered scenarios of a cumulative decline in GDP equivalent to one or two standard deviations relative to baseline. The big four banks in China were judged to be relatively strong. The FSSA recommended targeted increases in capital for both big banks and small, noting that "[m]ore capital is justified for the largest banks because of their systemic importance and interconnectedness, while the FSAP's analysis, including the stress tests, suggests vulnerabilities in a significant number of mid-tier banks. Increasing capital would enhance the resilience and credibility of the financial system, as well as reassure markets" (IMF, 2017c).

30. The 2017 FSAP followed up on the 29 recommendations from the 2011 FSAP. Of the 11 high priority recommendations enumerated above, 8 were found to be done or largely done. This includes key measures such as moving to more market-determined interest rates and exchange rate; establishing a permanent committee of financial stability, with PBC as its secretariat; strengthening the regulators' capability to do financial stability analysis; moving to an average reserve system; targeting the short-term repo rate as indirect liquidity management; and regularly issuing MOF instruments of different maturities to deepen the market and establish a yield curve.

31. The Fund rated as partly done a number of key measures, notably increasing the operational autonomy and flexibility of the financial regulators. The FSSA also found that "beneficial ownership information is not consistently captured or assessed for financial groups."

32. For the medium-priority recommendations, several were fully acted upon. Examples are: CBRC's risk rating system taking a more forward-looking assessment of credit risk; CSRC conducting regular site visits for inspection of the securities' exchanges; and CIRC implementing China Risk-Oriented Solvency Standards as of January 2016.

33. Overall the FSSA's assessment of progress with micro-prudential regulation was positive: "The authorities have addressed many of the recommendations of the last FSAP in 2011

(Annex VI), in particular on improving micro-prudential supervision, and continue to take numerous measures under challenging circumstances." Still, the FSSA had strong recommendations for further strengthening: "While most compliance indicators are impressive, three critical gaps common across China's regulatory agencies exist: lack of independence; insufficient resources for supervising a large and increasingly complex financial sector; and inadequate interagency coordination and systemic risk analysis. These gaps have been fundamental in contributing to the build-up of financial risks. At the same time, when distress in specific markets or institutions arises, regulators take swift and coordinated action" (IMF, 2017c).

34. The 2017 FSAP, however, found less progress on the macroprudential side: "[m]onetary and fiscal policies aimed at supporting employment and growth have, in recent years, been expansionary. Pressures to keep non-viable firms open—rather than allowing them to fail—are strong, particularly at the local government level where these objectives, at times, conflict with financial stability" (IMF, 2017c). The rapid growth of credit makes the planned further liberalization of the exchange rate and the capital account difficult in the near term, as it could exacerbate run-risk on financial intermediaries.

35. During 2017 the Chinese authorities moved to rein in the growth of credit, but slower than the IMF had recommended. It seems that IMF analysis has made an impression on the authorities, but there are differences in views on the speed of tightening. For example, speaking on the sidelines of the 19th Party Congress in October 2017, PBC Governor Zhou Xiaochuan warned of the risks of asset bubbles, suggesting that a faster pace of tightening would be desirable.[1] Some others believe that the various "buffers" (mentioned in IMF reports) such as its high savings rate, large stock of reserves, effective capital controls, and state-ownership of the financial system mitigate the risks. Following the 19th Party Congress, the authorities moved to rein in shadow banking and to moderate the overall growth of credit. They also merged the banking regulator and the insurance regulator in an effort to close regulatory loopholes and announced plans to liberalize foreign investment in financial services. The Fund has given detailed advice about reforms that would complement financial tightening such as SOE exit, fiscal reform, strengthening of the safety net, and other measures to encourage consumption.

D. *GFSR*, 2011–17

36. As China's role in the global economy has increased, so has its importance in central IMF documents such as the *WEO* and the *GFSR*. In general, these flagship reports are consistent with Article IV staff reports; the growth forecasts, for example, are coordinated. The *WEO* and the *GFSR* also highlight the same risks identified in the Article IV staff reports. One difference, though, is that Article IV staff reports emphasize some special characteristics of China that mitigate risks and provide buffers. The flagship reports have less of such language.

[1] See Glenn (2017).

37. In the April 2017 *GFSR*, for example, the China section is subtitled "Rising risks and financial vulnerabilities." The section argues that, "To the extent that credit growth remains excessive, the underpricing of credit risks remains an endemic characteristic of the financial system, and the search for yield remains a driving motivation, leverage will continue to build, and financial risks will continue to grow" (IMF, 2017a).

38. This language is consistent with the warnings in the Article IV staff report. The difference is that the *GFSR* does not have any talk of "buffers." The Article IV staff report discusses reserve adequacy, the still-good overall fiscal condition, the country's high savings rate, and its effective capital controls (IMF, 2017b). The *GFSR* only talks about the rising vulnerabilities and the risk of a financial crisis. Also, the 2017 FSAP rates China's move to a market-determined exchange rate as largely done, while the *GFSR* sees exchange rate flexibility as "very limited."

IV. INFLUENCE AND IMPACT

A. Market Participants

39. IMF Article IV staff reports and FSAP outputs are widely read. Analysts who cover China rely on these reports for data and analysis. China is unique in that it is a developing country that plays a critical role in the world economic and financial system. Unlike the other major economies in the world, there are not a lot of alternative sources of data and in-depth analysis. The China reports are among the most downloaded of Fund reports. The 2016 webcast of the Article IV consultation press conference received 300,356 views from approximately 80,000 unique visitors. The 2017 webcast had 493,635 views from over 200,000 unique visitors. Analysts in the financial industry generally have high praise for Article IV staff reports. Typical comments included: "fantastic;" "they are an invaluable source; the China mission is the most important IMF mission there is for a private sector analyst." Leading academic economists inside and outside China similarly regard the IMF reports as critical for data and useful for analysis. A leading Chinese economist expressed the view that it was the only thing from outside China that was worth reading: IMF staff have a better understanding of Chinese institutions and politics than the many private analysts who write about the economy.

40. However, some observers expressed the view that the Fund pulls its punches. Other analysts echoed this idea and would talk to IMF staff informally in order to get a better assessment of risks. There was also a sense that Article IV staff reports had become sharper in their criticism of China in the past two years. The 2017 staff report in particular generated headlines to the effect that China was on a "dangerous trajectory." One analyst described this report as the "clearest warning that the IMF has given to any major economy in years."

B. IMF Staff

41. A number of IMF staff expressed the view that the institution should take a "harder line" with China. One concern was that some Chinese reforms have followed Fund advice but may lack

substance in practice. For example, Fund staff find it hard to assess whether the regular meetings among the heads of the regulators and the central bank really provide the kind of data-sharing and coordination needed to address regulatory arbitrage and manage risks.

42. While there was some concern among analysts and Fund staff that the IMF pulls its punches on surveillance for such an important client, there are a number of cases of the IMF highlighting major risks in China. One example was cited above: calculating and popularizing the augmented fiscal deficit and debt. Another good example comes from 2015 with the identification of potential bubbles developing in the economy. The 2015 Article IV staff report documented the build-up of real estate inventory, especially in third and fourth tier cities. Inventory went from less than one year of sales in 2010 to three years of sales in 2014. Box 4 in the report also accurately assessed the rise of a bubble in the Chinese stock market. The market had risen 150 percent in a year, during a period in which global markets were flat and China's GDP growth and corporate profit growth were slowing down. The report noted some structural changes such as easing rules for margin borrowing as well as "comments by high-level officials that may have been interpreted as offering 'official support' to the market" (IMF, 2015). The report proved to be quite prescient; it was completed on July 7, and over the next few months the market corrected by almost 40 percent.

C. Authorities

43. The views of the authorities concerning IMF financial surveillance were solicited during a visit to Beijing, July 3–7, 2017. The agencies consulted were the PBC, CBRC, CSRC, CIRC, MOF, and the National Development and Reform Commission (NDRC).

44. A theme in all of the meetings with agencies was that Chinese financial officials find IMF analysis and advice very helpful. "From the top leaders to the working level, all pay due respect to IMF advice on financial linkages, structural reform, structural adjustment, SOE reform, and how to cope with financial risks and bad debts," according to PBC interlocutors. CBRC officials noted that "the first FSAP was a very useful tool for systematic assessment of the financial system, with the aim of appropriate policies for financial stability and development of the financial sector." The FSAP process itself was viewed as useful. The FSAP team brings international perspective, from research and the market. "The FSAP is a good opportunity for CBRC staff to learn international practices. The authorities attached great importance to the recommendations of the first FSAP: 29 recommendations of which 11 were pertinent for CBRC. It is the assessment of the new FSAP that all 11 were acted upon." The IMF's financial surveillance helped CBRC develop a medium- and long-term plan for strengthening banking supervision, which has been cleared by the State Council.

45. CIRC, similarly, had used the 2011 FSAP as a guide for reform: "The FSAP exercise is especially valuable for emerging markets trying to improve regulation. The first FSAP recommended things such as onsite inspection and consumer protection, which have been followed up on. It also highlighted capital adequacy, which has been acted on and received a

'largely observed' in the new FSAP." The insurance regulator noted that in the first FSAP it had received a lot of "partially observed" ratings. In the 2017 FSAP, the "partially observed's" have become "largely observed" or "observed."

46. Officials from the securities regulator said that they "were really impressed with the professionalism and hard work of the IMF staff." The IMF staff were concerned about information-sharing among regulators. China has a financial crisis response group (FCRG). There were helpful recommendations on its functioning at the FSAP wrap-up meeting. The FSAP recommends how FCRG can function better at different levels. Meetings among regulators occur at a higher frequency than recommended. Going forward, CSRC will ensure that the IMF's recommendations will influence evolution. Participants cited some specific examples of following through on IMF recommendations. The 2011 FSAP recommended on-site inspections of futures companies, and this was adopted by the futures department. The 2017 FSAP recommended that the treasury bond futures market should be open to commercial banks, and CSRC is pushing ahead on this.

47. It was clear from these discussions that IMF analysis and recommendations have been very influential, especially for strengthening supervision and regulation. It took longer for IMF advice on macroeconomic policies to have an effect, but over the past year China has taken steps to stabilize leverage in the economy. Still, the authorities have been less worried than Fund staff about macroprudential risks. The different views between IMF staff and the authorities came up in several meetings. The Chinese expressed a desire that the IMF make more of an investment in understanding China and pay more attention to the authorities' views. The implicit assumption is that if the IMF staff understood China more fully, they would agree with the authorities.

48. Chinese officials did see progress over time in the IMF's understanding of China. According to CIRC, "the second FSAP was much better than the first. The assessors this time understand China much better. They did a lot of preparation. They are very professional and really listen, without prejudging. The first FSAP assessors did not know much about China." MOF similarly noted that the China knowledge of the IMF had improved and that there are now some "Chinese faces" on the team.

49. Nevertheless, there are some important areas of disagreement between the Fund staff and the authorities. PBC expressed it this way: "China's capacity and staffing have improved, with more ability to understand our issues quite well. The relationship between IMF and China is no longer teacher-student, it is a more level playing field. The IMF staff need to more patiently listen to the views of the authorities. For example, on the local debt issue: local debt in China is much different from local debt in the U.S. or Europe. It is used for investment and is backed by an asset. Developed countries use debt for current consumption, not backed by an asset; they pay debt service via tax revenue. In China assets produce a cash flow. Hence, the nature of debt is different, and this should be taken into consideration. The general point is that we need to mutually improve the IMF-authorities dialogue. China is in a transition phase and cannot just borrow from the advanced countries' toolkit."

50. This issue of local government debt came up in several meetings. MOF saw the treatment of local government debt as an example of the Fund not being even-handed: "The Article IV should be 'even-handed' to all member states, but in practice there is not enough even-handedness. MOF's impression is that the concepts of 'augmented deficit' and 'augmented debt' were invented because of China. The IMF has not been responsive to Chinese views on this."

51. NDRC felt that the IMF has not fully appreciated that its growth targets are indicative, not mandatory: "the IMF still believes that the government is obsessed with growth at any cost but already for a decade we have emphasized quality and sustainability, not just the level of growth. President Xi has proclaimed this a 'new normal.' This year we engaged with the IMF staff and explained that the targets are indicative, not mandatory. The notion of 'addicted to growth at all costs' is a misperception. We will see in this Article IV staff report if the IMF listened."

52. Officials at the senior level also deeply appreciate the frank discussions with staff during the surveillance process. The involvement of Fund management is also appreciated. Article IV missions typically end with the IMF FDMD joining the team and meeting with senior leaders which helps bring the Fund's important messages to China's top officials.

53. While the FSAP exercises were generally appreciated for their analysis and advice, the Chinese interlocutors also indicated that they placed a considerable burden on the agencies involved. Reference was made several times to the fact that the 2011 FSAP involved 400 meetings and the 2017 FSAP, 550. Officials politely complained that sometimes different FSAP teams requested similar meetings and/or data, and that better coordination among the FSAP teams would make the process smoother. Also, all the documents have to be in English, so there is a lot of translation back and forth. Because of the translation time, Chinese officials would often have very short windows to review critical documents. The translation issue was much less of a problem in the 2017 FSAP because of Google Translate. A number of officials expressed the view that the FSAP did not have to be such a large and burdensome exercise, but that there could be more continuous communication in between the exercises. One suggested that there be a review of FSAP progress after two years. Article IV consultations provide some follow up, but a formal "mid-term review" would enable the Fund and the authorities together to assess progress and priorities for further reform.

54. Concerning consistency among different Fund products, the general view of Chinese officials was that the FSAPs and Article IV consultations are well coordinated, though Article IV consultations are more macroeconomic in nature. In terms of China-specific knowledge and understanding, there was a clear hierarchy of better knowledge on the Article IV team than on the FSAP team, and better knowledge on the latter than on flagship reports. Officials noted that the Fund's flagships such as *WEO* and *GFSR* are widely read and hugely influential inside and outside China. Several complained that the *GFSR* in particular does not have the nuance of the Article IV staff reports. They cited as an example the April 2016 *GFSR* which estimated potential losses of 7 percent of GDP ($770 billion) on corporate loans. The estimate had not been discussed thoroughly with Chinese officials. The authorities' view was that this kind of analysis, in particular the IMF's focus on risks, could undermine confidence in China in markets and among the general public. In this particular case, the area department was consulted and felt that the

analysis was new and useful, something that was followed up on in subsequent Article IV consultations and the 2017 FSAP. However, it is a necessary constraint of the flagships that drafts cannot be discussed extensively with the authorities in advance.

55. While there were suggested areas for improvement, the general assessment of IMF financial surveillance by Chinese regulators was quite positive. One signal of this was the fact that most agencies expressed a desire to have more opportunities to engage with the Fund and ideally to have more opportunities for internships, staff exchanges, and training courses. The interaction with the Fund is especially valuable for young staff, according to one official: "they should master the IMF toolkit and adapt it to China." China's respect for the IMF toolkit is reflected in its decision to provide $50 million to fund a China-IMF Capacity Development Center.[2] This virtual center is under IMF administration, is anchored in Beijing, and will offer courses both inside and outside China on core Fund topics.

V. CONCLUSIONS AND RECOMMENDATIONS

56. The transformation of China's financial system from a hand maiden of a planned economy to a complex and diverse set of institutions serving the largest economy in the world is truly extraordinary. Two FSAPs and a series of Article IV consultations in between both document the progress and reveal challenging additional reforms that are still needed. The world has an enormous stake in helping China get this transformation right, and the IMF has been the leading outside player analyzing financial stability issues, making recommendations, and providing technical support to Chinese officials tasked with financial regulation and supervision.

57. The main value from the IMF has been sharing international experience and bringing a toolkit that can be applied to China. The bank stress tests carried out for the 2017 FSAP are a good example of the toolkit. China has strong ownership of its reform program. Chinese officials want to learn the toolkit, so they can apply it themselves, and hear IMF recommendations as one set of options to consider in designing reforms. Looking at the financial reform in China over this period, some measures were taken fairly directly from IMF advice, while other actions clearly run counter to that advice. The authorities intervening in the stock market to try to prop it up in 2015 would be a good example of the latter. The correct interpretation of the interaction is that the IMF provided analysis and options that clearly influenced China's financial reform, while Chinese authorities clearly maintained control of the reform program.

58. The IMF was apparently more influential in the micro dimension of financial regulation and supervision than in the macro dimension. At least since the 2011 FSAP, the IMF has been warning that the growth of credit is too rapid and that the build-up of debt-to-GDP is alarming. Yet, credit to the private, non-financial sector relative to GDP continued to rise through 2016. Over the past year, however, that ratio has stabilized as the authorities took steps to rein in the growth of credit, especially in shadow banking. The IMF recommends that the monetary

[2] See IMF (2017d)

tightening be complemented with state-enterprise reform that would permit exit and fiscal reform to strengthen local government finances and reorient their expenditure away from investment towards social and environmental services. While reform has been slow in these areas so far, the recommendations may yet resonate in the future.

59. In looking at the IMF assessment of financial stability and risks, it is interesting that for the past couple of years market sentiment on China has been more negative than the IMF view, while the authorities have been more positive. The authorities believe that the risks are not that serious, given China's characteristics, and that is one reason that they allowed continued rapid growth of credit and encouraged real GDP growth close to 7 percent. Stationed between the market and the authorities is probably the right place for the IMF. So far, the IMF has been right, relative to the market: China's buffers have been sufficient to prevent a financial crisis.

