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BACKGROUND PAPER

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IMF Bilateral Financial Surveillance

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Contents Page

ABBREVIATIONS

BSR	Biennial Surveillance Review (IMF)
CEMAC	Central African Economic and Monetary Community (Gabon, Cameroon, the Central African Republic, Chad, the Republic of the Congo, Equatorial Guinea)
DGI	Data Gaps Initiative (G20)
EFSL	Enhancing Financial Sector Surveillance in LICs (IMF)
EMBI	Emerging Markets Bond Index
FSAP	Financial Sector Assessment Program (IMF–World Bank)
FSPN	Financial Stability Policy Note (IMF)
FSSA	Financial System Stability Assessment (FSAP)
FTE	full-time [staff] equivalent
G7	Group of Seven (Canada, France, Germany, Italy, Japan, United Kingdom, United States)
G20	Group of Twenty (G7 plus Argentina, Australia, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, European Union)
GFC	global financial crisis
ICM	International Capital Markets Department (IMF)[1]
IEO	Independent Evaluation Office (IMF)
IMF	International Monetary Fund
ISR	Interim Surveillance Review (IMF)
LIC	low-income country
LTV	loan-to-value
MAE	Monetary and Exchange Affairs Department (IMF)[2]
MCM	Monetary and Capital Markets Department (IMF)
MFD	Monetary and Financial Systems Department (IMF)[3]
NPL	non-performing loan
PDR	Policy Development and Review Department (IMF)[4]
SDDS	Special Data Dissemination Standard
SME	small and medium-sized enterprise
SPR	Strategy, Policy, and Review Department (IMF)
TSR	Triennial Surveillance Review (IMF)
WAEMU	West African Economic and Monetary Union (Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo)

[1] Merged with MFD in December 2006 to form MCM.

[2] Name changed to MFD in May 2003.

[3] Merged with ICM in December 2006 to form MCM.

[4] Name changed to SPR in September 2008.

EXECUTIVE SUMMARY

The paper assesses aspects of IMF bilateral financial surveillance, primarily drawing on 15 case studies but also utilizing a desk review of IMF documents and interviews with additional member country officials. The IMF has been making concerted efforts to strengthen its financial surveillance since the aftermath of the Mexican crisis in the mid-1990s, with numerous initiatives and other institutional innovations. Following the global financial crisis in 2008, the IMF's efforts have moved beyond expanding the coverage of financial sector issues in surveillance to intensifying its focus on better integrating macroeconomic and financial analysis. Macrofinancial integration has become an institutional priority, with the launch of a pilot initiative in 2014 and the issuance of a new Staff Guidance Note in 2015.

This paper generally provides a positive assessment of the fruits of these sustained efforts for bilateral surveillance, confirming that the overall coverage of financial sector issues and macrofinancial linkages has indeed expanded over the recent decade, especially in non-systemic countries (the coverage was high to begin with in systemic countries) and, in the views of most officials interviewed, the quality has also improved. Even so, there is a sense that coverage remains uneven, and the refocusing of attention on systemic countries has to some degree come at the expense of non-systemic countries, given the increasingly binding resource constraints. Much of the coverage of macrofinancial links in Article IV consultations is limited and pro forma, except when it benefits from a concurrent or recent FSAP or related technical assistance activity.

Effective surveillance is ultimately hampered by difficulties fundamental to the very nature of financial surveillance, not least data gaps and the absence of a well-established, quantifiable model of real-financial linkages. Even so, IMF staff has worked hard to overcome these obstacles to identify risks and vulnerabilities and to explore the macroeconomic impact of financial sector developments, especially in large systemic countries. The authorities of these countries express general satisfaction with the quality of the IMF's financial sector analysis, even though they do not find that Fund surveillance necessarily identifies risks or issues unknown to them. Those in other countries appreciate the useful roles of IMF financial surveillance but are more likely to complain that the staff lacks requisite financial sector expertise or country-specific knowledge.

The paper concludes that macrofinancial integration in bilateral surveillance remains a work in progress despite recent improvements, a view repeated by the succession of internal reviews over the past decade.

I. INTRODUCTION

1. This paper assesses aspects of IMF bilateral financial surveillance, thereby providing input to the IEO's evaluation of the IMF's overall financial surveillance. The paper primarily draws on the 15 case studies prepared for the evaluation, and the author's visits to five other countries to help cross-check the robustness of the conclusions.[1] In addition, the author conducted a content analysis of the staff reports for the Article IV consultations with 40 countries over 2011–17 (three reports for each country for a total of 120 Staff Reports), and reviewed internal and published IMF documents. He also utilized the results of an IEO survey of IMF staff as well as the thematic background papers prepared for the evaluation.

2. Surveillance is one of the main IMF activities—obligatory on the part of both the Fund and member countries. Article IV of the IMF Articles of Agreement obliges the Fund to "exercise firm surveillance over the exchange rate policies of members," with a view to fulfilling its functions to "oversee the international monetary system in order to ensure its effective operation" and "the compliance of each member with its obligations" (Section 3(a)(b)). Each member country, for its part, is obliged by the same Article, among other things, to "endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability" and to "seek to promote stability by fostering orderly underlying economic and financial conditions" (Section 1).

3. Although the IMF conducts surveillance both at the individual country level (bilateral surveillance) and at the global level (multilateral surveillance), this paper primarily addresses the former, with an exclusive focus on financial sector aspects (see Zettelmeyer, 2018 for an assessment of IMF multilateral financial surveillance). The primary vehicle of bilateral surveillance is the Article IV consultation process, under which "staff holds pointed discussions with country authorities on the economic situation, the authorities' policies and how these affect the country's stability—as well as global stability through spillovers where relevant—and desirable policy adjustments" (IMF, 2015).[2] For the financial sector, another vehicle of bilateral surveillance is the Financial Sector Assessment Program (FSAP), which the IMF conducts by itself with advanced economies, and jointly with the World Bank in the case of emerging market and low-income

[1] The studies were prepared by Jeffrey D. Anderson (Germany, Italy); Akira Ariyoshi (Japan); Monica de Bolle (Mexico); Mthuli Ncube (Ghana, Kenya, Nigeria); Latifah Merican Cheong (Malaysia, Singapore, Thailand); Sanjay Dhar (Brazil); David Dollar (China); Jean-Pierre Landau (Euro Area); David Miles (United Kingdom); and John Murray (United States). These studies are referenced only when the authors' opinions are cited. The author also interviewed authorities and other stakeholders in Korea, Lebanon, the Netherlands, Switzerland, and Turkey.