60. The IMF's financial surveillance of China has improved over time. While Chinese authorities learned a lot from the 2011 FSAP, the exercise suffered from problems of lack of data—either because it was not compiled, or data sharing was subject to confidentiality constraints—and from the team's lack of familiarity with China. Both problems have diminished over time. The Fund has built up more expertise on China, while data availability has improved .

61. While overall the Fund should get high marks for its financial surveillance of China, there are still areas for improvement. An interesting point of convergence is that mid-level officials said that they wished they had more continuous contact with Fund staff, while Fund staff wished that they had more regular contact with mid-level officials. One suggestion from several Chinese officials was that the FSAP be more focused and that there be more continuous contact in between FSAPs. One option could be a formal, mid-term review about two years after the FSAP to measure progress and update recommendations. Some of the FSAP assessors could join the Article IV team for that year and make the Article IV consultation something of a mid-term review. Several interlocutors recommended that the IMF put more staff into its Beijing office and that they spend more time in different parts of China "to understand the real situation on the ground." One even suggested that the Fund open regional offices around China.

62. Closely related to this recommendation is the idea that there should be better communication in both directions. There are still problems with data availability and the communication of China's financial policies, both to the IMF and to the world. On the IMF side, the *GFSR* and other flagship reports need to be more closely coordinated with the China team, or at the very least negative messages should be discussed with the authorities in advance. Chinese officials welcome the Fund's honest assessment, but they do not like to be surprised by criticism in print that they have not seen before.

63. There is huge demand from the Chinese side for training, staff exchanges, and internships. The IMF cannot meet all of this demand. And the new China-IMF Capacity Development Center, financed by China, should help. But the IMF should try to have a more coordinated and comprehensive response to this demand. One of the most systemically important countries in the world, one with still-glaring weaknesses in its financial regulation and

supervision, would like more help training staff and internalizing the IMF toolkit: meeting that demand is a good use of public resources.

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Chapter 3—IMF Financial Surveillance of Japan

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EXECUTIVE SUMMARY

The study addresses the relevance, technical quality, and influence of IMF financial surveillance for Japan, focusing on the period 2012 to 2017, based on extensive interviews with current and former senior officials as well as those from the private sector and the academia.

The authorities saw value in the assessment by an independent and neutral agent and acknowledged that the process helped to focus the authorities' thinking. They felt that a Financial Sector Assessment Program (FSAP) exercise every five years is appropriate, given the potential changes in the financial system that could take place within such a span of years. At the same time, they felt that the workload was burdensome, and could be streamlined in some areas including possibly in stress testing, where the usefulness of the output may not warrant the resources involved.

The authorities were in broad agreement with the assessments and recommendations in the two FSAPs in the period under review. While it may not have been the direct result of the Fund's recommendations, the issues raised by the Fund in past FSAPs have in most cases been addressed.

Among the external observers in the private sector and the academia, there was a concern that some important issues were not being addressed fully. One such issue that is intensely debated in Japan but which the latest FSAP did not address directly, is the financial stability implications of unconventional monetary policies, including those that might arise in the context of exit, and of risks to fiscal sustainability. This apparently reflects the division of labor between regular Article IV consultations and the FSAP, but FSAPs may provide an opportunity to present a different perspective from the Article IV process, which tends to focus on macroeconomic policies and outcomes.

In terms of communication, while policymakers should remain the primary audience, effort could be made to address the broader community of researchers and commentators that shape the policy debate in advanced economies such as Japan. Beyond delivering policy messages, consideration could be given to publishing a more detailed description of the analysis and logic behind the policy analysis and recommendations to inform the debate among professionals and academics.

I. INTRODUCTION

1. This study was prepared in response to the request from the IMF IEO to address the relevance, technical quality, and influence of IMF financial surveillance for Japan, focusing on the period 2012 to 2017. The report begins with an overview of the macroeconomic and financial situation in Japan during this period. The following section reviews the Fund's analysis, views and advice relating to financial surveillance in Article IV consultations and under the Financial Sector Assessment Program (FSAP). It then discusses the relevance and technical quality and the influence of these activities against the backdrop of policy debates within Japan, drawing on extensive interviews with current and former senior officials as well as those from the private sector and academia.[1] It concludes with some observations and recommendations.

II. CONTEXT

2. During the period under study, which spans two FSAPs—the 2012 FSAP (IMF, 2012) and the 2017 FSAP (IMF, 2017), Japan's financial system remained largely sound, having restored its health from the crisis and tensions it suffered in the late-1990s and early 2000s. The improvements in regulatory oversight as well as the reduced risk-taking appetite of financial institutions following the earlier crisis meant that the Japanese financial system did not incur large exposures to toxic instruments that featured prominently in the global financial crisis (GFC). The financial system also overcame the real shocks encountered during the GFC and the massive earthquake of March 2011, and no immediate risk to financial stability was evident during the period. This could be seen in the financial soundness indicators, where among other indicators capital adequacy and asset quality remained comfortable and improving (Table 1).

Table 1. Japan: Selected Financial Soundness Indicators, 2010–16[1]

	2010	2011	2012	2013	2014	2015	2016
Capital Adequacy							
Regulatory capital to risk weighted assets 2/3/	13.3	13.8	14.2	15.2	15.6	15.5	16.2
Regulatory tier 1 capital to risk-weighted assets	9.9	10.7	11.3	11.7	12.1	12.5	13.4
NPL net of provisions/capital 2/4/	22.7	22.2	21.4	19.2	16.2	12.8	10.9
Asset Quality							
NPL to total loans ratio 2/4/	2.5	2.4	2.4	2.3	1.9	1.6	1.4

Source: IMF, Japan: Staff Report for the 2017 Article IV Consultation.
[1] Data for these series are for Q1 of each year besides the 2016 data, which are for Q3.
[2] Including city banks and regional banks and but not *shinkin* banks.
[3] Aggregated based on consolidated basis.
[4] Aggregated based on unconsolidated basis.

3. In 2013, a comprehensive policy package to lift Japan out of deflation—"Abenomics"—was introduced, and this initiative would frame the economic and financial policy debate over the period under study. Japan had been suffering from an extended period of low growth and mild

[1] The interviews were conducted during August and September 2017.

deflation since its own financial crisis in 1997. This deflation had consequences for fiscal sustainability; gross general government debt had increased 3-1/2 fold from 67.0 percent of GDP in 1997 to 236.6 percent by 2012, with the increase coming in part from persistent dependence on expansionary fiscal policies to support demand and through the adverse debt dynamics resulting from low or negative nominal growth (the r-g effect). Indeed, the 2012 FSAP had identified the sovereign-financial nexus as posing the greatest potential threat to financial stability.

4. Abenomics initially comprised three "arrows" (pillars), namely, aggressive monetary easing, flexible fiscal policy, and structural reforms. Abenomics was also an answer to the growing concern over fiscal sustainability, by improving debt dynamics as well as encouraging autonomous growth that would allow fiscal consolidation to be undertaken without dragging down the economy.

5. Abenomics saw early successes, with a sharp reduction in long-term interest rates, a surge in stock prices, depreciation of the yen that boosted export profitability, and an upward shift in inflation expectations. However, output subsequently sustained negative impacts from the withdrawal of fiscal stimulus resulting from the increase in the consumption tax rate of April 2014 and the tapering of public investment for post-earthquake reconstruction. This was further compounded by sluggish external demand, which led the government to postpone the second stage of the consumption tax hike that had been planned for October 2015 (to April 2017) and to introduce stimulatory fiscal measures. The sharp decline in oil prices from mid-2014 further dampened inflation and inflationary expectations, and with the exchange rate appreciating and economic growth virtually flat, the government again in mid-2016 announced the postponement of the consumption tax rate increase by a further 2-1/2 years, to October 2019 (Table 2).

Table 2. Japan: Selected Economic Indicators, 2012–16

	2012	2013	2014	2015	2016
Percent change					
Real GDP growth	1.5	2.0	0.3	1.1	1.0
CPI Inflation (excluding VAT)	-0.1	0.3	1.2	0.3	-0.1
Percent of GDP					
General government fiscal balance	-8.3	-7.6	-5.4	-3.5	-4.2
Gross public debt	236.6	240.5	242.1	238.2	239.4

Source: IMF, Japan: Staff Report for the 2017 Article IV consultation.

6. With tangible results from the structural reform arrow limited and fiscal policy taking on somewhat of a stop-go nature between fiscal consolidation efforts and counter-cyclical responses, the load of Abenomics fell largely on monetary policy, which would have implications for financial stability risk.

7. In April 2013, the Bank of Japan introduced a policy of Quantitative and Qualitative Easing (QQE), involving a massive increase in longer-term Japanese Government Bond (JGB) holdings as well as purchases of equity share ETFs as well as REITs, with the objective of attaining

a 2 percent inflation target in two years. The JGB purchases were to be conducted at a rate of around 90 trillion yen per year, which was over double the amount of planned new issue of JGBs to finance the FY 2013 budget deficit.[2] Despite early promising signs, monetary policy failed to gain traction in the face of global economic headwinds, including slow global growth and a large fall in oil and commodity prices, as well as from the entrenched deflationary mindset. The BOJ responded by further increasing asset purchases (October 2014), introducing a negative interest rate of -0.1 percent for marginal excess reserves (January 2016), and adopting Yield Curve Control (YCC) to manage long-term interest rates (September 2016).

8. One market impact of these measures was a gradual decline in interest rates across the entire yield spectrum, with 10-year rates declining from 0.8 percent at end-2012 to about 0.25 percent by December 2015. With the introduction of negative interest rates, long-term rates fell into negative territory, reaching a nadir of -0.28 percent in July 2016. The adoption of YCC, where the BOJ committed itself to maintain long-term rates around zero, has led to the yield curve settling at a slightly negative rate at the short end and rising minimally to just above zero at 10 years. The slope of the yield curve also remains very flat beyond 10 years.

9. The reduction in interest rates and the flattening of the yield curve had a large impact on profitability of banks' traditional lending business. As the 2017 Financial Sector Stability Assessment (FSSA) paper notes, the margin on domestic lending has been reduced to about 1 percent, which barely if at all covers operating costs. Profit levels were maintained thanks to the claw-back of provisioning due to improving credit quality and the realization of capital gains from sales of securities holdings (helped by declining long-term rates and higher stock prices), as well as expansion of overseas business (especially in the case of large, international banks). However, it was realized that except for the latter, gains could not be sustained, and concerns over the longer-term viability of regional banks became a subject of major concern for financial sector policy. From 2016, the BOJ's Financial System Report began noting that while there were still adequate capital buffers and capacity for risk-taking in the banking sector, there was the need to consider not just the risk that low profitability would lead to excessive risk-taking in search of yield, but also the risk that financial intermediation may stagnate due to a sustained reduction in profitability.

10. Moving to the issue of sovereign debt risks, as noted above, fiscal policy at the start of the period under study was expansionary to meet the post-earthquake reconstruction needs and to provide an early lift in aggregate demand to compensate for the planned increase in the consumption tax rate in April 2014. Fiscal policy was then projected to focus more on consolidation, with a target of achieving primary balance (on the consolidated central and local government measure) by 2020. However, while not formally abandoning the goal, the government has implicitly acknowledged that the fiscal consolidation target is now beyond

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[2] The initial targeted annual purchase of ETFs and REITs were 1 trillion yen and 30 billion yen, respectively. These were raised to 3 trillion yen and 90 billion yen in the October 2014 asset purchase expansion, and ETF annual purchase target was further raised to 6 trillion yen in October 2016.

reach, even if accelerated economic growth is achieved. Nonetheless, because of low interest rates and some pick up in nominal growth, the public debt to GDP ratio has stabilized at around 240 percent of GDP despite the continued existence of large primary deficits.

11. The high levels of public debt notwithstanding, concerns over bond market stress were dampened by the massive BOJ purchase of JGBs, which more than fully absorbed new JGB issues to finance the fiscal deficit. On aggregate, this resulted in shifts of JGB holdings from the banking sector, in particular the large international banks, to the BOJ, with the BOJ's holdings now exceeding 40 percent of outstanding issues and surpassing the holdings by banks and insurance companies. Thus, a significant portion of the term interest rate risk now accrues to the BOJ. Under the circumstances, while longer-term issue of debt sustainability remains, the concern over whether investors will willingly absorb new JGB issues was replaced by the effects of possible shortage of JGBs in the market and attendant reduction in market liquidity, at least in the short run.[3]

12. Accordingly, while there was a considerable focus in the early days of Abenomics, including in the BOJ's Financial System Report, concerning the impact of a rise in interest rates on the banking system, the issue has received less attention of late. A more medium-term concern is the impact on BOJ's balance sheet in the event of a normalization of the monetary environment. The BOJ could face sizeable capital losses on its JGB holdings if long-term rates increase, and increases in interest rates to curb inflationary pressures could also result in large income losses and expansionary pressure on base money if interest is paid on commercial banks' reserves with the central bank. The BOJ has steadfastly taken the line that it was premature to speculate on exit from QQE, but the Governor has acknowledged that the Bank was "studying internally a number of possible scenarios."[4]

13. On the external front, Japan's vulnerability has always been seen to be limited because of the very large net international investment position, amounting to 65 percent of GDP as of end-2016, which includes $1.2 trillion (27 percent of GDP) of foreign reserves.

III. THE FUND'S ANALYSIS AND ADVICE

(i) Article IV surveillance

14. Given the history of Japan's financial crisis, financial sector stability issues had already featured fairly prominently in Japan's Article IV reports for many years, well before the adoption of guidelines on financial surveillance in the March 2015 Guidance Note for Surveillance Under

[3] The BOJ's share of ETF and REIT holdings are much smaller; as of September 2017, BOJ ETF holdings were a little over 3 percent of market capitalization, while the share of BOJ holdings for some major REITS reached 6 percent. The main concern with respect to ETF and REIT operations relate to whether they distort market pricing, including the possibility of a notion of "BOJ put;" i.e., that BOJ can be relied upon to support market prices.

[4] Stated in an answer to a Parliamentary question from Hodaka Maruyama on May 10, 2017 at the Finance and Financial Committee of the House of Representatives.

Article IV Consultations (IMF, 2015). This stance has been maintained after the adoption of the financial surveillance guidelines and the inclusion of Japan as a pilot to mainstream macrofinancial analysis in Article IV consultations, and there seems also to be some conscious effort to strengthen the analysis and coverage, with a larger range of financial indicators being tracked. In terms of macrofinancial linkages, the 2016 and 2017 Article IV reports included special boxes that highlighted the potential amplification of shocks through mutual feedback loops between the fiscal, financial sector and macroeconomic shocks.

15. This coverage notwithstanding, with immediate risks to financial stability seen to be limited, the focus of Fund surveillance in Japan during the period under study centered firmly on the macroeconomic challenges facing Japan. The main macrofinancial issue became, and continues to be, the impact of Abenomics and in particular the aggressive and unconventional monetary policy on economic prospects and to a lesser extent on financial stability.

16. The policy debate within Japan on aggressive monetary easing was initially split between those who saw it as a necessary and even belated response to persistent deflation, against those who thought it was an ill-advised gamble that could stoke uncontrollable inflation. The Fund's view was firmly supportive of BOJ's policies, and if anything, consistently urged the BOJ to consider further easing if developments disappointed on the downside while being careful to monitor evolution of financial stability risks.

17. The position was maintained even as it became evident that the need for aggressive monetary easing was likely to continue for an extended period. The Fund began to note the risks to financial stability in its 2014 Article IV report, warning that "[o]ver time, sustained easing without complementary reforms would raise risks to financial stability and complicate the exit" and that "there are clear risks from potentially overburdening monetary policy." Also, the Fund began to argue for more "flexibility" as to the target date for achieving its inflation objectives. Nonetheless, the Fund continued to place emphasis on growth and inflation objectives, arguing that "[t]he BoJ should act quickly if actual or expected inflation stagnates or growth disappoints."

18. Subsequently, the Fund has become more explicit in pointing out the specific financial sector stability risks from unconventional policies in its Article IV consultations. The Fund gave warnings on foreign currency funding risks as well as the longer-term resilience of regional banks due to declining lending margins, and, as the BOJ purchases of JGBs mounted, the loss of liquidity in JGB markets. Nonetheless, because of the perceived continuing need to maintain accommodative monetary policy in order to support demand and to achieve the inflation target, the Fund did not call for unwinding of policies but rather recommended the strengthening of the macroprudential policy toolkit to manage these risks.[5] At a broader level, the Fund also proposed

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[5] The Fund's view is that well-targeted prudential policies (including micro- and macro-prudential regulation and supervision) should be pursued actively (as opposed to using monetary policy) to attenuate the buildup of financial risks. Monetary policy, meanwhile, should deviate from its traditional response only if financial stability costs exceed the benefits of continued monetary accommodation. The Fund's support for continued monetary accommodation is based on the view that the benefits currently exceed the costs.

introducing incomes policy to directly influence wage increases, rather than relying simply on macroeconomic policies to lift output and inflation.

19. On the sovereign-financial nexus, the Fund had flagged this in the 2012 FSAP as a major risk. Debate in Japan on the appropriate fiscal policy objectives and the need for consumption tax increases has also been intense. While there are those who argue for fiscal consolidation from inter-generational equity concerns or to prevent a future fiscal crisis, there are those who believe that fiscal sustainability concerns are overblown, and that fiscal stimulus is necessary to restore longer-run growth. While there appears to be some differences in opinion, the government has tended to place short-term growth objectives over longer-run fiscal concerns as seen in the repeated postponement of a consumption tax rate hike.