[2] Since the adoption of the Integrated Surveillance Decision in 2012 (IMF, 2012c), the Article IV process is also a vehicle for multilateral surveillance, including financial sector spillovers.

economies.[3] This paper addresses the FSAP insofar as it has a bearing on Article IV consultations, leaving the substantive assessment of individual country FSAPs (and the associated stability assessments) to a companion paper prepared for the evaluation (see Caprio, 2018).

4. The legal basis of surveillance stresses the IMF's obligation to conduct exchange rate policy surveillance, but the attention paid to its surveillance over domestic economic and financial policies has increased over time as the world economy has become increasingly integrated and additional forces, including financial sector policies and conditions, come to play a larger role in influencing exchange rates. In view of the critical roles financial sector vulnerabilities played in triggering the emerging market crises of the 1990s and the global financial crisis of 2007–08, IMF surveillance has increasingly paid attention to financial sector issues, in addition to its long-standing focus on fiscal and monetary issues. To be sure, the IMF's work has always involved the financial sector, but "the intersection between the Fund's financial sector work and its surveillance activity" (IMF, 2012d)—as financial surveillance may be defined—has expanded in both depth and coverage over the past two decades.

5. The rest of the paper is organized as follows. Section II presents a brief review of the evolution of IMF bilateral financial surveillance. Section III discusses how the IMF's internal reviews have assessed the progress achieved in strengthening financial surveillance in order to identify obstacles to its effectiveness. Section IV examines the coverage, quality, and impact of IMF bilateral financial surveillance. Section V concludes by summarizing the main findings and identifying remaining issues. The Appendix provides an additional discussion on the coverage of macrofinancial links in staff reports for Article IV consultations.

II. EVOLUTION OF IMF BILATERAL FINANCIAL SURVEILLANCE

A. From the Mexican to the Global Financial Crisis

6. IMF bilateral financial surveillance began in earnest in the aftermath of the Mexican crisis of 1994–95. In early 1995, the IMF commissioned an outside expert to prepare a report examining the background to the Mexican crisis.[4] The report attributed part of the IMF's failure to detect the emerging crisis to the insufficient attention surveillance had paid to financial market developments. Following the IMF Executive Board's 1995 Biennial Surveillance Review

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[3] The IMF is responsible for the financial stability assessment component of the FSAP, which is prepared as an Executive Board document known as a Financial System Stability Assessment (FSSA). Technically, only the financial stability assessment of countries with systemically important financial sectors is considered to be a surveillance activity, with the assessment of non-systemic countries considered a technical assistance activity, provided on request rather than a country obligation.

[4] The report was prepared by Sir Alan Whittome, a former IMF Department Director and Counsellor, and is known as the Whittome Report (IMF, 1995a). Its findings and recommendations were extensively discussed in the IMF's 1995 Annual Report (IMF, 1995b). See also Gola and Spadafora (2009).

(BSR) and the Interim Committee's April 1995 meeting,[5] the IMF took measures, among other things, to "give more attention to members' financial policies and the soundness of their financial sectors" (IMF, 1995). Two years later, the Board, in discussing the 1997 BSR, called for increased attention to financial and banking system issues. This led to the issuance in July 1997 of a staff operational guidance note, which stipulated that staff reports for Article IV consultations "should include assessments of financial market developments and prospects as well as of problems and policy issues in the banking and financial sector" (IMF, 1997).

7. Despite these early efforts, the series of emerging market crises starting later that year were a stark reminder that IMF surveillance was not paying sufficient attention to financial sector developments (Lindgren and others, 1999). In April 1998, the Interim Committee called upon the Fund to intensify its surveillance of financial sector issues, including policy interdependence and risks of contagion. In June 1998, the IMF's Monetary and Exchange Arrangements Department (MAE) released a "Guidance Note for the Monitoring of Financial Systems under Article IV Surveillance," recognizing the importance of "the close interrelation between financial system soundness and macroeconomic policy implementation and performance" and stressing the need to identify "conditions and developments in the banking and the financial system and markets that may impinge upon macroeconomic conditions and policies" and "macroeconomic conditions and developments that may have detrimental effects on the financial system" (IMF, 1998). In October 1998, the Interim Committee reiterated the importance of widening the scope of the IMF's work to cover the regulation and supervision of the financial sector.

8. A series of institutional innovations followed from 1999 to 2005. First, in May 1999, a joint IMF-World Bank initiative, the Financial Sector Assessment Program, was launched on a one-year pilot basis in order to identify financial system vulnerabilities.[6] In April 2000, the Boards of both institutions agreed that the program should be continued, with coverage expanded to additional countries (IMF and World Bank, 2000). Second, the Managing Director in late 2000 commissioned a group of outside experts ("Financial Sector Review Group"), headed by John Lipsky, then Chief Economist at JP Morgan Chase, to identify how best to organize the Fund's financial sector work. In responding to the Lipsky Report's recommendations (IMF, 2001), in August 2001, management established an International Capital Markets Department (ICM) within the IMF in order to consolidate and further develop the IMF's capital market-related functions.[7] Third, in December 2006, following the recommendation of a management-appointed external panel

[5] The Interim Committee was transformed into the International Monetary and Financial Committee in 1999.

[6] The pilot included twelve countries: Cameroon, Canada, Colombia, El Salvador, Estonia, Hungary, India, Iran, Ireland, Kazakhstan, Lebanon, and South Africa. See IMF and World Bank (2000) and IEO (2006).

[7] ICM became operational in December 2001.

("Review Group on the Organization of Financial Sector and Capital Markets Work"),[8] ICM was merged with MAE's successor department, the Monetary and Financial Systems Department (MFD), to form the Monetary and Capital Markets Department (MCM).

9. Strengthening the coverage of financial sector issues became a recurring call. The 2004 Biennial Surveillance Review, for example, observed that the IMF was not adequately integrating financial sector analysis into bilateral surveillance, recognizing that, while the coverage of financial sector issues had improved, it was not on par with that of fiscal, monetary, and other macroeconomic issues. In response, in May 2005, the Fund's Policy Development and Review Department (PDR) issued a revised surveillance guidance note, in which the scope and modalities for covering financial sector issues in bilateral surveillance were clarified. The Guidance Note, for instance, stated that the "range of issues" to be covered included "financial sector issues" and "financial sector developments and policies," focusing on "assessing financial sector conditions, linkages with macroeconomic developments and prospects, and measures to address weaknesses" (IMF, 2005a). In the case of countries that had recently undertaken an FSAP, it further observed that "the main findings and policy recommendations contained in the [FSSA] should be presented in the Article IV report and integrated with the macroeconomic assessment."