20. Its warnings on the fiscal risks notwithstanding, the Fund's Article IV consultations during the period under study understood the need to support demand, calling for a neutral to expansionary fiscal policy in the short run (depending on the situation) combined with a credible medium- to long-term consolidation plan. In the most recent 2017 Article IV report, the Fund argues for a broadly neutral fiscal stance in the short run, while recommending a gradual and phased increase in the consumption tax rate over the medium and long term.

21. With economic performance remaining mediocre and room for monetary and fiscal policy becoming more limited over time, the Fund increasingly emphasized structural policies in its policy recommendations. In that vein, financial sector advice also turned towards improving the resource allocation functions of the financial sector, including through the strengthening of corporate governance, provision of risk capital, as well as eliminating the full public guarantee for small and medium enterprises (SME) lending to encourage SME restructuring. Following the FSAP exercise, the staff encouraged the authorities' greater engagement with financial institutions on the future of their business models.

22. The Fund had also begun including a comprehensive Risk Assessment Matrix[6] in its Article IV staff reports for Japan from 2012. Throughout the period under study, risks from external sources such as a slowdown in global growth have dominated, but the possibility of "bond market stress from a reassessment of sovereign risk in Japan" was identified as being a "Medium" likelihood risk with a "High" impact.[7] Nonetheless, given the favorable debt dynamic from low interest rates, the Fund appears to have placed less urgency over the last few years on the immediate risks to fiscal sustainability.

[6] The Matrix identifies events over the next 1 to 3 years that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The Matrix provides the staff's subjective assessment of the relative likelihood of each risk factor (from "low" indicating a probability below 10 percent, "medium" a probability between 10 percent and 30 percent, and "high" a probability of 30 percent or more), as well as the likely size of impact.

[7] The other domestic risk event, which was added from the 2016 Article IV consultations, is the risk of a major earthquake. This risk event is given "Medium" likelihood with a "High" impact.

(ii) Financial Sector Assessment Program

23. Japan has undergone three FSAP exercises since 2003. Officials who had been engaged in past FSAPs recalled that the first FSAP was conducted whilst Japan's financial system was under severe stress and resulted in some tensions between the Fund and the authorities, as the analysis was seen to be excessively alarming, and with insufficient appreciation of the efforts that were being made to stabilize the system. In the event, the outlook for the financial system improved considerably just as the FSAP was being concluded. Officials noted that they remained critical of the Fund's financial surveillance work as the 2012 FSAP was undertaken, mentioning that the Fund had praised the U.K. financial system highly in the run-up to the GFC. Given the residual mistrust, the FSAP team was not allowed access to supervisory data on individual institutions.

24. However, the 2012 FSAP process was felt to have been generally positive. It appears the 2017 FSAP was conducted under a much more collegiate atmosphere, with the authorities providing access to individual bank data. Overall, the recent exercise was considered to be fruitful by both parties, with some officials praising highly the FSAP team's work.

25. The financial stability assessment in the 2017 FSAP focused on the implications of low interest rates and low profitability for Japan's financial system, especially on the weaker regional banks and *shinkin* banks as well as life insurance firms. It emphasized the structural challenges for the financial system, coming not only from the extended period of weak growth and low interest rates but also from longer run demographics of an aging population. The analysis echoes the warnings in the BOJ's Financial System Report concerning the longer run vulnerability to the financial system.

26. For its assessment of shorter term systemic risk, the FSAP relied largely on the results of stress tests, given the generally favorable contemporaneous financial soundness related indicators. The stress test scenarios were designed to reflect the major risk events in the Article IV Risk Assessment Matrix, so that the test for solvency risk involved two separate scenarios driven mainly by changes in external conditions, namely: a "de-globalization" scenario resulting in a decline in Japanese output by 5 percentage points from the baseline as well as a sharp drop in CPI and equity prices; and a "U.S. monetary normalization" scenario which assumed a 200 basis point increase in U.S. rates which in turn triggered a 300 basis point jump in Japan's long-term rates. The JGB market stress in the Risk Matrix is thus assumed in the stress scenario to occur as a response to a U.S. interest rate jump. The output loss in the latter, severe adverse scenario was considerably larger than in the de-globalization scenario as well as in the previous stress episodes of the Asian and global financial crisis, both in terms of depth and duration. The stress testing also provided a separate analysis of liquidity risk and contagion risk.

27. The stress test's capital adequacy results indicated that, while there are pockets of vulnerability especially in the regional banks, the banking system was generally resilient to short-term stresses. The liquidity stress test indicated that, while yen and total liquidity are ample, foreign currency liquidity could come under significant stress because of the heavy

reliance on wholesale funding. The numerical results confirmed the more casual observations that had been made in earlier Article IV surveillance concerning foreign funding risks. The stress test on linkages between sectors also confirmed the central role of banks and the still dominant role of bank financing.

28. Solvency risks in the insurance sector were also given prominent treatment, and the vulnerability of life insurance companies to interest rate risk was highlighted. Under the stress scenarios, there would be a substantial decline in the regulatory solvency ratios, with a much more worrisome result when economic solvency measures were used. The contagion analysis indicated, however, that the systemic importance of the insurance sector in propagating shocks is limited, and banks are the most important source of systemic risk for the overall financial sector.

29. With short run risks of acute systemic risk seen as limited, recommendations in the 2017 FSAP focused on longer-term challenges, as well as the preparedness of the authorities to deal with the possible consequences of chronic and building stresses in the financial system. On the latter point, the FSAP drew on its assessment of compliance with standards and codes, in particular the Basel Core Principles, in providing its recommendations.

30. Many of the FSAP recommendations related to a call for more active intervention by the supervisors against individual banks, and the establishment of a formal regulatory framework that would allow such an approach. These included the use of Pillar II in capital, earlier supervisory action on weak institutions, and generally a more risk-based approach to determine the intensity of supervisory engagement with financial institutions, backed by an upgrading of capacity to effectively pursue such an approach.

31. The extensive discussions of financial institutions' business models in the FSAP mirrored the Japanese Financial Services Agency's (FSA) evolving approach to financial supervision. The FSA has announced its intention of shifting its focus from an assessment of solvency to an evaluation of the sustainability of institution's business model. It can also be seen as an extension of the more general trend in the Fund's recent policy advice to Japan that emphasizes corporate governance and structural issues over macroeconomic policies.

32. One prominent departure from the 2012 FSAP and the annual Article IV consultations was the lack of significant reference to the sovereign-financial nexus and the limited focus on the risks of bond market stress that was highlighted in the Article IV risk matrix. The FSAP team noted that the stress test involved a substantial 300 basis point jump in long-term yields in the severe adverse case, and thus had considered this risk. However, it did not particularly highlight the risk in the report (IMF, 2017). Moreover, because the scenario involved both a large jump in U.S. long-term yields and a spike in JGB yields, and did not clearly disentangle the effects of the

two shocks, it is difficult to judge from the published documents the exact extent of the impact of the idiosyncratic risk of fiscal confidence loss.[8]

(iii) Japan in global surveillance

33. The *Global Financial Stability Report (GFSR)*, the *World Economic Outlook (WEO)*, and other Fund publications discussed Abenomics in detail and provided substantive analysis of BOJ's monetary policy along broadly similar lines as in the Article IV reports. However, Japan did not fare prominently as a source of spillovers or potential financial instability risks at the global level, and the analysis was largely focused on macroeconomic impact. One exception was the possible impact of Japanese institutions' expansion into international lending and the possible spillover risks from its curtailment in the event of a tightening of funding conditions and access to cross-currency swaps, which were raised in the *2016 Fall GFSR*, albeit without a quantitative assessment.

34. In multilateral surveillance work, Japan appeared more often as a recipient of shocks, including those emanating from China. However, it is worth noting that many of the issues that have been raised in the *GFSR* at the global level, including the issue of low profitability and possible consequences for financial intermediation, had become prominent in Japan early on, and the experience in Japan appears to have informed the analysis.

IV. Evaluation of Article IV Consultations During 2013–17 and FSAP

A. Overall Evaluation

(i) The view of the authorities

35. The authorities agreed that the views presented in the IMF's financial surveillance were generally in line with their own views on key problems and risks. They saw value in the assessment by an independent and neutral agent and acknowledged that the process helped to focus their own thinking. They also felt that the technical analysis, some of which was novel—one example cited was that on the differing impact of low interest rates on bank profitability across regions and over time—was useful and would help them deepen their own analysis.

[8] IMF staff mentioned that it was clear to the authorities that most of the interest rate increase in this scenario came from potential severe stress in the Japanese bond market. The staff indicated that in addition to shocks to sovereign risk premia, discussions on with the authorities covered risks stemming from unsustainable public debt dynamics.

36. On the FSAP, the authorities noted that the workload was quite burdensome.[9] The authorities appreciated that the IMF team avoided duplication between FSAP and Article IV consultations by feeding the findings and recommendations of the FSAP into the Article IV report.

37. While they were happy to see that the stress tests did not indicate major systemic risks, the authorities were not particularly convinced by the scenarios, which were different from their own assumptions. They found some aspects, such as a spike in long-term rates, as artificial and not a likely scenario, with one official speculating that if a loss of confidence were to happen, the actual evolution of the markets would be much more severe and have catastrophic consequences. They felt that the Fund's view on the risks from domestic sovereign debt was overly influenced by the experience in the euro zone, which was not applicable for a country with its own central bank. They also viewed the assumed interactions between the macro and financial variables derived from the IMF's model as a "black box" to them, and therefore hard to explain to the financial institutions that were asked to participate in the exercise. The authorities also found it difficult to supply the data that the IMF requested as part of its top-down stress testing, as they were based on the data format used for European banks, which were not organized in the way data was collected in Japan.[10]

38. The authorities noted the exercise on compliance with standards and codes required provision of large amounts of material and at times entailed prolonged discussions. The authorities observed that the assessors were not particularly familiar with the legal, institutional and market characteristics in Japan, and this sometimes resulted in initial views and recommendations that were mistaken or not workable.[11] They did, however, note that the assessors in the current round were generally receptive to feedback and ultimately reached conclusions that were not unreasonable.

39. These reservations notwithstanding, officials felt that an FSAP exercise every five years or so is useful. In their view, the financial system could evolve considerably in the course of several years, and impact from advances in fintech as well as structural changes in the economy on the financial system need to be watched. Even if the financial system and stability conditions remain broadly unchanged, the authorities felt that they could usefully exchange views with the Fund on the development of methodologies to assess financial system stability.

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[9] The authorities counted roughly 250 meetings with the FSAP team. The number of meetings related to stress tests were about 20 per cent of the total, but the authorities felt that the associated workload was much heavier than this ratio would indicate.

[10] Separately, banks who were required to conduct simulations for the IMF's bottom-up stress test commented that the assumptions provided by the IMF were quite sparse and did not cover the data set required to run their own models. They had to fill in the gaps with their own assumptions, which they thought made the comparability of results across institutions suspect.

[11] IMF staff agreed that assessors were not necessarily familiar with the country's legal traditions. They explained that the selection of assessors and overall team members is designed to cater for technical expertise, and that it is important that the team brings a fresh, diverse, and independent look.

(ii) Private sector views

40. Private sector and academic observers also considered that the IMF assessments were generally reasonable, but expressed diverse views on the appropriate stress test scenarios in the 2017 FSAP, which they felt might have been usefully applied to shed more light on the vulnerability of the financial system. Some believed that a scenario of BOJ policies succeeding in lifting inflation could have a significant impact on monetary policy implementation, and that macrofinancial linkages could operate through the way in which BOJ manages the exit. According to this view, as BOJ exited from its YCC policy under an environment of accelerating inflation, the spike in long-term yields could be significant. Others felt that if there was a global slowdown, then a return to pre-Abenomics conditions of deflation and a sharply higher exchange rate was a more likely scenario, possibly supplemented by more negative interest rates, the implications of which needed to be investigated. Overall, many noted that the stress test results from one or two scenarios were not necessarily a particularly convincing basis for judging vulnerability.

41. They also expressed surprise at the lack of explicit discussion on the fiscal sustainability issue, as well as on the potential implications of BOJ's exit from its current policies. Some also expressed reservations on the identification of low interest rates and low profitability as largely structural problems rather than attributable to monetary policies. Private banks felt that they were being forced to take on foreign currency funding risks due to the low profitability in the Japanese credit market, and that it was unfair to simply point out the associated risks. People generally felt that the advice to strengthen revenues from financial services was an obvious strategy that all institutions were pursuing, but without much success.

(iii) Additional observations

42. There was a general sense that the IMF's assessments and advice were not particularly ground-breaking, but that this was to be expected given that Japan's economy and financial sector is being tracked and analyzed by many analysts and economists from private and public organizations as well as research institutions and academia.

43. On the policy recommendations related to monetary policy and financial stability, the Fund appears to judge the appropriate stance of monetary policy first and foremost from a macro perspective, and recommends that any side effects be dealt with through (unspecified) macroprudential policies. The Fund is largely silent on the possibility of the BOJ exit from unconventional policies and the possible implications of such a move on financial stability. The Fund FSAP team noted that the perimeter of the FSAP exercise was defined to exclude monetary policy and fiscal policy, so that the recommendations and analysis pertaining to monetary policy should be conducted in the framework of Article IV consultations. The Article IV team noted that they had wide-ranging discussions with the BOJ, and that they agreed with the BOJ position that it was too early to discuss details about a possible exit. The BOJ also believed that the FSAP need not examine monetary policy related issues that were covered in Article IV consultations.

44. Nonetheless, the risks to the financial system in Japan arise not necessarily from the weaknesses in the financial sector per se, but from the interactions between monetary and fiscal policies and the responses of financial institutions and the financial markets. Strictly confining the analysis to financial sector issues seems to reduce its usefulness, particularly in the Japanese context. A prime example is the impact of unconventional policies on financial stability. Looked at from a pure fiscal-financial nexus, the reduction of sovereign exposure due to massive purchases of JGBs by the central bank has apparently reduced financial sector risks. But based on a consolidated government balance sheet that includes both the government and the central bank, the result of BOJ operations is a massive shortening of the maturity structure of broader public liabilities, since the long-term bonds held by private financial institutions have been replaced by overnight deposits at the central bank. This has potential implications for monetary policy as well as broader public finances. Even if exit is not foreseen in the immediate future, continuation of policies could exacerbate the magnitude of the challenge of exit when it occurs.

45. A possible concern in this regard is that the Fund may have trapped itself into its policy position concerning monetary policy, having consistently advocated expansionary policies. This may make it reluctant to question the policy or to assess the negative consequences of the policy. This attitude may also be reinforced by the fact that the BOJ is in a similar position. An analysis in the context of FSAP could have provided an opportunity to address these issues outside the standard annual surveillance framework.

B. Impact on Policies

(i) Direct influence on authorities

46. On the value of financial surveillance in shaping policies, the authorities considered that the process of consultation and discussions were quite useful, as they potentially provided alternative points of view and helped to sharpen official thinking. The recent FSAP and the associated policy advice could be useful as providing options in their endeavor to further strengthen and upgrade regulatory and supervisory policies. They did feel, however, that it was important that the recommendations should not be presented as the only correct solution in moving forward. Officials also expressed reservations about the strong reliance on the moral hazard argument made by the Fund team in drawing their recommendations on crisis resolution: they felt that the behavioral characteristics of Japanese management was different from that in other global banks, and assuming that they would rationally exploit safety net arrangements was as unrealistic as the pre-GFC assumption that the self-interest of bankers would lead them to manage risks conservatively.

47. In terms of the actual impact on policies, it is useful to review the policy actions taken against the previous 2012 FSAP and the financial sector related recommendations in the Article IV consultations. The 2017 FSAP judged that there has been progress across all areas, with

the status for all recommendations classified as either partially implemented or implemented.[12] The authorities noted that many of the issues flagged in the FSAP were already recognized and policies to address them under consideration, so they did not see the FSAP as being instrumental to, or having influenced the course of policy to any significant degree. The one area where they acknowledged that the Fund's insistence in the 2012 FSAP had had influence was in the creation of formalized meetings between the FSA, BOJ, and the Ministry of Finance (MOF). They noted that while they had felt that informal contacts already in place at that time were sufficiently robust, the creation of a formalized meeting had positive results in terms of coordination.

(ii) Peer pressure to/from other authorities

48. Another channel for influence, one central to the Fund's surveillance, is that the discussions at the IMF Board act as peer pressure to adjust countries' policies. The financial sector information in a country's FSAP may also influence policies towards financial institutions from that country by other supervisors. On this point, officials indicated that IMF reports were often the first port of call in understanding issues in other countries, especially for important countries where information was not easily accessible, such as China. However, the use was limited to general information gathering, and they did not recall any instances where reports influenced supervisory decisions relating to banks from these countries. The Board discussion on the FSAP seemed to be limited, given that they were discussed in conjunction with the Article IV reports, and Board members could only give limited time to discuss the FSAP reports. In the case of Japan, this may simply reflect the relatively lower urgency of financial sector issues at this juncture.

(iii) Influencing the broader public policy debate

49. A further potential contribution of Fund surveillance is that it could help shape the public debate on policies. On this front, many from the private sector said that they did look at the IMF Article IV staff reports, though not necessarily in detail, but many had not been aware of the recent FSAP publication.[13] One observer thought that the public would assume that the FSAP documents reflect agreement between the government and the IMF. The authorities noted that this sort of perception presented a potential risk in their communications policy as well as in its interaction with the financial industry. They recognized that the recommendations given by the Fund did have merit, and could help deepen the public debate on policies, but they felt that, therefore, it was important that they not be presented as the only solution to the issues.