10. Initiatives to strengthen financial surveillance continued through the eve of the global financial crisis (GFC). In April 2006, the Managing Director's "Report on Implementing the Fund's Medium-Term Strategy" proposed that "the coverage of financial sector issues in Article IVs … be elevated to a higher level," to "give financial issues coverage that is at least on part with, say, the traditional fiscal policy analysis" (IMF, 2006). In February 2007, the interdepartmental Taskforce on Integrating Finance and Financial Sector Analysis into Article IV Surveillance, based on a stocktaking of the existing state of financial surveillance, proposed a broad organizing framework for integrating finance into Article IV surveillance, highlighting inter alia the need to address: (i) the channels of interaction between the macro-economy, financial markets, and the financial sector; (ii) the role of the financial sector in initiating, amplifying, or muting disturbances to the economy; (iii) the diagnostic information from financial markets and the financial sector about the risks of financial crises; and (iv) the role of the financial sector in facilitating or retarding growth (IMF, 2007a).[9] In the meantime, the scale of the FSAP continued to expand (covering as many as 125 countries through mid-2009, with some of them multiple times), even though it

[8] The Review Group on the Organization of Financial Sector and Capital Markets was appointed by the Managing Director in June 2005 and chaired by William McDonough, former president of the Federal Reserve Bank of New York. The report (IMF, 2005b) was released in November 2005.

[9] The interdepartmental taskforce was established by management in response to the recommendations of the McDonough Report. Its mandate was to examine how the Fund could improve its analysis of financial issues and how this analysis could be better integrated into Article IV surveillance.

remained on a voluntary basis and therefore left out a large number of systemic countries, most notably the United States (IMF and World Bank, 2009).[10]

11. Related to, but separate from, these initiatives, the Fund was concurrently engaged in revising the legal framework of surveillance. Article IV of the IMF Articles of Agreement obliges the Fund to "adopt specific principles for the guidance of all members with respect to [exchange rate] policies" (Section 3(b)), and the Board decision adopted in 1977 on "Surveillance over Exchange Rate Policies" (the "1977 Surveillance Decision") had served this purpose for nearly 30 years. In part to reflect the profound changes that had occurred in the world economy, in June 2007, the Board adopted a decision on "Bilateral Surveillance over Members' Policies (the "2007 Surveillance Decision") following months of deliberation. Whereas the 1977 Decision had hardly made mention of financial issues under the purview of IMF surveillance,[11] the 2007 Decision explicitly defined the scope of IMF surveillance to include all member policies that "can significantly influence present or prospective external stability," including "monetary, fiscal and financial sector policies," while replacing the expression in the title "exchange rate policies" with a broader expression "members' policies" (IMF, 2007b). The impetus to revise the 1977 Decision, however, did not come from the need to strengthen financial sector surveillance, and the 2007 Decision in retrospect remained focused on exchange rate policies per se.

B. Post–Global Financial Crisis Developments

12. The financial and economic crisis that engulfed the world from 2008 provided an occasion for serious reflection and soul searching on the part of the IMF. It was apparent that, despite the years of efforts to strengthen financial surveillance, the IMF had insufficiently appreciated the severity of the vulnerabilities in the financial systems of major countries and their interconnectedness. Many lessons have since been drawn from the experience, not only for IMF surveillance, but also for the global financial architecture as a whole. Among the weaknesses identified by IMF staff were a generally sanguine view IMF surveillance had held of financial conditions in advanced countries, which tended to cause any warning to be muted;[12] and the "silo" culture of specialized financial surveillance, evidenced by "the incomplete integration of macroeconomic and financial analysis" (IMF, 2009a). The dominant "micro-prudential view"

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[10] In 2006, the IEO evaluation of the FSAP presciently observed that "current incentives for participation" was insufficient "to ensure coverage of countries where a strengthening of financial sector surveillance is most needed" (IEO, 2006).

[11] The 1977 Decision mentioned financial issues as triggering discussion with a member only in the context of "the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows" (IMF, 1977).

[12] IEO, 2011, explaining the high degree of deference IMF staff paid to the authorities of advanced countries, highlighted the roles played by "groupthink" (e.g., the presumption that "crises were unlikely to happen in advanced economies with sophisticated financial markets) or "intellectual capture" (e.g., unwillingness to challenge the national authorities thought to possess superior knowledge and greater access to information).

implicitly held that, the cases of Japan and Sweden notwithstanding, systemic financial crises were only an issue for low- and middle-income countries, as financial regulation was thought to be sufficiently robust in advanced countries (Caprio, 2018).

13. As the global financial crisis began to unfold, the Executive Board in October 2008 adopted the Statement of Surveillance Priorities for 2008–11, as part of the discussion of the 2008 Triennial Surveillance Review (TSR),[13] which identified as one of the four priority areas "integration of macroeconomic and financial sector surveillance," especially the analysis of transmission channels from the financial to the real sector. As one of the operational priorities, the Statement mentioned "financial sector surveillance and real-financial linkages," namely, to "improve analysis of financial stability, including diagnostic tools; deepen understanding of linkages, including between markets and institutions; and ensure adequate discussion in surveillance reports" (IMF, 2008). Subsequently, initiatives to strengthen financial surveillance moved in two parallel directions: (i) to strengthen the analysis and understanding of two-way links between finance and macroeconomics; and (ii) to expand the focused attention of financial surveillance to all countries with systemically important financial sectors, not just emerging market economies.

14. To facilitate the integration of financial issues into Article IV consultations, in April 2009, management issued a "Financial Sector Surveillance Guidance Note" as a complement to the broader Surveillance Guidance Note, which presented in general terms the issues to be addressed in Article IV surveillance (IMF, 2009b). The 2009 Financial Sector Guidance Note, in providing advice on approaches and analytical tools relevant for bilateral surveillance, observed that macrofinancial linkages centered on the two-way interactions between the real economy and the financial sector, outlined methodologies to assess macrofinancial stability, and provided "an organizing framework to help country teams conduct financial sector surveillance and access quantitative tools and other analytical material on macrofinancial risk assessment and policy issues."