50. The published documents also suffer from being too parsimonious in presenting the findings and analysis. The staff stressed that they were constrained by word limits for Board papers that were strictly enforced. Nonetheless, the lack of information made it difficult for an

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[12] Most of the recommendations in the 2012 FSSA were couched in words such as "Develop," "Consider," "Intensify," etc., so it is somewhat difficult to objectively confirm the degree of implementation (IMF, 2012).

[13] The interviews were conducted mainly during August, shortly after the publication of the 2017 FSSA report (IMF, 2017) at the end of July and before the technical notes were published in mid-September.

outside observer to fully appreciate the analysis from the publications alone. For example, the stress scenarios showed only the impact on Japan's economy, and though the tables compared them to past episodes such as the GFC, the lack of information on global GDP and other external variables under the scenario made it difficult to appreciate the size of the external shocks assumed. Similarly, the severe adverse scenario shows the combined effects of the rise in U.S. interest rates (which would impact global growth and possibly exchange rates) and the rise in Japanese rates, and it is not possible to disentangle precisely the effects from a purely Japanese domestic shock.[14] A more detailed description, perhaps in the technical notes, would have been helpful in assessing the vulnerabilities.

51. Similarly, some of the recommendations were not very specific and couched in general terms, so that outside readers found it difficult to understand the exact content of the recommendations made by the Fund.

V. CONCLUSIONS AND RECOMMENDATIONS

52. Given the perceived overall strength and stability of the financial system at this juncture and the overriding policy objective of lifting Japan out of deflation and initiating a robust, self-sustaining growth, it is natural that immediate financial stability concerns have taken a back seat in the IMF's surveillance for Japan. Nonetheless, the topics that have been covered can be judged as relevant and the analysis generally of high quality. There is, however, room for improvement.

53. In addition, going beyond Japan specific surveillance, Japan's experience could be helpful in informing common global issues. In earlier periods, Japan was often thought to have unique characteristics, that provided few lessons to other economies. However, this changed as many advanced economies were seen to be facing the same issues that Japan had been facing, and the term "Japanization" became popular in the early years of this decade. Japan is now seen more often as a harbinger of what other countries might face in the years ahead. An analysis of the Japanese economy, the challenges it face, and policy proposals to address these challenges may be useful to other IMF members.

A. Overlooked Issues

54. Financial surveillance for Japan has been largely silent on some issues that are attracting strong interest among economists and financial experts in Japan. The most prominent example is the implications on financial stability of unconventional monetary policies and exit from them. The recommendations in the Article IV consultations have focused largely on macroeconomic policy goals, and while the side-effects of the policies in terms of financial stability are recognized, it is assumed that macroprudential policies can be deployed to address the issues. The 2017 FSAP

[14] In fact, some of the information was included in the FSSA. For example, a footnote in the 2017 FSSA states "[t]he additional decline in Japan's GDP compared to the moderate adverse scenario is primarily due to the assumed increase in JGB yields triggered by the accelerated U.S. monetary policy normalization" (IMF, 2017).

look at the effects of low interest rates on financial sector soundness (IMF, 2017/285), but it did not sufficiently consider monetary policy in its assessment, perhaps because it took the view that that the flat yield curve was mostly driven by structural factors. It would have been useful for the FSAP exercise to address to a greater extent the magnitude of risks posed by monetary policies, what risks macroprudential policies can be reasonably expected to contain, and what financial system risks may emerge in the event of exit. Such an analysis could have provided a better cost-benefit analysis associated with the current monetary policy stance.

55. There are other risks that financial surveillance covered, but that could have received greater attention. First, while the 2017 FSAP considered risks stemming from unsustainable debt dynamics that had been emphasized in the 2012 FSAP, it could have usefully discussed more explicitly the risks from loss of fiscal confidence, rather than being buried in the discussion of a U.S. normalization risk. Risks from fiscal unsustainability is another topic that was insufficiently covered in the 2017 FSAP despite the emphasis given in the 2012 FSAP and repeated reference in recent Article IV staff reports on risk amplification involving the sovereign-financial channel, as well as the continuing public debate in Japan. Another scenario that could have received more attention was the risk from major earthquakes.[15] The macrofinancial linkages from an earthquake risk are also important; the staff report's Risk Assessment Matrix recommends that "the government should deploy additional fiscal and monetary stimulus to restore growth and inflation momentum and to restore confidence," but depending on the impact of the damage on financial system soundness and fiscal sustainability, such a response may well be constrained or counterproductive. Finally, cyber security risk and the risks from the Fintech revolution on the existing financial system is something that is on the minds of many observers, and more attention to the issue would be welcome, either in the context of bilateral surveillance or at a more global level.[16]

B. Communicating the Findings

56. In assessing the work done by the Fund in bilateral surveillance, particularly in the FSAP, one should distinguish between the actual work and the published documents. For example, the close working relationship between the authorities and the Fund staff means that the authorities will be fully aware of the details of the output from the stress scenarios. However, as noted above, it is difficult to appreciate the magnitude of the shocks and the mechanism through which they manifest themselves from the published documents, which reduces the contribution of the

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[15] The Japanese government is studying the impact that major earthquake scenarios could have on major financial institutions, including their business continuity plans. The IMF, considered earthquake risk through a sensitivity analysis in its insurance stress testing as part of the 2017 FSAP.

[16] The Japanese authorities were somewhat skeptical whether the Fund was well placed to deal with risks from natural disasters, cyber security and terrorist actions, given the nature of the risks and the sensitivity and confidentiality of authorities' responses in the latter two areas.

Fund's work to the public debate. The Fund should also make further efforts to communicate to private sector economists and researchers that are actively involved in the policy debate.

C. Recommendations

57. From the experience in Japan, a number of recommendations that may be applicable to a broader set of countries may be drawn:

- The perimeter of the FSAP exercise could be broadened to encompass inquiry into macrofinancial interactions and monetary and fiscal policy issues as they pertain to financial stability. While the FSAP is in one sense a snapshot of the current state of financial sector and policies, it provides an opportunity to explore the longer-term implications of current policies. Japan's FSAPs have done so to a degree in considering the longer-term structural challenges, but have shied away from assessing the longer-term implications of macro policies for financial stability. Given the shorter-run, macroeconomic focus of the Fund's annual Article IV surveillance, the FSAP could provide a vehicle for discussing in depth about the longer-run vulnerabilities and policy interactions.

- Under such a broadened mandate, the Fund should have a wider discussion with the private sector in choosing the topics and risks to be examined in the FSAP. Where appropriate, the IMF could provide its own views and analysis on these issues to influence the policy debate.

- Given that the FSAP has now become a regular activity, it would be useful to not only follow-up on the authorities' implementation of recommendations, but also to review the Fund's analysis on financial stability risk assessment, and how the implementation of recommendations contributed to financial stability. For example, where a structural risk factor that had been previously identified is not touched upon, as in the sovereign-financial nexus in the case of Japan, the FSAP should provide an explanation as to why the risk has been downgraded.

- Given the very large resources being devoted to stress testing, it may be worthwhile to reconsider their usefulness. Stress tests are useful in cases such as those immediately after the financial crisis, where the nature of downside scenarios is relatively clear and imminent. On the other hand, when the system is largely at "cruising altitude," the scenarios can be seen as somewhat arbitrary, and the movement of financial variables are hard to pin down and depend on the specific macroeconomic model used to generate the scenario. While there are merits to a consistent, integrated scenario, it may be less useful in evaluating the risks in the financial system. Given that it is not practical to examine a large number of different scenarios, it may be more useful to conduct a factor-by-factor sensitivity analysis (e.g., based on interest rate shifts, exchange rate shifts, external demand shifts, etc.), perhaps as a supplement to the main stress test, that could

show the risk profile of the financial system and what shocks the system is most vulnerable to.

- The practice of the Fund conducting its own stress tests based on its own models may also be revisited. According to the authorities, transformation of available data into those used in the Fund's model is burdensome, and it is not clear whether conducting stress tests based on the Fund's own model provides value added over the assessment of the models and the output of the authorities' own models, when they exist.

- Similarly, the assessments of standards and codes are a resource intensive endeavor, especially if they are conducted by assessors that are not familiar with the country's characteristics—an issue that is particularly important for countries outside the European Union or the Anglo-Saxon legal tradition. Unless there are significant changes to the standards and codes or the regulatory and supervisory framework of the country, a review that focuses on the follow-up from earlier assessments should be sufficient.[17] Also, the accumulation of assessments puts the Fund in a unique position of evaluating the effectiveness of the regulatory framework across countries and to propose adjustments. In past *GFSRs*, there had been warnings about the possible unintended consequences from the multitude of regulations that were being introduced.[18] Through its assessments across countries, the Fund might be able to identify if such unintended negative effects from excessive and/or overlapping regulations exist.

- The Fund should also consider how their communication of financial surveillance could be improved upon. The policymakers would remain the primary audience, but the ability to influence them directly on a bilateral basis is limited for advanced economies, and more thought could be given to addressing the broader community of researchers and commentators that shape the debate on public policy. The Fund's communication strategy seems to be too intent on delivering messages and policy recommendations to a broad audience; it is not possible to sway professionals with simple assertions, hence a more active outreach to the policy shaping community with a more detailed and careful explanation of the analysis and logic behind its recommendations could deliver a stronger impact on the policy debate.

[17] IMF staff commented that this is in fact already the practice. A full assessment, however, was justified in Japan's 2017 FSAP since the methodology for the standards assessed had been changed markedly by the standard setters between FSAPs.

[18] The Fund cautioned the "uncoordinated initiatives to directly constrain banking activity in different jurisdictions and ring-fencing of operations" in the April 2013 *GFSR*, and also on the "proliferation of national and regional rules applicable to global institutions' in the April 2014 *GFSR*. More specific concerns were raised, for example, regarding regulations that result in asset encumbrance and impediments to loan securitization.

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Chapter 4—IMF Financial Surveillance of Malaysia, Singapore, and Thailand

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EXECUTIVE SUMMARY

This paper assesses IMF financial surveillance in Malaysia, Singapore, and Thailand. In these countries, authorities saw the main value of IMF financial surveillance as being the validation of their own analysis and the acknowledgment by an independent and knowledgeable third party that they were managing their financial systems well.

Authorities in all three countries shared a positive view of their experiences with the FSAP, which had strong traction as demonstrated by the countries' implementation of its recommendations, including some with major impact (e.g., the reforms in the supervision of specialized financial institutions in Thailand). Authorities recognized the technical knowledge of the FSAP teams, appreciated the inclusion of external experts with real-world experience, and welcomed the knowledge exchange with IMF teams. Overall, they conveyed a more positive view of the effectiveness of the FSAP than of the financial surveillance conducted through Article IV consultations, even as the IMF worked to integrate the two.

While recognizing substantial progress in coverage and technical quality in recent years, authorities did not consider Article IV consultations fully effective as a tool for financial surveillance. Singapore is perhaps the exception, where given its status as an international financial center (and, more recently, its inclusion in the IMF "macrofinancial pilot program"), the Article IV has consistently covered the financial sector. The Fund has strong expertise in broader macroeconomic issues but much less in macrofinancial issues. The analysis of macrofinancial linkages in Article IV consultations had improved but was still not deep, and authorities did not expect the Fund to detect blind spots or new financial sector risks. Article IV teams' attempts to follow up on FSAPs were constrained because of the different coverage of FSAPs and Article IVs, as well as the lack of financial expertise in the latter.

Authorities were frustrated that sometimes staff reports presented a view different from the positions presented by IMF teams at the mission wrap-up sessions. While recognizing that these changes were the natural consequence of a robust internal review process at the IMF—in principle necessary to ensure consistency and even-handedness—they suggested that this created confusion and weakened the traction of IMF advice. They suggested that the Fund should explore ways to provide staff teams with greater flexibility to take into account country circumstances in implementing policies—especially on macroprudential and capital flow management issues.

To strengthen the quality and traction of its financial surveillance the IMF should include more financial sector expertise in Article IV teams and expand and deepen coverage of financial inclusion, capital markets, and non-bank institutions. Better coordination with the World Bank would strengthen the FSAP, as would allowing more time between scoping and main missions for better preparation by the IMF team and the authorities. Finally, closer collaboration with the BIS and AMRO could improve the traction of IMF financial surveillance in the region.

I. INTRODUCTION

1. This case study assesses the relevance, technical quality, and impact of IMF bilateral financial surveillance in Malaysia, Singapore, and Thailand through Article IV consultations and the Financial Sector Assessment Program (FSAP). It covers the period 2013–17 (going back to 2010 in some cases).

2. Although the assessment was undertaken on a country-by-country basis, there were many common threads in the responses from country authorities, IMF staff, and market participants. The authorities of the three countries expressed similar views on the extent to which the Fund's financial surveillance was able to identify and address key vulnerabilities and risks to financial stability and to add value to their own work: in most instances, the differences were a matter of degree. Fund staff on the three country teams also raised similar issues about the effectiveness of financial surveillance. For this reason, the key findings of this assessment, as well as the recommendations, are presented on a consolidated basis for the three countries. A few, secondary country-specific issues are presented in a separate section.

3. The assessment was based on a review of relevant documents from the IMF and external sources, as well as interviews with officials in these countries who were directly involved with IMF financial surveillance, IMF current and former staff in Article IV and FSAP teams, and private sector financial analysts, mainly from major banks and asset managers, including sovereign wealth funds. The assessment tried to go beyond just a reading of the final reports and to evaluate the relevance of the diagnosis, the robustness of the discussions of risks and vulnerabilities, and the impact of the policy recommendations. Extensive discussions were conducted with both country officials and IMF staff in cases where there had been disagreements between the authorities and IMF staff regarding the conclusions or policy recommendations, in an effort to fully understand the circumstances and conduct of the Fund surveillance team and to derive relevant lessons.

II. CONTEXT

4. The financial institutions in all three countries safely weathered the global financial crisis (GFC) and the economies were able to return to a moderate growth track quite quickly. Past IMF surveillance, as well as lessons learnt from the East Asian and earlier financial and economic crises, had prompted Southeast Asian countries to tighten bank capital and governance regulations, while liberalizing many other aspects of the banking business, including entry of new banks and allowing establishment of bank branches across the region. These measures facilitated sustained regional investment during the global slowdown following the GFC. Tighter regulations, continuous strengthening of supervision of financial institutions, and human capacity development in the financial sector built resilience. Nevertheless, country authorities interviewed for this evaluation continued to accord high priority to strengthening their financial sector supervision, as well as making banks stronger and more efficient to support economic growth.

5. The IMF and other observers acknowledge that the current standards of supervision and regulation of financial institutions in the three countries, and especially in Singapore and Malaysia, are high. The Financial Stability Reports published by the central banks in all three countries increasingly provide high-quality analysis. Stress tests by the Malaysian central bank, Bank Negara Malaysia (BNM), and the Monetary Authority of Singapore (MAS) are based on more granular data and more demanding assumptions than the equivalent FSAP stress tests. Financial supervision in Singapore, in particular, is considered among the most stringent in international financial centers worldwide, and MAS feels it is well ahead of the IMF in its financial surveillance work. The same is true in Malaysia, although a key difference is that MAS regulates all financial entities, while there are several different financial regulators in Malaysia. Even in Thailand, financial sector risks have been drastically reduced with the reform of the specialized financial institutions (SFIs) and the shift of supervisory functions from the Ministry of Finance to the Bank of Thailand (BOT).

6. These high standards are the result of a process that took a long time and sustained efforts by the country authorities. Having strong supervisors is widely seen in all three countries as necessary for financial stability. Partly as a result, individual regulatory authorities have invested heavily in IT, human resources, and training. The IMF played a significant role in the latter through its capacity building and training programs, alongside the World Bank and the Bank for International Settlements (BIS). Central banks in the three countries have developed sophisticated data warehouses with very granular data. Combined with strong in-house technical skills, this allows the central banks to identify and monitor financial sector risks at a very granular and detailed level. This was acknowledged by most Fund team members.

7. As a result, the authorities particularly in Singapore and Malaysia today feel that they are well equipped to conduct effective surveillance of their own financial systems. Thailand is undergoing a significant strengthening of financial sector supervision, but with a less developed financial sector, there is more scope for IMF support.

III. Overall Views of IMF Financial Surveillance

8. Although relationships with the Fund have improved considerably since the Asian crisis, the authorities do not expect the IMF to detect blind spots or new risks. They see the main value of IMF financial surveillance in the validation of their own analysis and the acknowledgment by an independent, knowledgeable third party that these countries are managing their financial sectors competently. Overall, country authorities conveyed a more positive view of the effectiveness of the FSAP than of the financial surveillance conducted through Article IV consultations, even as the IMF worked to integrate the two.

A. Financial Sector Assessment Program

9. The three countries had varying degrees of experience with the FSAP. Two FSAPs have been completed for Singapore, while Malaysia and Thailand have had only one each thus far.

FSAPs were completed for Singapore in 2004 and 2013, and a third exercise is upcoming in 2019. Malaysia's FSAP was conducted in 2012–13. Thailand received an FSAP in 2009, and another is now scheduled for 2019 following many years of financial reform in which principles and methodologies for the standards have changed considerably.