15. To strengthen the surveillance of all countries with systemic financial systems, the FSAP was reformed in two stages. First, in September 2009, the administration of the FSAP was made more flexible, with a clearer delineation of responsibilities between the IMF and the World Bank, allowing the Fund to conduct financial stability modules separately from financial development modules by the Bank. Second, in September 2010, the Executive Board made financial stability assessments under the FSAP a "regular and mandatory part of the Fund's surveillance for members with systemically important financial sectors" (IMF, 2010). Initially, a total of 25 jurisdictions were identified as having systemically important financial sectors, based on a methodology that combines the size and interconnectedness of each country's financial sector,

[13] The 2008 TSR identified the need to strengthen macrofinancial surveillance, recommending, among other things, that a clearer organizing framework be developed for such purposes, quantitative and other methodologies be continuously updated, and macrofinancial expertise be built up further.

covering nearly 90 percent of the global financial system and 80 percent of global economic activity (Table 1). For these countries, the FSAP formally became a surveillance activity. In 2013, the number of countries with systemic financial sectors was increased to 29 (the S29), with the addition of Denmark, Finland, Norway, and Poland.

Table 1. Jurisdictions Deemed as Having Systemically Important Financial Sectors (S29)	
Original jurisdictions (2010)	Australia, Austria, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russian Federation, Singapore, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States (25)
Additional jurisdictions (2013)	Denmark, Finland, Norway, Poland (4)

16. A parallel work stream involved the integration of bilateral and multilateral surveillance, which gave greater prominence to financial policies. The goal was to clarify the place of multilateral surveillance in the IMF's legal framework, which remained focused on bilateral surveillance. In July 2012, the Board adopted the Integrated Surveillance Decision, a decision on bilateral and multilateral surveillance that superseded the 2007 Decision in January 2013. Although the primary purpose of the 2012 Decision was to provide principles for conducting multilateral surveillance, including the interface between bilateral and multilateral surveillance, it also gave greater attention to financial sector issues, for example, by adding "domestic economic and financial policies" in several places where the 2007 Decision only made a reference to "exchange rate policies." A new principle was added for the guidance of members' policies: "A member should seek to avoid domestic and economic and financial policies that give rise to domestic instability," whereas the existing principles had only referred to exchange rate policies broadly defined (IMF, 2012c). The 2012 Decision made it clear that staff was expected to explore all financial sector issues relevant for countries' stability as well as financial sector shocks and policies that could have large outward spillovers.

17. The IMF has repeatedly highlighted financial surveillance as an area of strategic priority throughout the post-GFC period. For example, the 2011 TSR set forth operational priorities for 2011–14, which included "financial stability," namely, to "adopt a strategic agenda for the Fund's financial sector surveillance, take further steps to mainstream financial stability analysis in bilateral surveillance, and strengthen understanding of financial interconnectedness." This was followed, in April 2012, by a report on key elements of its strategy for financial surveillance (IMF, 2012a). In August 2012, the IMF issued a document entitled "The IMF's Financial Surveillance Strategy," outlining strategic priorities for financial surveillance in the coming years, which included: (i) to strengthen the analytical underpinnings of macrofinancial risk assessments and policy advice; and (ii) to upgrade the instruments and products of financial surveillance to foster an integrated policy (IMF, 2012d). In October 2012, the "Guidance Note for Surveillance under Article IV Consultations" noted that the focus of bilateral financial surveillance "should be on financial stability, the cross-border transmission of risks, and two-way linkages between the

financial sector and the real economy" (IMF, 2012e).[14] Low-income countries, while not a high priority, also received increased attention in financial surveillance (IMF, 2012b; Tiwari, 2014).[15]

18. In 2014–15, these and other efforts sustained over many years led to a Fund-wide initiative to "mainstream macrofinancial surveillance" into Article IV consultations, an idea that the financial sector should not be treated as an isolated element in surveillance but as part of the two-way links with the real economy, via "credit creation, borrowing, financial deepening, and the buildup and transmission of risks between the financial, real, and fiscal sectors" (Lipton, 2015). In March 2014, the First Deputy Managing Director convened an inter-departmental working group to explore practical proposals to enhance the coverage and depth of analysis of financial sector issues in Article IV consultations. The report of this group noted that, despite the progress made over the last decade, integration of financial sector issues into bilateral surveillance remained a challenge, and made a number of recommendations across a wide range of areas, such as developing new analytical tools, hiring new staff with financial sector skills, and developing a more effective training curriculum for existing staff (IMF, 2014a).

Table 2. Jurisdictions Under the Macrofinancial Pilot, 2015–16

	Advanced and emerging markets (47)	Developing markets (18)	Monetary union (1)	Total number (66)
Original Jurisdictions (2015)	Australia, Azerbaijan, Brazil, Canada, Colombia, Iceland, Japan, Kazakhstan, Lebanon, Mauritius, Mexico, Montenegro, Namibia, Philippines, Poland, Saudi Arabia, Spain, U.A.E.	Benin, Cote d'Ivoire, Kyrgyz Rep., Malawi, Samoa, Uganda		24
Additional Jurisdictions (2016)	Bahamas, Belgium, Belize, Chile, Costa Rica, Ecuador, Equatorial Guinea, Finland, France, Georgia, Guatemala, Hong Kong SAR, India, Italy, Jordan, Korea, Kuwait, Luxembourg, Malta, Morocco, New Zealand, Nigeria, Oman, Russia, Singapore, South Africa, Sweden, Switzerland, United Kingdom	Bangladesh, Cambodia, Chad, Congo, Dem. Rep., Honduras, Liberia, Mauritania, Sao Tome and Principe, Sierra Leone, Tanzania, Uruguay, Vietnam	CEMAC	42

[14] In March 2015, a revised "Guidance Note for Surveillance under Article IV Consultations" was issued, defining stability as the organizing principle of surveillance and calling staff to focus on the conduct of all relevant economic and financial policies (IMF, 2015).

[15] The low-income country pilot, known as EFSL (enhancing financial sector surveillance in LICs), covered six countries (Benin, Bhutan, Ghana, Haiti, Senegal, and Sudan) and a currency zone (WAEMU) from Fall 2012 to 2014.

19. In the meantime, the Board endorsed several areas of operational focus for 2014–19, which included macrofinancial surveillance, in the context of the 2014 TSR discussed in September. The recommendations of the 2014 TSR included mainstreaming "macrofinancial analysis and strengthening surveillance of macroprudential policies" (IMF, 2014b). The Managing Director's Action Plan laid out specific steps to achieve these goals, and staff followed up by introducing new analytical tools and boosting staff training. In November, a Staff Guidance Note on Macroprudential Policy was issued to better embed the Fund's evolving thinking on macroprudential policy (IMF, 2014d). As a culmination of these steps, in December 2014 area and relevant functional departments formulated specific plans to mainstream macrofinancial surveillance, with a total of 24 countries for 2015 on a pilot basis (the number was expanded to 66 in 2016) (Table 2). After reviewing progress with these pilots at the March 2017 Board discussion of "Approaches to Macrofinancial Surveillance in Article IV Reports (IMF 2017)," it was decided to extend the initiative across the full membership by the end of 2018.

III. Internal Reviews of IMF Bilateral Financial Surveillance

A. Identifying Obstacles to Effective Surveillance, 2008–14

20. What has been the IMF staff's own assessment of the progress achieved in strengthening bilateral financial surveillance? The IMF conducts periodic reviews of the implementation of the respective surveillance decisions, as mandated, to assess the effectiveness of surveillance and to identify areas for improvement.[16] The staff has also produced other ad hoc, internal reviews and (sometimes jointly with World Bank staff) dedicated reviews of the FSAP (e.g., IMF, 2014c). The focus here is on Article IV consultations, including their integration with the FSAP, but not on the FSAP process itself or the substantive content of FSSAs.

21. With respect to financial surveillance under Article IV consultations, each of these reviews has at least since 2008 typically concluded that, while progress had been made, more needed to be done. For example, the 2014 TSR characteristically noted: "The Fund has made progress in strengthening financial surveillance, but this work is not yet sufficiently incorporated into its core macroeconomic analysis" (IMF, 2014b). Given the nature of these exercises, such a conclusion is to be expected. What is of greater interest for our purpose is not the conclusion, but the staff's identification of the obstacles to effective financial surveillance at each stage of the progress.

22. Broadly, strengthening bilateral financial surveillance has involved two objectives: (i) increasing the coverage and depth of financial sector issues in Article IV consultations; and (ii) better integrating financial and macroeconomic analysis. Achieving the second objective has proven to be far more challenging than the first. For example, the 2008 TSR, while concluding that financial sector surveillance had "received increasing attention, leading to considerable

[16] The process was known as biennial surveillance reviews through 2006 and triennial surveillance reviews in 2008, 2011, and 2014. It now takes place every five years as a comprehensive surveillance review, with an intervening interim surveillance review. The next comprehensive review is scheduled to be completed in January 2020.

progress in identifying financial sector vulnerabilities," observed that "further improvements [were] needed regarding the analysis of two-way transmission channels between financial and real sectors" (IMF, 2008). Four years later, staff continued to observe the challenges of macrofinancial integration even while acknowledging the increasing efforts made thus far to highlight macrofinancial linkages and to quantify the risks to the real economy arising from financial vulnerabilities (IMF, 2012d). In 2014, staff noted that, even where coverage was adequate, the analysis was not always integrated with "the more traditional topics of IMF bilateral surveillance" and was "often treated as an add-on" (IMF, 2014a).

23. Two types of obstacles have been identified in terms of strengthening financial surveillance in general and, more specifically, integrating macroeconomic and financial analysis. One set relates to issues internal to the IMF, such as:

- Internal "silo" organization, which hampers integration of work across departments
- Inadequate financial sector skills and experience, especially in area departments
- Resource constraints

24. The repeated findings in the successive internal reviews that FSSAs are insufficiently integrated into Article IV consultations may well be a consequence of the silo structure (e.g., IMF, 2011). Officials in some countries stated that FSAP teams appeared not well coordinated with area department teams, observing that FSAP questionnaires often repeated questions already raised by Article IV teams. Staff is aware of these and other recurring obstacles. To address the silo culture, for example, an interdepartmental review process has been introduced for the FSAP in which the concerned area and other departments comment on a draft Financial Stability Policy Note (FSPN). To address the skill and resource issues, efforts are being stepped up to build up the financial sector capacity of area department staff through training, and additional budgetary resources have been raised to support financial surveillance (see Stedman, 2018 for an in-depth discussion of these ongoing organizational issues related to financial surveillance).[17]

25. The other group of obstacles is more fundamental as it concerns the nature of financial surveillance itself, including:

- Lack of a unified theory of macrofinancial linkages
- Data gaps

[17] For example, MCM's spending increased from 8 percent (in FTE terms) of the IMF's total budget in FY 2009 to 9.1 percent in FY 2017; MCM support to bilateral surveillance increased from 39 FTEs in FY 2010 to 70 FTEs in FY 2017. Even so, the IMF operates with a fixed budget in real terms and, given other competing priorities, a large increase in resources devoted to financial surveillance cannot be expected.

26. Despite years of increasing attention in the economics profession, a unified theory that integrates the real and financial sectors does not exist and, given the importance of non-quantifiable variables in financial transactions (e.g., investor sentiment, risk tolerance, expectations), the complexity of interactions between real and financial developments, and the rapid evolution of the structure of financial markets, building such a model is likely to remain a challenge for many years (see Jeanne, 2018, for a discussion of the IMF's analytical frameworks and toolkits in financial surveillance). The Fund's response to this reality has been pragmatic, resorting to a variety of analytical approaches that seem most helpful in particular circumstances, including subjective judgments where "much of the analysis is contextual and has a large country-specific component" (IMF, 2014a; see also IMF, 2012d).

27. As to the provision of data, national authorities are understandably hesitant to share with IMF staff proprietary information on individual financial institutions often because of national legal restrictions on the disclosure of such data. If at all, the IMF is given access to supervisory data only at the discretion of the authorities.[18] In some countries, a full risk assessment may be hindered not only by the lack of access to confidential data but also by broader data gaps. Sixty-seven percent of mission chiefs responding to a summer 2017 survey for the Interim Surveillance Review cited data availability as a main challenge to macrofinancial surveillance. To be sure, substantial progress has been made in improving the availability and quality of financial data in recent years, thanks to such initiatives as the G20 Data Gaps Initiative (DGI), in which the Fund played a leading role,[19] and the associated Special Data Dissemination Standard (SDDS) Plus designed for countries with systemically important financial sectors. Even so, the Fund's access to proprietary data with sufficient granularity remains incomplete.