10. Overall, the authorities in all three countries shared a positive view of their experiences with the FSAP, which had strong traction as demonstrated by the countries' implementation of nearly all the FSAP recommendations. The authorities attributed this to several reasons:

- FSAP teams included external experts, who were highly qualified and had substantial hands-on experience in regulation and supervision. The authorities found that that these experienced practitioners more often than not "speak the same language," and could bring to bear valuable real-world expertise to the discussions.
- FSAPs were viewed as a useful benchmarking exercise against peers, based on a common set of standards and methodology.
- FSAPs had a strong focus on governance, which is now widely seen as a core factor behind financial system stability.
- FSAP recommendations also covered structural issues in the financial sector, an area where the Fund's knowledge of global best practices was helpful to the authorities.
- Lastly, despite their earlier reticence, county authorities were now comfortable with the transparency aspects of the FSAP, and few adjustments were necessary to the published Financial Sector Stability Assessment (FSSA) reports to delete market sensitive information.[1]

11. As regards the assessments of compliance with international supervisory standards, all three countries felt that this aspect of the FSAP was an essential component of financial sector soundness. However, some of the regulators were concerned about the level of expertise of the assessors, as well as the depth of understanding of their own officials, who were expected to complete the self-assessments. In the case of Singapore, officials noted that the compliance exercise took too much time. In any case, the next FSAP for Singapore would not undertake a full assessment of compliance with the Basel Core Principles, since standards and methodologies had not changed. In this light, the authorities thought that the next FSAP could spend more time on identifying sources of vulnerabilities.

12. Another concern raised by some country officials was the need for adequate preparation and sufficient time given to the country authorities ahead of the mission. Workshops conducted by IMF staff prior to the mission on new standards and methodologies introduced since the global financial crisis would enable officials to complete the self-assessments on the various

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[1] FSSAs reviewed for this evaluation include IMF (2009; 2013a; 2013b).

standards appropriately. Also, there should be sufficient time—at least six months—between the scoping mission and the full mission to allow for adequate preparation by both the authorities and the FSAP team members.

13. Recent efforts to have Article IV missions follow-up on FSAP recommendations were welcome, as they enhance the integration between the two processes and strengthen the coverage of financial sector issues in Article IV consultations. Some country officials, however, felt that the relative lack of financial sector expertise in Article IV missions limited the usefulness of this follow-up. One possibility they mentioned would be to include in Article IV staff reports information reported by the authorities on countries' implementation of the FSAP recommendations.

B. Article IV Consultations

14. Despite the progress in the most recent years, documented in more detail in Section V, officials interviewed for this evaluation thought that financial surveillance overall was still not deep or extensive in Article IV consultations, except perhaps in Singapore where, given its status as an international financial center, the Article IV consistently covered the financial sector. In the other two countries, the coverage was limited, except in the Article IV consultation immediately following an FSAP, as for example the 2013 consultation with Malaysia.

15. Officials commented that the analysis of financial implications from macroeconomic developments in Article IV consultations was typically quite superficial. The situation improved somewhat in the Article IV consultations with Singapore in 2016 and 2017, when macrofinancial linkages were more robustly analyzed through the pilot program to integrate macrofinancial analysis in Article IV surveillance (Singapore was among the pilot countries in this IMF staff initiative). In these two years, the Article IV team made deliberate efforts to include assessments of financial sector impact from macroeconomic developments. This was demonstrated most visibly in the Risk Assessment Matrix, where the financial sector impact of each identified risk was discussed. But this was not the case in Malaysia or Thailand, which were not part of the pilot program.[2]

16. The main reason for these weaknesses, according to authorities, was the limited financial sector expertise in Article IV teams. They recognized that the IMF has made significant progress in strengthening its financial sector assessment capabilities and that the level of technical expertise of the staff on financial matters has improved over time. This was resulting in better, more robust policy discussions on financial sector issues, which the authorities saw as beneficial. Overall, however, the lack of practical experience and, in particular, a deep understanding of

[2] There were instances nonetheless in which financial sector issues were addressed in Article IV consultations, for instance identification of issues with non-banks in Thailand as part of the 2013 Article IV, as discussed in paragraph 27 below.

financial market operations among Article IV team members was still a major handicap. For this reason, the authorities had low expectations of the ability of Article IV teams to detect risks that were not already known or to provide practical financial sector policy advice.[3]

17. Staff acknowledged that mainstreaming financial sector issues in bilateral surveillance was a work in progress. They pointed out, however, that in Article IV consultations, they follow a selective, risk-based approach to surveillance that focuses on topics deemed critical for macroeconomic and financial stability and growth. This means that financial sector issues will not necessarily be covered in the same depth in every country every year. They pointed out that the more consistent coverage of these issues in Article IV consultations in Singapore, compared to the other two countries, illustrated exactly this point. Moreover, some staff noted that the "low expectations" signaled by some authorities created a risk of a self-fulfilling prophesy: low expectations might lead to low level of engagement, which in turn would diminish the value of the consultation process.

18. There was one financial sector area in which Article IV consultations in recent years had paid more attention: macroprudential policy and capital flow management (CFM) measures. The experience, however, had been mixed, according to the authorities.

- For years now, countries in Southeast Asia have been using measures to complement monetary and fiscal policies to support financial stability and reduce speculative activity in asset markets. Most of these measures have been in the housing sector. Malaysia and Singapore have had significant experience with such policy approaches, and authorities indicated that the IMF could learn much from their experience about the practical use and effectiveness of these measures. However, the authorities felt that instead of recognizing their flexibility and innovativeness in using these instruments, IMF teams were more focused on applying the IMF's institutional view on macroprudential policy and capital flow management, as s approved by the Board. Even in cases in which there had been a convergence of views between authorities and the Article IV team during the mission—for instance, in the case of macroprudential measures on housing loans and mortgage-related consumer debt in Singapore and Malaysia—the authorities were disappointed to see in the final Article IV staff report (IMF, 2017a; 2017b) what they perceived as a backtracking from the positions taken by the team in the wrap up sessions. The authorities saw this as the product of the IMF post-mission internal review process.

- An episode in Singapore's 2017 Article IV consultation illustrated authorities' concerns about IMF staff's interpretation of the IMF's position on macroprudential policy and capital flow management. The 2014 guidance note on macroprudential policy indicates

[3] In some cases where IMF teams raised what they considered to be new issues, not yet analyzed by the authorities (such as corporate sector risks in Singapore), it was later discovered that the authorities had indeed been aware of those risks but had chosen not to go public yet, in order to prepare better for managing them.

that "a relaxation of macroprudential policy tools should be considered if systemic risk dissipates" (IMF, 2014). Accordingly, and citing the IMF's Institutional View on Capital Flow Management[4], the 2017 Singapore Article IV staff report stated that "a further cautious relaxation of cyclical measures … could be considered as systemic risks stemming from the housing market continue to dissipate." Although the threat to financial stability had eased, the authorities opted to retain the measures to restrain housing prices and allow the development of a more stable housing market. From the authorities' perspective, macroprudential measures may be used not just for financial stability objectives but also more broadly to stabilize asset markets and prevent renewed speculation. Although the authorities felt that the Article IV mission team was receptive to the authorities' view, they felt that outcome of the staff report was driven by pre-set IMF policy positions.

- There were also tensions over a CFM issue in Malaysia in 2016–17 when Malaysia introduced an exports proceeds repatriation rule and new directive to foreign banks on trading in the Non-Delivery Forward (NDF) markets. Despite intensive discussions and agreement on the specific issues during the mission, in the authorities' view the final Article IV staff report adopted a narrow interpretation of the IMF's institutional view on CFMs and macroprudential policy, leading the authorities to conclude that IMF did not understand the NDF markets. The authorities felt that this was unfortunate, because the IMF Article IV team, with market intelligence from the Resident Representative Office in Singapore, had given valuable advice to BNM. During the Board discussion, Directors expressed the view that IMF staff focused too much on definitional issues (whether measures should be classified as CFMs or macroprudential) rather than the analysis of market impact and correctness of the measures.

19. Other aspects of surveillance viewed more favorably were the Selected Issues Papers (SIPs), which authorities in all three countries valued highly, although they felt more value could be derived if authorities would be more closely involved in the selection of topics and the preparation of SIPs, including provision of more current information. However, they noted that here, too, there were wide variations in quality, reflecting the variations in the depth of financial sector skills among Fund teams. Authorities also appreciated and encouraged more research by the IMF on new areas of Fintech and Bitcoin digital currencies to support research by country central banks.

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[4] The guidance note on capital flow management states that: "In certain circumstances, introducing CFMs can be appropriate for supporting macroeconomic policy adjustment and safeguarding financial system stability." The note further states that "when CFMs are adopted they should generally be *temporary*, being scaled back when capital inflow pressures abate" with some exceptions that are discussed further in the paper (IMF, 2013c).

IV. QUALITY, IMPACT, AND EFFECTIVENESS OF FINANCIAL SURVEILLANCE

A. Technical Quality and Impact of Fund Surveillance

20. Representatives from all three countries—especially from the central banks—acknowledged that the technical quality of IMF surveillance, including financial surveillance, had improved considerably over time. This was particularly meaningful, given the region's historical distrust of the IMF since the East Asian crisis. The IMF had gradually gained greater respect from the authorities through better approaches, greater focus on financial sector issues—particularly macroprudential policies—and, recently, a more structured approach to macrofinancial surveillance. Policy discussions during surveillance missions were robust, which was seen as helpful by the authorities. However, since Asian countries had been using macroprudential measures for decades as part of their monetary policy frameworks, the authorities felt that the IMF had been late in understanding the full scope of these policies. Each of the countries had a long record of developing their own prudential regulation mechanisms and have established fairly sophisticated risk identification and mitigation tools. Still, and despite the shortcomings, the authorities welcomed the IMF's increasing focus on the financial sector, especially the IMF's macrofinancial pilot. Authorities also acknowledged that Fund surveillance had recommended relevant changes in supervision and regulatory frameworks for the non-bank sector, such as in the case of the SFIs in Thailand. In addition, all three countries accorded high value to the research done by the Fund toward improving the toolkit and methodologies for financial surveillance.

21. The improvement in the technical quality of financial surveillance in recent years was most visible in Singapore, perhaps as a reflection of Singapore's status as a global financial center. Singapore also had an advantage because the Resident Representative was able to provide market intelligence (more so than for the other countries in the region).

22. Officials felt that the Fund's strongest expertise was in the analysis of broader macroeconomic issues. But according to the authorities, limited financial sector expertise among Fund economists, especially in Article IV teams, constrained the ability of the Fund to analyze macrofinancial linkages. IMF macroeconomists had some knowledge of the financial sector but no hands-on experience in regulatory, financial sector supervision, or market operations. The Fund lacked sufficient expertise in certain specialized financial sector areas, notably Islamic finance, financial inclusion, bond markets, insurance, and fintech. Country authorities indicated that it would be worthwhile to bring in expertise from the markets and central banks as external experts at short notice when specific issues arise, in order that specialized knowledge can help support the Article IV team. This would help gain the authorities confidence and enhance the relevance of financial surveillance.

23. Fund staff acknowledged that there were inadequate numbers of financial sector specialists to support Article IV missions. But they argued that, unlike the BIS, which focuses mainly on financial sector issues, the Fund's strong technical competence on macroeconomics brought a different—and valuable—perspective to financial surveillance. Also, Article IV mission

chiefs indicated that the teams were extremely stretched. Several viewed that resources allocated to the Asia-Pacific region seemed disproportionately low relative to the size and complexity of countries and their financial sectors. During the 2010-2017 period, a Monetary and Capital Markets Department (MCM) expert participated in Article IV missions to Malaysia in 2013 and to Singapore in 2014 and 2015 (but none to Thailand).

24. The authorities found the SIPs on financial issues to be useful. Since the global financial crisis, IMF research had become more focused on financial sector issues, and this had spurred the authorities to strengthen further the quality of their own work. The authorities noted that there were more financial sector SIPs for Singapore relative to Thailand and Malaysia but, as noted above, this may reflect the staff's judgment of the relative macro-criticality of financial sector issues across these three economies

25. While valuing the SIPs, the authorities suggested SIPs would be more helpful if they were undertaken after prior consultation with the country. The authorities believed that when there was insufficient consultation, data and information used to support the analysis were not always accurate. This had sometimes resulted in skewed findings and conclusions. Given that SIPs were an important input into IMF financial surveillance, the authorities emphasized that it was critical to ensure the accuracy and correct use of data. While the authorities did not seek to influence the IMF's choice of topics, they felt that issues intended for "deep dives" in SIPs, which required more background research, could have been usefully discussed with them ahead of the final choice.

26. Country authorities—especially in Singapore and Malaysia—welcomed the research the IMF had launched on emerging financial issues, like fintech, digital currencies, and cyber risks for the financial sector. Although this research was not specific to their countries, the authorities found it supportive of their own exploration of the implications of these developments for their financial regulation. The authorities felt that such research should be given greater priority in IMF financial surveillance in Asia, given the potential for Asia to play a leading role in financial sector technology. They cautioned that since developments in these areas were progressing rapidly, it was essential for the Fund—as well as financial regulators—not to fall behind the curve.

B. Traction of Fund Advice

27. Generally, country authorities agreed with Fund policy advice on financial issues. Indeed, in some cases, the advice provided had been a gamechanger for the financial sector in these countries. In the case of Thailand, IMF Article IV surveillance as early as 2013 was instrumental in identifying the build-up of risks in the non-bank sector and pushing for better supervision of non-banks through changes in the legal framework to separate the ownership of state financial institutions from their prudential and supervisory oversight. It took several years of persistent push for reforms in the oversight of SFIs before the government adopted IMF proposals and brought supervision of SFIs under the purview of the Bank of Thailand in 2015.

28. In more recent years, however, disagreements with Fund policy advice in Article IV staff reports had become more frequent. This, for example, was the case for monetary policy advice that, authorities felt, ignored financial stability considerations in Thailand; macroprudential measures for the housing market in Singapore (discussed above); and advice on external sector risks in all three countries, among others.

29. In some cases, officials considered recommendations by Article IV missions reflective of a lack of expertise on financial sector issues among the team. For example, in the Article IV consultation with Malaysia in 2016–17, the Fund recommendations regarding the export proceeds repatriation rule and new directives to foreign banks on trading in the NDF markets led the authorities to conclude that IMF staff did not understand NDF markets.

30. Another factor that hampered the ability of the IMF to analyze and provide effective policy advice was the lack of continuity in country teams. Authorities from all three countries expressed concern with the frequent rotation of team members. They believed this was a factor in reducing the effectiveness of Fund surveillance in general but was especially relevant for financial sector issues. The authorities felt that continuity was important for building expertise and understanding of the markets and operations in the financial sector.

C. Private Sector Perspectives

31. Market participants views on IMF bilateral and multilateral surveillance reports varied across different categories of market participants. Singapore is host to many entities that undertake fund management and invest in countries in the region. Analysts in these firms viewed IMF surveillance reports on the smaller countries as reliable sources of information and analysis. This was similar in Thailand, where Article IV staff reports on neighboring countries were useful sources of information for Thai corporates with investments, especially in Indochina. In contrast, IMF reports for Malaysia, Singapore, and Thailand were not seen as providing information that was not already known to them and, given the delays in publication, the information they did contain was dated. Furthermore, these market participants felt that IMF bilateral and multilateral surveillance reports were addressed to policymakers rather than market players, and that risk assessment were "watered down" and avoided "delicate issues." In response, IMF staff pointed out that this perception reflected to some degree the role of the IMF as a "trusted advisor," which constrains the extent to which Article IV staff reports can publicly discuss current risks in detail.

32. Sovereign wealth fund managers and analysts who prepare reports for long-term investors valued IMF bilateral and multilateral reports as sources for high-quality data on the financial sector. Still, while acknowledging that the analysis in these reports was accurate and the issues were comprehensively covered from several perspectives, these market participants also felt that IMF surveillance reports generally did not identify risks that were not already known to the market. Moreover, they felt that there was not enough emphasis on the role of non-banks, developments in bond markets, or macrofinancial spillovers. Pointing out the liberalization of

capital flows within the region, some analysts mentioned that they would like to see more IMF analysis of cross-border flow of funds.

33. Market participants also looked at reports from other organizations, such as the OECD, the BIS (seen as a better authority on financial regulatory issues) and, increasingly, the ASEAN+3 Macroeconomic Research Office (AMRO). Compared to the outputs of these organizations, IMF surveillance reports were seen as more backward-looking. In addition, IMF surveillance reports used very cautious and at times vague language, camouflaging the significance of emerging risks.

D. IMF Surveillance Relative to Engagement with Other Institutions

34. Authorities from all three countries shared the view that engagement with the BIS was more useful than IMF financial surveillance. The BIS brought to the table better quality cutting-edge research, fresh angles, and alternative ideas on policy approaches. Its constant monitoring and analysis of financial market developments and sharing of this analysis with central banks helped progressively strengthen the capacity of home regulators. The BIS was also seen as putting more investment in the region (such as the regional office in Hong Kong SAR) than the IMF.

35. The BIS, of course, has a different focus, no surveillance mandate, and less macroeconomic expertise than the IMF, so a direct comparison between the two is not appropriate. But its approach to topical issues and emerging risks has a significant influence on the way central banks conduct monetary policy and oversight of the banking system, according to country authorities, and this might hold useful lessons for the Fund. To some extent, the BIS's influence the result of deeper and more robust discussions between BIS and country authorities on the application of banking standards and the implications of regulation on banking businesses. Furthermore, the BIS conducted significant operational and timely research to support these discussions. Engagements with the BIS were focused on specific issues and took place at various levels (technical, Deputy Governor, and Governor). In addition, these engagements took place throughout the year, with deep dives on relevant topics of the day, compared to the once-a-year comprehensive discussion with the IMF in the context of the Article IV consultation. These practices reinforced the quality of discussions and cascaded through the entire organization, reaching lower level officials implementing banking regulations and supervision.