28. These obstacles can have a compound effect. For example, the lack of specificity often observed in the IMF's financial advice (IMF, 2011a; b) may be due to the combined effect of the absence of a unified model, the inadequacy of financial sector skills, and limited access to institution-level data. The absence of an established model may lead to an issue of skill deployment across the institution, by making it "difficult to know where macrofinancial begins and how far it goes before it becomes a specialist pursuit, requiring expert resources" (IMF, 2014a). Some of the specialist skills built up within the IMF (especially in MCM) over the

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[18] The Japan case study (Ariyoshi, 2018) illustrates how the cooperative attitude of authorities could help mitigate the data access issue.

[19] The DGI began in 2009 in the aftermath of the global financial crisis in which data gaps and deficiencies were revealed. The IMF, working with the Financial Stability Board, took the leadership role in implementing the majority of the 20 recommendations to close the data gaps. With the initial phase completed in 2015, the DGI has been in its second phase, focusing on financial sector risks and real-financial linkages. The SDDS Plus, established in 2012, is a voluntary scheme in which adherents agree to observe requirements in mine data categories that are closely related to the 20 recommendations under the DGI. See Heath (2013) and Heath and Goksu (2016). Also, as a result of STA's work, there has been a significant expansion in key financial sector data bases, e.g., Financial Stability Indicators and the Financial Access Survey. The 2016 IEO evaluation of data and statistics at the IMF discusses these and other data initiatives at the IMF (IEO, 2016).

years were regulatory and micro-prudential in nature, less suited for integration of financial sector work into bilateral surveillance (IMF, 2014a).

29. The 2014 report of a staff working group (the "Marston–Demekas Report") summarized the crux of the matter by attributing the "root of the problem" to "the 'macro generalist–financial specialist' dichotomy," which is "deeply embedded in the fabric of the institution."[20] As a result, in the view of the Marston–Demekas Report, area departments see the problem of financial surveillance as a problem for MCM, while MCM sees the problem as a resource issue. Considering that macrofinancial surveillance encompasses more than financial stability—such as the efficiency of financial intermediation, the role of the financial system in monetary policy transmission, the interrelationship between evolving market practice and credit cycles, and the role of state-owned banks—the report concluded that "real progress" would require area departments fully taking ownership as well as a "fundamental shift in the profile of Fund staff" (IMF, 2014a; see also Stedman, 2018). The 2014 TSR called for "gradually shifting the profile of Fund economists to ensure they have adequate macrofinancial skills through training and personnel policies, and changing work practices to generate incentives and opportunities for individual staff to acquire and use the needed skills" (IMF, 2014b).

B. Staff Views of Challenges in Macrofinancial Surveillance, 2017–18

30. Staff produced a major stocktaking of macrofinancial surveillance ("Approaches to Macrofinancial Surveillance in Article IV Reports") in 2017, followed by an interim review of surveillance in 2018. The 2017 review found that the IMF had made good progress over the past two years in integrating macrofinancial analysis into Article IV surveillance, with a focus on "developing a fuller understanding of macrofinancial linkages, and applying this analysis to inform policy advice;" and that staff had "sought to articulate the role of the financial sector in the macroeconomic baseline, and to integrate the financial sector into the risk assessment, taking into account both the impact of macro shocks on the financial sector as well as the effect of financial shocks on macroeconomic stability." In the absence of an established framework, the review characterized the staff's approach as "eclectic," "combining expert knowledge with ad hoc analytical tools," and making "qualitative assessments, informed where possible by tools assessing the impact of financial sector risks on the rest of the economy" (IMF, 2017).

31. In the view of staff, its "pragmatic approach with an emphasis on learning by doing" was appropriate, "given the state of knowledge in the literature and the large variance in quality and availability of macrofinancial data across the membership" (IMF, 2017). Even though it was "too early to precisely assess the benefits from a greater macrofinancial focus in Article IVs," the review saw a strong "case for progressively mainstreaming it across the full membership," which

[20] The 2014 TSR echoed essentially the same assessment: "financial and macroeconomic analyses remain fragmented. In part, this reflects a longstanding tendency for the 'generalist' macroeconomic perspective to be largely divorced from the 'specialist' financial perspective. This is reinforced by the absence of a unified model that links macro and financial variables" (IMF, 2014b).

it considered was feasible with "determined focus and efforts," observing that considerable investments had already been made in building capacity especially within area departments. Such a judgment appears to enjoy wide support from IMF staff: 72 percent of the staff respondents to the IEO survey considered the IMF's efforts to improve the integration of financial sector issues in Article IV surveillance as an initiative of critical importance to improve the quality of surveillance for all countries.[21]

32. A similar assessment was repeated in the 2018 Interim Surveillance Review (ISR) (IMF, 2018). In the first instance, it observed that "considerable" progress had been made "in integration of macrofinancial surveillance … incorporating lessons from pilot efforts," while noting that more than 70 percent of Board members characterized the quality of staff's advice and analysis of macrofinancial issues as having improved.[22] Yet, it recognized that macrofinancial integration was a work in progress. In particular, the ISR viewed pursuing the initiative to mainstream macrofinancial surveillance across the membership as entailing "a significant ramp-up in training and knowledge-sharing, including delivery of a specialized curriculum, and dissemination of knowledge across and within departments through dedicated macrofinancial teams."

33. Against these broader assessments of recent developments, an internal review of 2017 addressed the quality impact of expanding the coverage of the pilot initiative in 2017, "the third year of the initiative to strengthen the integration of macrofinancial analysis in bilateral surveillance" (Adrian and others, 2017). The review, after reporting that the number of countries under the pilot had increased from 67 in 2016 to 128 in 2017, compared all "mainstreamed macrofinancial staff reports" for Article IV consultations between the two years. Based on a study of 64 Article IV staff reports that went to the Board between January and September 2017, its assessment was that the average quality of macrofinancial integration had somewhat declined from 2.7 to 2.5 (on a scale of 1–4) as the number of cases increased (Figure 1).[23]

34. The 2017 review observed that the fall in average quality was concentrated among new cases and suggested possible reasons. Among the more important were: (i) less intensive involvement from MCM and the Strategy, Policy and Review Department (SPR), (ii) competition from other pilot initiatives, given resource constraints, (iii) less attention paid to macrofinancial

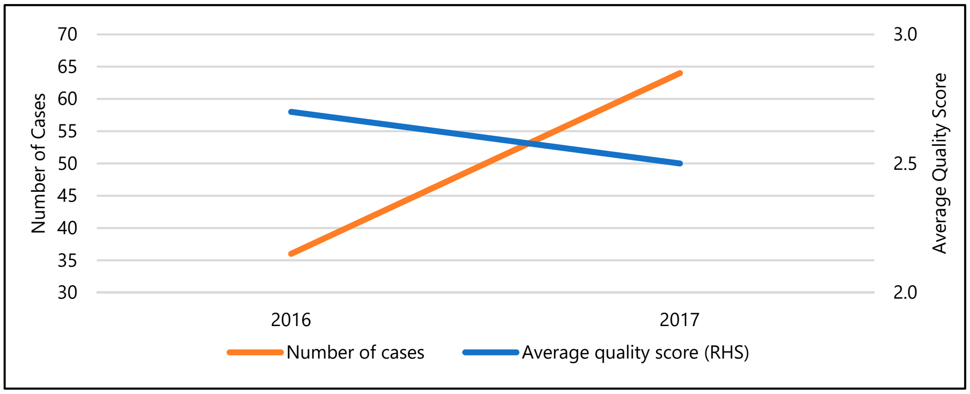
[21] In contrast, 16 percent thought that it was an important initiative but relevant only for a relatively few number of countries; 5 percent thought that financial sector issues were already adequately covered in surveillance, and that the initiative had little or no value added.

[22] According to the IEO survey of staff, 63 percent of the respondent stated that they had integrated financial vulnerabilities and risk "significantly" in Article IV surveillance, followed by another 31 percent who said that they had done so "to some extent."

[23] A score of 1–4, reflecting how financial sector analysis was judged to be integrated with analyses of fiscal, monetary, real, and external policies, was assigned to each of the following three areas: (i) baseline; (ii) risks; and (iii) policies.

integration issues in area departments' internal reviews and in SPR's reviews, and (iv) high staff turnover. The review then proposed a set of corrective actions, such as: doing more in-reach by MCM and SPR to area departments, organizing brainstorming sessions for new cases, and ensuring appropriate focus on macrofinancial integration issues in the inter-departmental review process. In this context, the establishment of a Macrofinancial Unit within SPR was considered to be a positive step.

Figure 1. IMF Staff Assessment of Macrofinancial Integration, 2016–17



Source: IMF staff calculations, as appear in Adrian and others (2017).

IV. Assessing Aspects of IMF Bilateral Financial Surveillance

35. This section assesses the coverage, quality, and impact of IMF bilateral financial surveillance. The assessment draws on a content analysis of Article IV staff reports for a diverse group of 40 countries;[24] and the evidence provided by the country case studies, notably interviews with country officials. The content analysis attempts to identify how the coverage of financial sector issues in Article IV consultations may have evolved, as well as how it may have been systematically related to country characteristics and other factors, during the period 2011–17.[25]

[24] Australia, Bhutan, Bolivia, Brazil, Canada, Chile, China, Cote d'Ivoire, Denmark, Egypt, France, Germany, Ghana, India, Indonesia, Iran, Italy, Japan, Jordan, Korea, Kosovo, Lebanon, Malaysia, Mexico, the Netherlands, Nigeria, Peru, Rwanda, Saudi Arabia, Senegal, Sierra Leone, Singapore, South Africa, Sweden, Switzerland, Thailand, Timor-Leste, Turkey, the United Kingdom, and the United States. These countries include 14 of the 15 case study countries (Kenya is excluded because no Article IV staff report was available for the period 2016–18 at the time of the desk review in early 2018) and 26 non-case study countries; Group of Seven (7), other advanced (7), major emerging (5) countries, and non-systemic (21) countries. The countries are evenly split between 2014–15 pilot and non-pilot countries (20 each).

[25] Staff reports were selected for 2011, 2014, and 2017. To ensure that a minimum of two years intervene between two successive consultations (where consultations were held irregularly), those designated as 2011 Article IV consultation reports could be discussed by the Board as early as March 2010 or as late as February 2012. Likewise, the 2014 reports could be discussed by the Board as early as September 2013 or as late as May 2015; and, for the 2017 reports, as early as May 2016 or as late as February 2018.

A. Coverage

36. It is the opinion of most officials interviewed for this evaluation that IMF financial surveillance has become more focused on financial stability and has for the most part identified relevant financial sector issues. Article IV surveillance now employs a greater number of analytical tools to examine financial risks and to explore links between the financial and real sectors; use of standardized diagnostic tools (e.g., financial soundness indicators; risk assessment matrix) has become routine (see Jeanne, 2018, for various risk indicators used in IMF financial surveillance). In this sense, the IMF's bilateral financial surveillance has undoubtedly improved in recent years in terms of coverage and depth.

37. This section has a narrow focus: how much space has been devoted to financial sector issues in Article IV staff reports as a crude measure of the weight of the financial sector in IMF bilateral surveillance relative to other key issues. The content analysis identifies paragraphs (based on a careful reading of each) that make *substantive* references to financial sector issues generally and, as a subset, *explicit* macrofinancial links (see Appendix for specific examples). The metric employed is the share of financial sector (or macrofinancial) paragraphs as a percent of all paragraphs in each report.[26] The purpose is not to form a judgement as to whether the coverage was appropriate (which must be assessed taking into account each country's specific circumstances), but to estimate how coverage changed over time and varied across certain country characteristics.

38. The content analysis shows that, for the period 2011–17, about 25 percent of all paragraphs in Article IV staff reports discussed financial sector issues. In contrast, the share of paragraphs referring to macrofinancial links was a mere 3.2 percent. The relative paucity of macrofinancial coverage is further corroborated by the fact that 36 staff reports (out of 120 examined) contained no paragraph referring to macrofinancial links and another 30 reports had only one such paragraph. Moreover, in-depth analysis of macrofinancial links was rare even when discussed, and any reference tended to be pro forma. To be sure, there were notable best practice cases (see Appendix), but the practice of most staff reports was only to mention macrofinancial links (e.g., the impact of financial inclusion on growth, how financial market development affects monetary policy transmission) without offering a supporting analysis.

39. A rather surprising result, given the recent emphasis on the financial sector, is that the overall coverage of financial sector issues has not increased over this period (Figure 2(a)). For

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[26] The metric is biased in favor of giving more weight to the financial sector because a paragraph with any substantive reference to the financial sector is counted as a financial sector paragraph even if the rest of the paragraph also discusses non-financial sector issues. At the same time, the metric for macrofinancial links is likely to be an understatement of the true weight of macrofinancial issues, which are broader than just macrofinancial links. The focus on explicit macrofinancial links comes from a desire to minimize room for subjective judgment. It is easier to identify macrofinancial links than macrofinancial issues. It is not clear where macrofinancial issues end and financial sector issues begin.