36. In the view of country authorities, AMRO was also fast showing its increasing relevance, covering issues in greater depth (for example, its coverage of capital markets in Singapore) and reaching more candid conclusions than the IMF. AMRO can be more forthcoming and open with its assessments as it is not bound by any rigid institutional view. However, AMRO is just beginning to conduct financial surveillance, and its reports are only recently being made publicly available.

E. Do Transparency Policies Constrain the Effectiveness of Financial Surveillance?

37. Both the authorities and IMF staff believed that the Fund's transparency policies with regards to Article IV staff reports did not constrain frank discussions during the consultations. But

because in the final, published reports market sensitive information was deleted, various government agencies not directly involved in the discussions, as well as private sector market participants, were not able to see the full extent of the issues discussed and assessed. Partly as a result, as mentioned above, private sector market participants regarded the IMF as tending to defer to the authorities, and the published Article IV staff reports as being sanitized.

38. In the case of the FSAP exercises, a confidential Aide Memoire that set out the priorities and level of risks in the different areas being assessed. These issues were presented in a direct and frank manner to the authorities in the field but were adjusted somewhat when discussed in the FSSA. In more recent FSAPs in the three countries, the differences between the Aide Memoire and what was published in the FSSA had shrunk to a minimum.

39. As the IMF's transparency rules evolved and these countries became more open, IMF reports were increasingly seen as helpful in making the case for reforms and for the adoption of global best practices among the countries' political elites, supporting countries' management of their political masters to undertake reforms and implement best practice regulations. The fact that FSSAs and Article IV staff reports were consistent in their recommendations made it easier for authorities to push these recommendations with their Cabinets/Parliamentarians.

F. Institutional Issues and Internal Processes

40. As interviews with country authorities and with IMF staff progressed, it gradually became evident that a number of recent frictions between the three countries and the IMF in the context of surveillance were caused by certain aspects of the IMF's internal processes. Specifically, the authorities felt that conclusions and recommendations arrived at by Article IV teams in the field were sometimes adjusted following the IMF internal review without informing the authorities prior to the circulation of the final Article IV staff reports to the authorities and the Board. These adjustments, in the view of authorities, modified the conclusions of the IMF country team, discounting the evidence and explanations provided by the authorities to the mission. This was particularly evident in the case of IMF recommendations on macroprudential and capital flow measures in the housing market, already mentioned above.

41. Evenhandedness is, of course, critical for the credibility and effectiveness of surveillance. IMF staff emphasized that the internal review process is a key vehicle for ensuring evenhandedness. Moreover, staff guidance notes are intended to convey IMF policies as adopted by the Board. While the authorities understood this, they thought that in at least certain areas—like macroprudential policies, in which these three countries have significant experience—the IMF would be well advised to adopt a more flexible approach. This could help the IMF gain greater traction for its advice, innovation and flexibility in dealing with country-specific circumstances, and help counter the entrenched view in Southeast Asia that the Fund, despite the significant improvements it had achieved in the conduct of financial surveillance, still followed a one-size-fits-all approach.

V. COUNTRY-SPECIFIC ISSUES

42. This section highlights a few additional points that were raised by the authorities or by staff in the context of one of the countries, but that may be of broader relevance.

A. Malaysia

43. **Data collection and compilations.** The Malaysian authorities have repeatedly noted that too much time and effort of the Article IV mission is spent on data collection and compilation when these data have also been provided to the IMF's Statistics Department (STA). Data provided to Article IV teams are later again requested by STA. Mission teams also agreed that this was a point of contention with the authorities, taking away time from other more significant matters.

44. **Flow of funds analysis.** Both authorities and mission teams agreed that flow of funds analysis can provide a good basis of understanding of the sources of financing of the economy, is not undertaken regularly by Article IV missions, although is generally done in the FSAP. The authorities conduct their own analysis in their Financial Stability Reports. The Malaysian authorities, as well as several private sector analysts, thought it would be useful for the Article IV to undertake its own flow of funds analysis on a regular basis. This could help establish a clearer understanding of financial exposures across the real sector and the non-bank financial sectors, where risks are often missed.

B. Thailand

45. **Financial deepening and financial inclusion.** While there may have been greater attention to financial deepening and financial inclusion in IMF surveillance across the membership in recent years, these issues had not yet been included in IMF surveillance of the Thai financial sector. The authorities highlighted the importance of financial inclusion for a large proportion of the population and noted that lack of financial deepening was not only a problem per se but also made monetary policy less effective. More work on financial deepening would also shed light on the household debt situation. Therefore, the authorities would like to see these topics, as well as the associated risks, covered more extensively in Article IV consultations.

VI. RECOMMENDATIONS

Strengthening the Article IV consultation as a financial surveillance instrument

- Financial surveillance should be integrated with macroeconomic developments in a more seamless way through application of the macrofinancial surveillance toolkit (applied in Singapore as one of the countries in the macrofinancial pilot since 2016).

- The coverage of financial surveillance should be expanded to include financial inclusion and financial deepening, as this is essential to diversifying risks from the banking system, as well as the analysis of non-bank financial institutions, including cross-border linkages

through capital market instruments and non-bank credit. Flow of funds analysis should also be a regular feature of Article IV surveillance. Given increasing regional cross-border flows, this would also support regional risk assessments.

- Article IV teams need stronger financial sector expertise. Teams should include a good mix of macroeconomic and financial sector skills, which would result in far more effective macrofinancial surveillance. This could be achieved through a combination of means, such as hiring more staff with financial sector expertise—in particular, experience in and understanding of financial markets—deployment of more MCM economists on Article IV teams, and participation of external experts on Article IV missions, as is currently the case with FSAPs.

- Internal knowledge management should be improved. This could be achieved through greater continuity of mission members, better knowledge transfer between them, as well as through a data warehouse approach and closer cooperation between area departments and the Statistics Department to make the work of the latter closely aligned to the operational functions of the IMF.

Strengthening the FSAP

- There should be sufficient time, perhaps six months, between the scoping and the full FSAP mission to allow adequate preparation for the assessment by both, the IMF team and authorities. Where necessary, staff should familiarize the authorities with new or revised standards or methodologies to enhance the effectiveness of assessments.

- Coordination with the World Bank should be enhanced, with a view to ensuring the selection of strong experts across stability and development issues.

Improving institutional and governance processes affecting surveillance

- When policy recommendations are changed after a mission team leaves the country, this should be conveyed and discussed with the authorities before finalizing the report for circulation to the Executive Board.

- The IMF should consider whether there are sufficient Resident Representative offices in Southeast Asia.

Collaboration with other institutions

- The Fund should consider closer collaboration with the BIS and other international organizations engaged in financial sector issues in the region.

- Given the deepening integration of financial markets in Southeast and North Asia, it would be helpful to more closely integrate regionally certain aspects of financial surveillance.

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Chapter 5—IMF Financial Surveillance of Mexico

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EXECUTIVE SUMMARY

The IMF considers Mexico's financial system to be systemically important, and its financial surveillance activities are thereby detailed and resource intensive. Overall, Mexican authorities appreciate the contributions of IMF surveillance and technical assistance in recent years, including its surveillance over the financial sector. These activities have been relevant, of high quality, and have been of help to the Mexican authorities.

The authorities appreciated the opportunity of the 2012 and 2016 FSAPs to use the Fund as an expert sounding board to test their own analysis and policies. They commented that the 2012 FSAP had been particularly helpful as input in designing the 2014 financial reforms. At the same time, they saw room to make the process more helpful and less onerous. They thought that more advanced consultation would lead to a more useful focus of the FSAPs and financial sector studies as part of Article IV consultations. They also thought that some aspects of the FSAP create lots of work without commensurate value added. One major example is stress tests of the banking sector, where authorities believe the IMF to be overly rigid on scenarios and horizons. They also suggested that Fund staff working on Mexico generally had greater macroeconomic than financial expertise, there was a lack of market experience, and that turnover was quite high.

I. INTRODUCTION[1]

1. This paper assesses the quality, relevance and impact of the IMF's surveillance of the financial sector in Mexico during the period between 2012 and 2017. The note draws on interviews with IMF staff, members of the IMF FSAP and Article IV missions, Mexican officials at the Bank of Mexico, the Ministry of Finance, and state-owned development banks, as well as some private sector representatives.

2. The note is organized as follows. Section II provides some context on the Mexican financial sector and economic performance. Section III discusses the findings for the two FSAPs concluded in 2012 and 2016, respectively. Section IV addresses financial surveillance in Article IV consultations, while Section V discusses the technical expertise of IMF staff.

II. CONTEXT

3. Mexico has a bank-dominated financial sector, and a relatively underdeveloped nonbank sector. The commercial banking sector is highly concentrated, with the seven largest banks accounting for about 80 percent of total bank assets. Five of these seven largest banks are foreign subsidiaries of large global financial groups and account for some 65 percent of commercial banks' assets.[2] Despite the large foreign presence, the bulk of operations of Mexican banks, including foreign subsidiaries, are on-shore, with funding depending on domestic savings and uses directed mostly towards domestic lending and government securities.[3]

4. Mexico's economy has expanded at a low but generally steady pace since the global financial crisis, benefitting from the sustained U.S. recovery. According to the IMF and to Mexican officials, banks and nonfinancial sector institutions are relatively resilient. The banking system holds large buffers of liquidity and capital, and household debt is low. Mexico's sovereign bond market exhibits the highest liquidity and depth among emerging markets, and is affected by trends in the global economy, particularly in the Unites States. Authorities are keenly sensitive to how foreign investors might react to global and local shocks, since bond market volatility can affect policymaking decisions.

III. FINANCIAL SECTOR ASSESSMENT PROGRAM

5. Mexico's financial system has been assessed by two FSAPs. The first FSAP was concluded in 2012 following extensive discussions in 2011, while the second was finalized in 2016. The Financial Sector Stability Assessments (FSSAs) produced by the IMF in 2012 and 2016 show some

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[1] I would like to thank Joshua Wojnilower and Chris Monasterski for excellent assistance in interviews with IMF officials and in facilitating access to relevant IMF documents.

[2] Some of which are subsidiaries of global systemically important banks (G-SIBs).

[3] A detailed up-to-date description of Mexico's financial sector can be found in the IMF's Financial System Stability Assessment prepared in 2016, as well as in recent Article IV Staff Reports.

important distinctions. While the 2012 report was largely preoccupied with Mexico's adherence to supervisory and regulatory standards, as well as compliance with standards and codes, the 2016 report was more focused on financial stability and macrofinancial linkages.

6. Officials highlighted that one of the benefits of the FSAP had been that recommendations by the 2012 FSAP teams helped catalyze a fruitful internal dialogue between the different agencies responsible for financial supervision. Officials and IMF staff alike recognized that the 2012 FSAP helped shape the broad financial sector reform adopted by the government in 2014.

7. Officials in public development banks and senior Central Bank officials recognized that discussions with IMF staff helped resolve internal tensions on key issues, such as controversial credit targets that were adopted in 2012 to foster credit growth. These officials underscored that the Fund's insistence that these targets could be detrimental to private sector credit growth helped them convince the government to phase them out.

8. Officials who participated in both financial surveillance and stability assessment exercises commented on the shift in focus from 2012 to 2016. They observed that the 2016 FSAP was more clearly concerned with macrofinancial linkages, but indicated that it could have been better aligned with its intent by focusing less on institutional aspects and on the review of standards and codes. More generally, authorities welcome the FSAP's sharpened focus on financial stability and macrofinancial linkages. They emphasized that the assessment of slow moving institutional issues and review of standards and codes should be more selective, and less frequent.

9. Authorities mentioned that pre-mission meetings ahead of the 2016 FSAP were useful and served to incorporate the government's views on broad financial stability themes. However, they indicated that there was still a lack of clarity ex ante about the issues and main themes to be covered by the FSAP.[4] IMF staff partly corroborated the sentiment expressed by Mexican officials, underscoring that there had been coordination problems in the preparation and during the missions of the 2016 FSAP; they particularly pointed at lack of coordination between the IMF and the World Bank.[5] Officials in both the Ministry of Finance and the Central Bank (Banxico) agreed that coordination between IMF staff and the authorities could be improved by involving the office of the Executive Director—as in the Article IV missions.

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[4] They complained about not being aware in advance of the scope of the 2016 FSAP mission and emphasized that Fund staff did not consult authorities on the themes they found most relevant. They explained that the mission requested the same information from several agencies, leading to internal tensions. Finally, months after the FSSA had been presented to the Board, some officials involved with the exercise were still unclear of what technical notes had been published.

[5] The difficulties in coordination between the IMF and World Bank teams may be difficult to address as they were partly due to differences in their respective timelines and processes. The IMF timing is driven by the need to deliver the FSSA to the Board in conjunction with the Article IV consultation, while the World Bank team does not have any external hard deadline. In fact, the authorities were surprised to receive drafts of World Bank FSAP background papers months long after the FSSA had been discussed at the IMF Board.

10. Most officials shared the view that the 2012 FSAP served as a catalyst for several financial sector reforms. They thought that FSAP teams were most helpful when sharing the experiences of other countries, when acting as a sounding board for authorities' analysis and plans, and in advising on international best practices. At the same time, they explained that there had been areas of disagreement with IMF staff on some issues. Both the 2012 and the 2016 FSSAs highlighted the importance of unifying the supervisory framework. Specifically, both reports identified "significant deficiencies in operational independence, budget autonomy, and legal protection" emphasizing that a "fully functioning consolidated supervision framework is not in place" (FSSA, 2016). While some officials in the Ministry of Finance considered the discussion about unification of supervisory authority and budgetary independence to be constructive, others, particularly in Banxico, were confounded by why the IMF would place such strong emphasis on issues about which there is no professional consensus. Regarding the 2016 FSAP recommendations on crisis management and resolution, authorities thought the Fund came with prescriptive approaches that were not necessarily applicable to them.[6]

Macrofinancial linkages and stress tests

11. Authorities indicated that sometimes the Fund did not sufficiently take into account local conditions and institutions when conducting stress tests and other financial stability assessments. The Fund's macrofinancial modeling and simulations were adequate, and similar to what the Banco de Mexico had developed for their own use. Authorities emphasized that discussions with the FSAP team on stress tests were useful in validating their own methodologies. However, they were frustrated by IMF staff insistence on conducting tests that they did not consider meaningful and that were difficult to run. As an example, officials underscored that the Fund's standard of adopting a five-year horizon for stress testing was too burdensome and unrealistic for Mexico's quickly evolving financial landscape. Their models are built for a three-year horizon, which they consider appropriate for Mexico's stage of financial development. In interviews, Fund staff largely accepted the authorities' criticism and recognized that the models used by the authorities—especially by Banxico—are adequate and in fact quite sophisticated relative to other emerging markets. Given the level of sophistication in stress tests and financial stability assessments already conducted by the authorities, Fund discussions should focus on the concerns and directions for solution, rather than on differences regarding technical and methodological issues.

12. The authorities found great value in financial stability discussion forums organized by the IMF, where authorities can learn from the experience and expertise of other countries.

Frequency of FSAPs

13. Most officials agreed that the 5-year frequency of FSAPs was adequate for Mexico. One senior government official suggested that it would be more useful if FSAP missions could take

[6] Authorities mentioned bail-ins, and the possibility that some recommendations may have been too tailor-made for advanced economies in the wake of the 2008 financial crisis and the crisis in Europe.

place every six years and made to coincide with the beginning of an administration, noting that this would greatly help to inform the incoming government's policy priorities in the financial sector. It was noted that, in this respect, the 2012 FSAP was more useful than the 2016 FSAP, since the mission's findings were published when a new government was taking over and therefore the FSAP was able to influence the design of the 2014 financial sector reform. Fund staff agreed that timing can be important for the impact of FSAPs but underscored the difficulties of scheduling FSAPs to coincide with incoming administrations. They explained that Article IV consultations could and in fact are being used as a conduit for informing the policy debate when there is a change in government.

14. Some officials thought that the changing landscape of Mexico's financial system—particularly with the increasing presence of fintech companies which had so far received very limited coverage from Fund financial surveillance—would call for more frequent engagement perhaps by conducting mini-FSAP updates every two years focused on a few emerging topics, shorter and with smaller missions. IMF staff were receptive to the idea, but noted that coordination issues with the World Bank could complicate both higher frequency FSAPs, as well as update missions between FSAPs.

15. In any case, officials indicated that FSAP reports are not user friendly. Rather than having a lengthy report with a significant degree of granular information, it might be more useful to structure the FSAP report around the Fund's concerns and recommendations, and the authorities' responses. Finally, a few officials pointed at gaps in the coverage of FSAPs. These officials would also have wanted more intense and detailed discussions, specifically, on anti-money laundering initiatives.

IV. FINANCIAL SURVEILLANCE IN ARTICLE IV CONSULTATIONS

16. Officials were broadly satisfied with financial surveillance in Article IV consultations, noting that there is much greater familiarity with the process than with FSAPs. They welcomed the exchange with IMF staff, which they characterized as very open and transparent. Although some authorities mentioned the high turnover of team members, they did not generally view this as a hindrance to the broader discussions on macroeconomic and financial issues.

17. Officials were not clear on the criteria used by Article IV missions to decide on the follow-up on the findings and recommendations of FSAPs. Some authorities thought that there was insufficient focus of Article IV consultations on the most important FSAP themes. They thought that Article IV staff reports and Selected Issues Papers should review the FSAP main concerns and recommendations, and discussions should only focus on these key issues. At the same time, follow up should continue until recommendations are fully implemented or superseded. IMF staff explained that in consultations that follow shortly after the publication of FSAP, staff reports tend to discuss most FSAP recommendations and themes at some length, but that subsequent consultations tend to focus on themes that were considered most relevant, leaving others out.

V. TECHNICAL EXPERTISE OF IMF STAFF

18. Officials generally thought that the level of expertise of the FSAP team varied widely within and between FSAP missions—a similar view was expressed by some authorities regarding Article IV missions. They saw IMF staff's comparative advantage in the macro aspects of financial stability, where their expertise is well above that of other international organizations, although not necessarily above that of Mexican experts in these areas. However, they felt that IMF expertise on financial issues was not at the level of expertise on macro issues. One senior government official noted that Fund staff lacked the market expertise to adequately advise them on potential market movements that could prove challenging for macroeconomic policymaking. This official underscored that it would be useful to complement the IMF's superior macroeconomic expertise with experts that have a deep understanding of how markets function—this would potentially make discussions with authorities more relevant for policy decisions.

19. Some authorities also underscored that there seemed to be too much turnover of mission members, leading to lack of understanding of Mexican institutions. IMF staff agreed that this was the case, but noted that there had also been a lot of turnover within the Ministry of Finance, which made discussions somewhat complicated, especially during intensive and time-consuming FSAP missions.

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Chapter 6—IMF Financial Surveillance of the United States

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EXECUTIVE SUMMARY

This paper assesses the relevance, technical quality and influence of the IMF's surveillance of the U.S. financial system. The main conclusion can be summarized simply: it is important to distinguish between quality and influence in assessing the IMF's work in this area.

The financial risks that have been noted for the U.S. in recent Article IV surveillance, assessments under the Financial Stability Assessment Program (FSAP) and in *Global Financial Stability Reports* (*GFSRs*) all seem to be relevant and reasonable. The coverage, especially in the 2010 and 2015 FSAPs and in the *GFSRs* over the 2012–17 period, also appears to be quite comprehensive. In fact, the coverage was seen by many observers as perhaps too inclusive.

The tools used for the IMF assessments appear to be varied and generally well suited to the task, offering complementary and more comprehensive perspectives on the state of the U.S. financial system. U.S. authorities, when asked for their views on the IMF's work in this area, and how it compared with that of other official institutions and private sources, gave it high marks and remarked that in many respects the IMF was best in breed.

However, the IMF's financial surveillance work seems to lack influence or traction in the U.S. official community. The message here was virtually unanimous. The GFC and the improved focus of IMF surveillance do not seem to have had any evident effect on the willingness of U.S. authorities to accept outside advice. Fund staff, nevertheless, reminded us that the IMF serves a much broader audience that includes the general public, financial markets, foreign authorities and other multinational institutions. Sharing information about recent developments in the U.S. therefore should help promote the efficiency, safety and soundness of financial markets around the world, and might even influence U.S. legislation through the backdoor by sensitizing foreign government officials to emerging issues and by helping to shape opinion in the business community.

I. INTRODUCTION

1. This paper has three main objectives. The first is to assess the relevance, technical quality and influence of the IMF's surveillance of the U.S. financial system; the second is to compare its post-crisis surveillance with its pre-crisis surveillance; and third is to identify any gaps in the process and to provide suggestions for improvement. The analysis draws importantly on a series of interviews that the author had with current and former senior staff at the IMF, the U.S. Treasury and the Federal Reserve ("the Fed"), as well as a careful review of internal and external IMF documents. It is one of several background papers that are being drafted as input for a more wide-ranging assessment of the IMF's financial surveillance activities by the Independent Evaluation Office (IEO).

2. The IEO conducted an evaluation of *IMF Performance in the Run-Up to the Financial and Economic Crisis—IMF Surveillance in 2004-2007* immediately following the Global Financial Crisis (GFC) (IEO, 2011), with a view to determining the various factors that might explain the IMF's failure to anticipate the nature and severity of the crisis—recognizing that the IMF was not alone in this regard. Several analytical and institutional weaknesses were identified that contributed to the disappointing performance, and a number of related recommendations for improvement were made. IEO (2011) provided a sobering assessment of how the IMF had failed to fulfill its most important mission.

3. The present paper can be viewed as a follow-up to this earlier work—ten years after the crisis began—examining whether the steps that have been taken by the IMF are likely to improve the prospects for the timely identification and remediation of future risks to the U.S. financial system.

4. The remaining sections of this paper are organized as follows. Section II reviews the major documents that the IMF prepares as part of its surveillance of the U.S. financial system. Section III assesses the IMF's performance over the most recent period, while Section IV investigates some potential gaps in the surveillance process. Some recommendations for improving the traction of the IMF's surveillance are provided in Section IV, and the paper concludes with some final thoughts.

II. REVIEW OF THE MAJOR FINANCIAL SURVEILLANCE DOCUMENTS

5. This section reviews the three major documents that form an integral part of the IMF's surveillance of the U.S. financial system and discusses the central issues that were identified in the course of our examination.

A. U.S. Article IV Consultations (Article IVs)

6. Article IV consultations and the resulting staff reports are the centerpiece of the IMF's surveillance exercise, providing and drawing on material from the *WEO*, the *GFSR*, and—perhaps most importantly—the assessments prepared as part of the FSAP.

7. Although several changes are evident when one compares the pre- and post-crisis Article IV documents, the basic format and tone are quite similar. It would be a mistake, therefore, to exaggerate the differences. Many of the same supporting documents were used prior to the crisis (the exceptions being the Spillover Reports, which were introduced after the crisis, and FSAP outputs, which were not produced for the Unites States before the crisis). In addition, bilateral developments were interwoven with multilateral developments in an attempt to provide a more complete picture.

8. One notable difference, of course, is the greater attention that is now paid to risks and vulnerabilities within the U.S. financial system.[1] While the financial reporting might not be as extensive on every occasion, this needs to be put in perspective. The importance of financial concerns should be expected to vary over time relative to that of other issues, and there is a constant fight for position in the Article IV staff report. Difficult decisions have to be made about which issues need to be featured. Unlike the FSAPs and *GFSRs*, which are devoted exclusively to financial matters, Article IVs are required to cover a wide sweep of macroeconomic, structural and financial stability questions. Some culling is inevitable, therefore, and difficult decisions have to be made about which financial issues are most critical and how they compare to other, non-financial, issues.

9. In addition, one might also argue that the chastening effect of the crisis coupled with the reforms initiated under Basel III and Dodd-Frank,[2] have given the IMF less to worry about—especially in the case of the U.S.

10. This is not to suggest that the IMF has once again adopted a rose-colored view of the U.S. financial system. An extensive list of vulnerabilities and risks has been included in all of the recent Article IV staff reports and is presented with considerable directness and clarity. Possible external spillovers from any instability that might arise are also highlighted with specific references to the Spillover Reports. Relevant passages from the *GFSR* are also cited and a detailed list of agreed reforms and their current status is included as an Annex in every Article IV staff report, based on the most recent FSAP.

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[1] Surveillance of the financial system before the crisis received less attention and focused largely on external issues such as the U.S. current account deficit and external imbalances

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in July 2010.

11. While IEO (2011) expressed concern about the lack of directness and clarity in the IMF's pre-crisis messages, and a reluctance to speak truth to power, this was less obvious in U.S. Article IV staff reports than in those for many other countries. The direct criticism of government debt and deficits, external imbalances, and foot-dragging on a long list of structural reforms before the crisis are clear examples of a more forthright approach to Fund surveillance.

12. The same candor, directness, and questioning of authority cannot be said of issues related to financial markets prior to the crisis, but the perceived deference to official views seems to have been more a matter of mistaken belief than a reluctance to twist the lion's tail. As one senior IMF manager said, "there is a difference between being wrong and being negligent."[3]

13. More investigation could and should have been done prior to the crisis, but it does not appear that the reason for this failure was a desire to avoid confrontation with U.S. authorities or the result of political pressure from outside the Fund.[4]

14. One of the views that was often expressed in our interviews, both inside and outside the Fund, was that U.S. authorities tended to take a very laissez-faire attitude towards IMF reports. At times they might evince concern over the messaging in certain reports or take issue with some of the conclusions that were reached, but for the most they part took a hands-off approach.

15. A major reason for this is the overwhelming amount of reporting on the U.S. economy that is received from many other sources, such as investment analysts, business columnists and other official institutions, to name a few. It would be impossible and futile to react to all of the critical views that came forward. The IMF is simply one of many voices striving for attention.

B. Financial System Stability Assessments under the FSAP

16. The primary purpose of the FSAP is to identify any risks and regulatory gaps that have developed and provide a road-map for future reform efforts. They also serve as a critical foundation for *GFSRs* and Article IV consultations and an important cross-check on their analyses. For each FSAP exercise in an individual country, IMF staff prepares a summary report

[3] It is also worth repeating that many of the problems in the U.S. financial system subsequently experienced were eventually flagged by the IMF. Unfortunately, this happened rather late in the game, and their seriousness was underappreciated by both the IMF and the U.S. authorities.

[4] One cannot rule out the possibility that political pressure was exerted at the very highest level but simply not observed by other staff. Senior staff at the Fund were unanimous, however, that this was not a relevant consideration. Staff in MCM, for example, cited several instances where the Managing Director defended their position on contentious issues.

known as a Financial System Stability Assessment (FSSA) for consideration by the Executive Board, as well as a range of supporting documents.[5]

17. Two FSAPs have been completed for the U.S.—one in 2010 and the other in 2015 (see IMF, 2010; 2015). The U.S. authorities for the most part regarded them as useful, if painful, exercises. They saw the FSAPs as a helpful driver for inter-agency cooperation and the sharing of information, and thought the documents provided useful support for the adoption of improved financial regulations and oversight mechanisms. The IMF was seen as a credible and independent sounding board with "no skin in the game." Importantly, there appears to have been very little disagreement at the end of each exercise over any of the FSAP observations. Essentially all of the recommendations that came forward seemed to be accepted and were in the process of being acted upon—perhaps because they were pushing on an open door (i.e., they were things that the U.S. authorities had already decided needed correcting).

18. U.S. authorities remarked that while little or nothing new was revealed regarding the state of the U.S. financial system, the FSAP outputs that were published for other countries did provide potentially useful information on the state of the financial sectors elsewhere. FSAPs were simply the dues that the U.S. had to pay in return for getting this reconnaissance.

19. Despite this generally positive though lukewarm assessment, several of the people who were interviewed questioned the amount of time and effort that had to be devoted to these exercises ("no rock was left unturned"). They suggested that the primary benefit from their participation was to demonstrate that the U.S. was a team player.

20. The stress tests that were conducted as part of each FSAP were cited as a prime example of unnecessary duplication. U.S. officials noted that they had access to far more resources than the IMF as well as more detailed information. If the IMF's results and the Fed's results were similar, nothing new would have been learned; and if they differed, they would probably be rejected by the U.S. authorities. The IMF was best advised, therefore, to review the details of the Fed's exercise and satisfy itself that the methodology was sound.

21. There was also a widely shared view that too many risks were identified in the U.S. FSAPs, and that every risk was regarded as equally serious. "The barn is always on fire." A greater effort to prioritize issues and take a less encyclopedic approach to things would have been appreciated.

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[5] FSAP supporting documents may include Technical Notes, which provide additional background information and analyses, and Detailed Assessments of Observance of relevant financial sector standards and codes. The results of detailed standards and codes assessments are summarized in Reports on Standards and Codes (ROSCs) and accompany the FSSA. Publication of FSSAs and accompanying ROSCs is presumed but not mandatory, and publication of Technical Notes and Detailed Assessment Reports is voluntary.

22. The first FSAP, in 2010, was subject to some inevitable awkwardness and difficulty as participants felt their way along, but the second evidently went more smoothly. Some officials said it would be helpful if IMF consultants had more familiarity with FSAPs in other countries and could use them to put the state of play in the U.S. in better perspective. They realized, however, that the demands this would place on the team might be unreasonable.

23. Other officials indicated considerable frustration over the tendency of some FSAP staff to draw on experiences taken from countries that faced entirely different challenges, especially small less-developed economies. They would have preferred FSAP teams to have a deeper understanding of the U.S. financial system itself. They noted that the IMF's resource requirements would be significantly reduced if its FSAP efforts focused on the five or six financial systems in the world that were truly systemic. In their view, it was a mistake to spread them over twenty-nine economies as at present.[6] This was cited as an obvious example of the Fund bowing to political pressure and not wishing to hurt the sensitivities of certain member countries by designating them non-systemic.[7]

24. U.S. officials also expressed irritation over the pressure that they regularly experienced in the course of FSAP examinations to share confidential information with IMF staff. Legal constraints made this impossible but did not stop the requests from coming.

25. Looking beyond their experience with the U.S. FSAP, U.S. officials highlighted two broader issues with FSAPs. First, noting the importance that they give to the detailed assessments of standards and codes in other countries, one official noted that they were aware that sometimes, at the request of authorities, a detailed assessment of observance of the Basel Core principles was not conducted, despite recent institutional changes. Second, U.S. officials indicated that it was difficult to locate and access summary reports of these detailed assessments, i.e. Reports on the Observance of Standards and Codes (ROSCs), on the IMF's public website. These officials indicated that from their perspective these issues seriously reduce the usefulness of FSAPs by making it difficult for authorities to assess vulnerabilities elsewhere and conduct meaningful cross-country comparisons.

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[6] FSAPs are currently mandatory every five years for 29 jurisdictions deemed by the IMF to have systemically important financial sectors. Alternatively, it was suggested by interviewees that FSAPs for the remaining 23 or 24 countries might be conducted on a less frequent basis.

[7] Views on this were divided, however. Some people we talked to believed that FSAPs for countries such as the U.S. were a waste of time, as were the stress tests that the IMF conducted. It would be better, in their view, if the IMF focused on those countries that would really benefit.

C. Global Financial Stability Reports

26. *GFSRs* complement other IMF surveillance documents by providing a wider view of international financial pressures and cross-border linkages and giving users a better sense of the most important risks facing the global financial system.

27. Unlike Article IV staff reports, *GFSRs* deliberately focus on the "dark side," viz. the most worrisome emerging risks and their possible consequences. In the *GFSRs*, as opposed to the Article IVs, there is no attempt to present a balanced picture with upside and downside risks carefully weighed in order to provide a best estimate of the most likely economic outcome. In this sense, they are more like the Financial Stability Reports that many central banks publish, as opposed to their Monetary Policy Reports. Unlike Article IVs, *GFSRs* also have a more flexible timeframe that can often extend well into the future rather than one or two years.

28. U.S. authorities' views on the extent to which the *GFSR* has managed to accomplish its main objectives were generally positive. Although some criticized it for trying to cover too many topics in the Chapter 1, others commented favorably on a more focused presentation in recent reports that also have a more user-friendly format. Authorities also admitted that the *GFSR* deserved credit for warning about some of the serious risks that were emerging just prior to the GFC. Few other official reports, inside or outside the Fund, displayed similar perspicuity or gave sufficient attention to these issues.[8]

29. While our interviews uncovered some evidence of irritation on the part of IMF staff who were not involved in the *GFSR* exercises, and who accused their *GFSR* counterparts of occasional grandstanding, there was broad agreement that the analyses were usually on target.

30. Authorities in other countries and some external analysts also observed that the U.S. financial system had received less attention over the past few years than one might have expected given its pivotal position in the global financial system. However, this can perhaps be credited to the fact that the U.S. economy recovered much faster than most other economies following the crisis and had also made more progress on financial reform. While the IMF has been careful to note that more needs to be done with regard to structural reform, supportive macroeconomic policy and financial sector reform, it was understandably preoccupied over much the recent period with the financial crises in Europe, growing signs of instability in several emerging market economies, and mounting geopolitical risks which threatened the entire global economy. When the U.S. has been featured in *GFSRs*, it is often with a view to drawing comparisons between the improved state of the U.S. financial system relative to those in other countries—especially with respect to the banking system and household balance sheets.

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[8] Unfortunately, these warnings came rather late in the game and their seriousness was underappreciated by both the IMF and the U.S. authorities.

31. Now that some of the risks in other countries have receded, somewhat more attention has been devoted to the U.S. in the last two or three *GFSRs*. This is not a sign that risks in the U.S. financial system have necessarily increased in an absolute sense (although they may have), but rather that they have risen in a relative sense, as risks in other countries diminished. Areas of concern that have been flagged for the U.S. have included: increasing risks in the nonbank sector, the problems posed by low-for-long interest rates and the search for yield, rising leverage in nonfinancial corporations and declining credit standards, and the dire consequences that might attend a bumpy exit from unconventional monetary policy.

32. Suggestions for further improvements to the *GFSR* that were offered in the context of our interviews included: passing along an advance copy of the *GFSR* to another body (e.g., the Fed) for vetting before it was released; fast-tracking the editing of the first chapter in the *GFSR* to prevent its current analysis from getting stale; and assigning a letter grade to each of the systemically important countries indicating how secure its financial system was.[9] The latter was mentioned, half facetiously, as a means of fostering more cross-country competition on the financial reform front. It is not clear, however, if any of these suggestions would ever be actionable.

III. Overall Assessment of the IMF's Performance

33. Have the changes that the IMF has made since the crisis had any noticeable effect on the perceived performance of its financial surveillance for the U.S.? How does it measure up in terms of the three criteria that were listed at the beginning of the paper—relevance, quality, and traction? Have the efforts to improve its inputs led to better outputs?

A. Relevance

34. Relevance is a broad category referring to the value added by the Fund's surveillance, most particularly, its ability to perceive emerging risks to the financial system and provide helpful advice on how to address them. In this sense, it is closely related to the reliability, breadth and completeness of Fund surveillance. Success in this regard can be assessed from a number of perspectives.

Does anything appear to be missing?

35. One approach to judging success would be to wait to see if a crisis actually occurs, as happened in 2008. This would be unhelpful for a number of reasons, of course, and an unreliable gauge of performance in any event—at least without further investigation. If there were a crisis, it might have been correctly identified by the IMF but the authorities might have refused to act. (Admittedly this was not the case in the most recent crisis.) Alternatively, if a warning were issued

[9] In other words, the IMF would become a kind of official rating agency.

but nothing happened, other developments (such as effective remedial action) might have saved the situation. More specifically, we could be subject to a Type I or Type II error.[10]

36. Stepping back and taking a somewhat wider view, there is no doubt a more promising, albeit less conclusive, way of measuring the relevance of IMF surveillance—one that does not rely on outcomes and a wait-and-see strategy. Tentative judgements can be made ex ante about whether the risks that the IMF has identified appear to be significant, comprehensive, and convincing. Do all of the material risks that one might reasonably imagine seem to have been flagged and presented in a credible and persuasive manner?

37. On this basis, the IMF appears to be doing a thorough and conscientious job. The financial risks that have been noted for the U.S. in recent Article IVs, FSSAs, and Global Financial Stability Reports all seem to be relevant and reasonable. The coverage, especially in the 2010 and 2015 FSSAs and in the *GFSRs* over the 2012-2017 period, also appears to be quite comprehensive. Indeed, some people have suggested the coverage might have been too comprehensive.

Coverage of the Shadow Banking System

38. The three sets of documents reviewed above identify risks in the shadow banking system including: (i) inflated prices across a wide range of financial assets; (ii) rising indebtedness in the form of auto and student loans; (iii) the credit cycle and increased leverage in non-financial corporations; (iv) financial strains in the insurance industry combined with diffuse official oversight; (v) data "blind spots" for many parts of the shadow-banking sector; and (vi) concerns about the systemic risks posed by investment funds and pensions.

39. None of these, however, was believed to pose an immediate threat to the stability of the U.S. financial system.

Coverage of the Banking System and Households

40. More satisfaction is expressed by the IMF with the state of the U.S. banking sector, housing prices, and the general level of household debt.

41. "Authorities' Views," which are presented at the end of each section in Article IV staff reports, indicate very little difference in opinion between the authorities and IMF staff regarding this characterization of bank, household and nonbank financial stability concerns—perhaps not surprisingly. Although some of the people outside the Fund who were interviewed questioned the importance of some of the risks that the IMF had identified (e.g., rising corporate debt), at a

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[10] A Type I error is better known as a "false positive" error, i.e. falsely inferring the existence of something that is not there, while a Type II error is better known as a "false negative" error, i.e. falsely inferring the absence of something that is there.

minimum, the Fund's work seemed to have provoked a productive discussion and a careful re-examination the issues.

The IMF's role as a valued neutral observer and reform advocate

42. Viewed even more broadly, the relevance of the IMF's work should not be gauged solely on the basis of whether potential problems are correctly identified. Helping the financial sector operate more efficiently and smoothly is also an important part of the IMF's mandate (i.e., making things better, not just avoiding calamity). On this score, the IMF also received generally positive grades.

43. IMF efforts to better understand how the financial system works is of definite value, as are the monitoring exercises that it regularly undertakes to promote the adoption of improved financial codes and standards. Its global perspective and respected neutral third-party position give it a comparative advantage not shared by many other institutions. Although there is some overlap with the work of the OECD, the Bank for International Settlements (BIS) and the Financial Stability Board (FSB), the IMF is in many ways unique as an international monitor and auditor. No other institution has the same ability to capture the synergies associated with rigorous bilateral and multilateral financial surveillance. The greater effort now devoted by the IMF to financial surveillance increases the likelihood of improved products for the U.S. and others.

B. Analytical Tools and Quality of the Staff

44. Technical quality is another aspect of the IMF's operations that is critical for surveillance success. It involves two essential components: capable staff and technical support and tools. The interviews that were conducted inside and outside Fund were informative in this regard.

Quality of staff

45. In terms of personnel, the comments we received from policymakers at the Fed, the U.S. Treasury and other outside sources were generally very positive regarding the quality of IMF staff. They noted that IMF staff frequently publish articles in respected academic journals, were regularly invited to external conferences, and were often asked to co-author papers with well-known economists.

46. Views expressed inside the Fund concerning the quality of their colleagues who were working on U.S. issues in departments other than their own were also quite positive. Although one might expect an element of bias in these favorable peer assessments, critical and candid observations provided by IMF staff on other topics in the interview process suggested otherwise. Indeed, IMF staff are usually quite eager to participate in assessments of the U.S., owing to its importance in the global system, and as a result are often thought to be of higher average quality than those in other country studies.

47. The attraction of working on U.S. issues can be both a blessing and a handicap, however. Even as it facilitates the recruitment of high quality staff, it also attracts increased interest across the organization, with everyone wanting to have their views recognized and "share in the glory." This can complicate the editing process significantly and at times require unhelpful compromises.[11]

Technical support and tools

48. Economists at the IMF have access to a broad range of data and technical support that are not usually available to researchers elsewhere.[12] It is important to note, however, that although the empirical work frequently relies on sophisticated statistical tools and models, this is not done to the exclusion of other, more low-tech, approaches such as spread sheets and a careful examination of firm level financial statements.[13] The tools that are being used, in other words, appear to be varied and generally well suited to the task, offering complementary and more comprehensive perspectives on the state of the U.S. financial system.

49. While many of these positive technical qualities were also evident in much of the work done prior to the crisis, it has evolved since then along with the economics profession more widely. Some of the modelling and data limitations that hampered earlier analyses have been overcome, or at least reduced, and the IMF's more recent work has taken advantage of these advances.[14] Financial stability analysis nevertheless remains a work in progress.

50. U.S. authorities, when asked for their views on the IMF's work in this area, and how it compared with that of other official institutions and private sources, gave it high marks and remarked that in many respects the IMF was best in breed. There was no other institution, in their view, that they would place ahead of the IMF for careful bilateral and multilateral surveillance.[15]

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[11] These compromises are described in greater detail in the recommendations section of the paper.

[12] One caveat could be noted here. As mentioned previously, staff are unable to access the confidential information that various U.S. agencies collected owing to legal restrictions.

[13] Staff working on the *GFSR*, for example, indicated that they were making much greater use of micro-data.

[14] See, for example, the detailed market and firm-level data that the IMF has recently acquired and the new solution techniques that have been developed allowing Dynamic Stochastic General Equilibrium models to include more elaborate and realistic representations of the financial sector.

[15] The BIS is also highly regarded, though here too the authorities thought the IMF compared very favorably, albeit with a slightly different mission. The FSB and Basel Committee, it was suggested, are mainly responsible for the design of financial reforms, while the IMF is mainly responsible for monitoring the implementation of reforms and the identification of risks. This is not to suggest that there are no border skirmishes about who should be doing what. One or two people who were interviewed felt the Memorandum of Understanding (MOU) that had been agreed between the Financial Stability Forum (FSF) and the IMF some time ago was in need of an update (IMF-FSF, 2009).

(However, this did not prevent several of the U.S. authorities from suggesting that they could do a better job themselves. See below.)

C. Traction and Influence

In official U.S. circles

51. The IMF's surveillance did not score very highly with regard to its influence on the thinking or actions of U.S. policymakers. Relevance and solid technical analysis, did not translate into much observable traction in U.S. policymaking circles. The message here was virtually unanimous. Comments made at the U.S. Treasury and the Fed essentially conveyed that the IMF does not provide anything that they really need and cannot do better themselves and that the documents produced are interesting, but not very informative.

52. While this could reflect the sort of closed institutional mindset that contributed to the GFC, a number of reasons were given in support of this rather dismissive attitude. The first concerned the access that the Fed and the Treasury had to superior resources.[16] The second concerned the access that these agencies had to more detailed and confidential information, which only they are allowed to see. In other words, while the IMF might be better than its counterparts outside government, the Treasury and Fed believed that they had little or nothing to learn from the IMF, at least regarding developments in the U.S. financial system.

53. When pressed, U.S. officials acknowledged that the IMF's work could prove useful in other respects however. For example, it might provide an informed second set of eyes with which to test ideas and confirm the authorities' own views. It could also help to socialize or sell emerging issues and generate political support for contentious policy recommendations. In addition, as noted earlier, it might help authorities by alerting them to risks that existed elsewhere in the global economy. Finally, the regular monitoring that the IMF provided with respect to how much progress had been made on the updating of rules and regulations might help support the reform effort.

In the broader global community

54. Before drawing any definite conclusions regarding the traction and influence of IMF surveillance in official circles, it is important to remember that there are other important stakeholders beyond the U.S. official sector. While Fund staff were aware of how little traction their work might have at the Fed, the Treasury and U.S. agencies, they reminded us that the IMF served a much broader audience. It is expected to inform the general public, financial markets, foreign authorities and other multinational institutions about recent developments in the U.S. and possible concerns that the IMF might have. Sharing this information should help promote the efficiency, safety and soundness of financial markets around the world, and might even

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[16] This was linked mainly to the number of researchers that the Fed and the Treasury have at their disposal to study the U.S. economy, but not exclusively. While the quality of Fund staff was judged to be very high, some of the U.S. officials who were interviewed believed the quality of their own staff was even higher.

influence U.S. legislation through the backdoor by sensitizing foreign government officials to emerging issues and by helping to shape opinion in the business community.

IV. POTENTIAL GAPS

55. No major gaps were noted in the course of our investigation in the IMF's coverage of U.S. financial sector issues. In fact, the coverage was seen by many observers as perhaps too inclusive. Nevertheless, one possible omission might be noted.

Three kinds of surveillance

56. The IMF's financial surveillance activities of the U.S. financial system can be grouped under three main headings. The first and probably most important activity is the identification of emerging risks and vulnerabilities; the second involves a regular and rigorous assessment of how well the U.S. is doing with regard to fulfilling the commitments it has made for financial sector reform; and the third is providing a critical view on whether the reforms that have been promised are sufficient to significantly lower the risks facing the financial system.

57. As noted earlier, the IMF has done a reasonably thorough job in terms of fulfilling its first two responsibilities—near-term risk identification and monitoring progress on the reform effort. It has also taken strong positions on whether the reforms that are being put in place in most areas of the financial system are likely to have their intended effect on crisis reduction and improved resiliency. Much of the attention in this third leg of the surveillance effort has been directed towards regulatory and data deficiencies in the shadow banking system as well the work on Financial Market Infrastructure (e.g., derivatives markets and central clearing and payments systems).

58. Nevertheless, some observers have suggested that this does not go far enough. They argue that the IMF should be taking a much more critical view of the reforms that have already been agreed and giving the policy debates that surround them a greater profile.

Casting a more critical eye on banks

59. One could argue that the absence of a sufficiently critical mind set is perhaps most evident in the banking sector where issues such as capital adequacy, perverse pay incentives and the too-big-to-fail problem remain hotly-contested subjects. Moreover, these concerns seem to stand in sharp contrast with the largely positive assessment that the IMF has given the U.S. banking sector in its recent documents.

60. At least three possible counter arguments can be offered in response to this criticism. First, the IMF may believe that enough has already been done, or is in process, to strengthen the U.S. banking sector. Results from the numerous stress tests that U.S. authorities and IMF staff have conducted over the past few years could be cited in support of this view. Second, Fund staff may have judged that relative to the needs in other sectors it was best to focus their attention

elsewhere in the U.S. financial system and to pick their fights where they mattered most. Third, staff may have determined that banking reforms in the U.S. had been driven as far as they can feasibly go in light of the industry response and the political environment at this time. U.S. banks are already believed to have more and higher quality capital than most of their European and Asian counterparts. Pushing much further in the U.S. might risk losing what has been gained to date. Indeed, looking ahead, the main mission of the IMF's surveillance exercises may be to guard against any significant weakening of the existing regulatory and supervisory framework, particularly in the banking area.

61. On balance, therefore, we are not inclined to judge the IMF too harshly in terms of its performance on the third leg of its financial surveillance activities. We conclude that it has done a reasonably thorough job in this area as well.

V. Recommendations and Other Observations

A. Recommendations

62. Two major recommendations can be offered following this review of the IMF's surveillance of the U.S. financial system. However, there is reason to believe they have broader applicability for many of the IMF's bilateral and multilateral surveillance activities. The first is what one might call "less is more," and the second concerns the extent to which the Fund's various financial surveillance activities need to be more clearly delineated.

Less is more

63. Several of the authorities who were interviewed suggested that the IMF's financial surveillance documents tried to be too comprehensive and "analyze every blade of grass." Some thought this might reflect a strong desire on the part of staff never to be caught out again or accused of overlooking an issue that later proved to be important. Others felt this was driven by an overly mechanical approach to surveillance, in which the same methodology was applied to every country in the name of "equal treatment."

64. As an alternative to this encyclopedic approach, a more selective and nuanced process was recommended by many observers, reflecting the country's specific circumstances and challenges.

65. Shorter and more individually-tailored documents might simplify the surveillance process, reducing time and effort on the part of both examiners and examinees. More

importantly, it could also improve the impact of IMF surveillance and lead to more focused and productive exchanges between IMF staff and the U.S. authorities.[17]

Respecting different mandates

66. A related but distinct issue involved a potential confusion over the separate functions that each IMF document is expected to fulfill. This requires IMF staff to put different emphasis on certain parts of the surveillance process, and one would not want to lose the additional color that they provide by making their products too similar. While it is important to provide a consistent message across the various documents and avoid apparent contradictions, it is also important for people inside and outside the Fund to appreciate the different objectives underlying each document. The documents are expected to draw material from one another, as appropriate, and not contradict one another; but their different perspectives also have to be respected. Too much overlap could lead to wasteful repetition and create unnecessary friction among different IMF divisions, as staff struggle to negotiate a common party line.

67. Some annoyance was observed, for example, between the group responsible for drafting the *GFSR* and other groups in the IMF. The *GFSR* was accused by some of being too provocative and dramatic in its pronouncements—more interested in chasing headlines than shedding light on issues. This was countered by a view that the *GFSR* was expected to be more provocative and to focus on the dark side—this was *GFSR*'s mission.

68. The FSAP offers another interesting example of separate missions, as well as the benefits that might be realized by sharpening its focus. The most important part of the FSAP's mandate, one person suggested, was to benchmark the progress that had been made implementing the financial reforms that were agreed after the GFC and to identify gaps in the financial system more generally. The FSAP's five-year cycle meant that it was poorly suited to flagging near-term risks in a timely fashion. It was best left to pursue its main mission.

B. Other Observations

69. Various other comments and suggestions came forward as part of our investigation.

(i) *Speaking with a louder voice*. The IMF's surveillance might have more traction if more direct language were used in the messaging. Although the IMF's reporting on the U.S. economy was already regarded by several observers as quite direct, there might be some advantage to taking it to a higher level. Speaking with a soft, diplomatic voice may be part of the IMF's culture, but the compromises that are made in the drafting process as

[17] Using the same template for everyone may also contribute to a rather clinical and formal atmosphere that some authorities said characterize many of the meetings they have with the IMF. One official said that he felt like a witness giving a deposition owing to the stilted atmosphere. He believed the all-inclusive, mechanical process followed by the IMF, in which every box is checked, fostered this sort of officious attitude.

the reports pass through numerous departments might also be contributing to the lack of traction. The laissez-faire attitude attributed to U.S. authorities should give IMF staff greater license to speak more forcefully.

(ii) *Making the GFSR data more accessible.* The *GFSR*, unlike the *WEO*, does not publish in a systematic way the data that are used in its analyses. Although some of these series may be bound by confidentiality agreements, making the rest readily accessible could be a significant benefit to researchers outside the Fund.[18]

(iii) *Making the ROSCs more user friendly*. As noted earlier, officials urged that the IMF make detailed assessments of observance of standards and codes a mandatory part of the FSAP exercise. Moreover, they emphasized the need to make ROSCs easier to locate, access, and use for cross country comparisons.

VI. CONCLUSIONS

70. The main conclusion of our investigation can be summarized simply: it is important to distinguish between quality and influence when assessing the IMF's surveillance of the U.S. financial sector.

71. The relevance of the Fund's surveillance and the quality of its reports (and staff) are judged to be "very good, an A-." They are as good or better than the financial reconnaissance available from other sources outside the U.S. Government. Moreover, there is evidence that the many of lessons of the GFC have been taken on board by the IMF, as well as the recommendations that came forward from IEO (2011). Nonetheless, considerable humility is still needed when gauging the stability of financial systems. Only time will tell if all the relevant risks and vulnerabilities have been identified, and if effective measures have been put in place to reduce the likelihood and severity of future crises.

72. In terms of influence or traction, however, a significant gap remains. Improving the reports in the manner suggested above might help to narrow this gap, but U.S. authorities are likely to remain a very challenging audience. The GFC and the improved focus of IMF surveillance do not seem to have had any evident effect on the willingness of U.S. authorities to accept outside advice. In this respect, the IMF and the U.S. authorities are like "ships passing in the night," briefly greeting one another but then quickly moving off (with at least one of the parties largely ignoring the other).

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[18] IMF staff noted that all data which is not confidential is already available on the *GFSR*'s public website. But this is an issue raised also by authorities in other countries, suggesting that there is room to improve its accessibility.

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