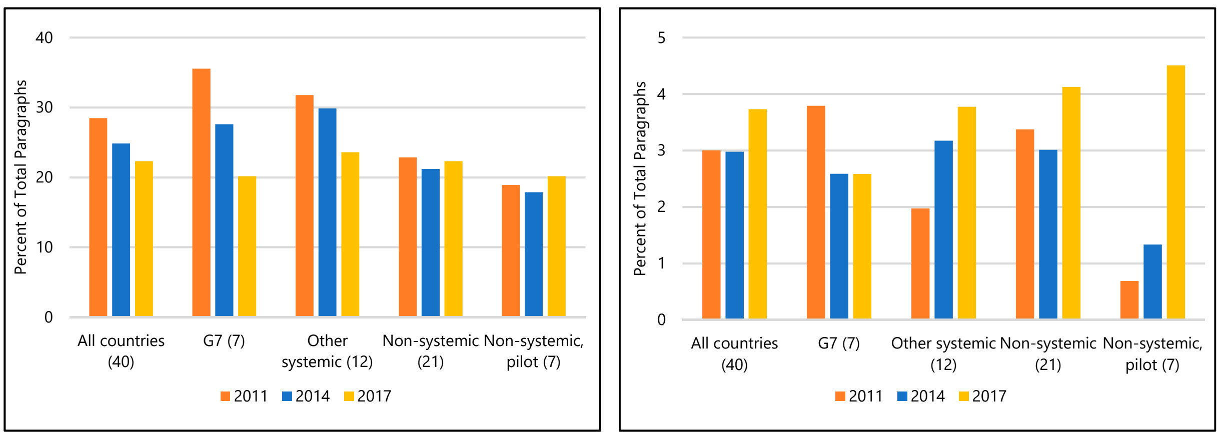
systemic countries, especially the G7 countries, the coverage in fact declined from 2011 to 2017. This may mean that (i) much attention was already being paid to financial sector issues in 2011, especially in the immediate aftermath of the global crisis and that (ii) reflecting the subsequent normalization of the financial sector, financial sector issues have become progressively less pressing. Staff has exercised selectivity in focusing on what was more relevant (than the financial sector),[27] such as macroeconomic challenges in Japan given the evident absence of an immediate risk to the financial system during much of this period (Ariyoshi, 2018).[28] More limited coverage therefore should not necessarily be equated with insufficient attention to financial sector issues. It could just mean that the coverage has reverted to a more normal level.

Figure 2. Coverage in Article IV Staff Reports

(In percent of total paragraphs)

(a) Financial sector issues

(b) Macrofinancial links



Source: Author's estimates based on Article IV staff reports.

40. For macrofinancial links, a similar result obtains for the G7 countries. The coverage (again measured as a percent share of all paragraphs) declined from 2011 to 2017, likely for similar reasons (Figure 2(b)). For other systemic and non-systemic countries, however, there was a notable pickup in the coverage of macrofinancial links in recent years. The strengthening of the coverage is particularly striking for non-systemic countries in the 2015–16 Macrofinancial Pilot: the number of paragraphs increased from 0.7 percent of total in 2011 to 4.5 percent in 2017. Also, the coverage of macrofinancial links in 2017 was broadly similar across different types of countries, except for the G7 countries. The lower weight given to macrofinancial analysis in the G7 countries likely reflects the diminished relevance of financial sector issues in more recent

[27] The 2015 Staff Guidance Note clearly stresses the importance of "selectivity" and advises against covering all issues in all cases (IMF, 2015).

[28] Nonetheless, Ariyoshi (2018) argues that staff could have more fully explored emerging risks, including those arising from the interactions between macroeconomic policies and the responses of financial institutions and markets.

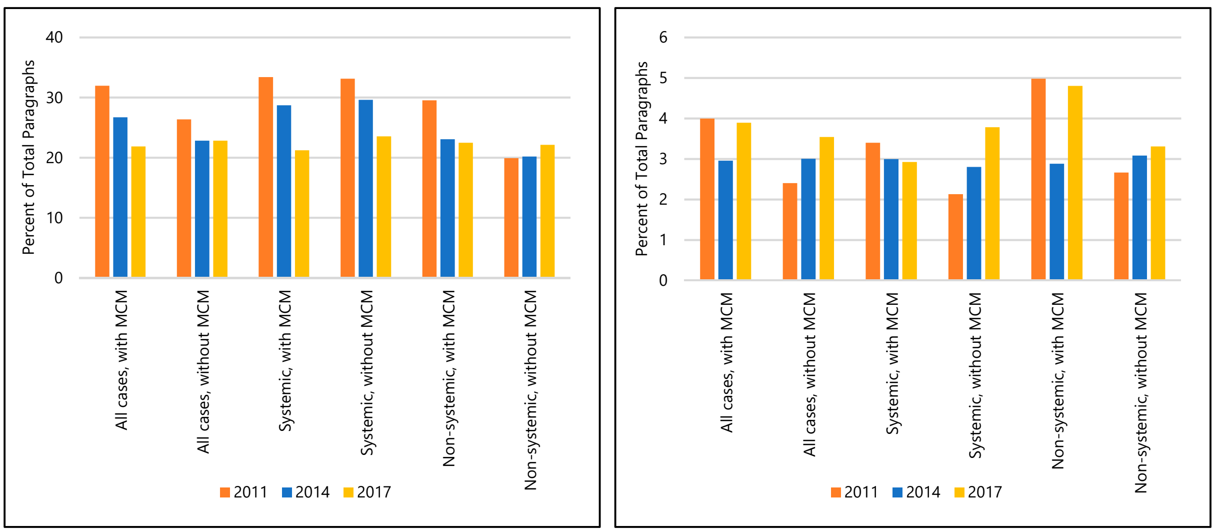
years, as noted above, and the fact that financial development (with direct links to real economic activity) is less of an issue for countries with more developed financial systems.

41. The content analysis further suggests that the coverage of financial issues responded differently to the participation of an MCM economist, depending on the type of country. Of the 120 Article IV missions examined, slightly less than half (57) included a staff member from MCM, which is broadly representative of MCM's involvement in Article IV consultation missions during this period.[29] In the case of systemic countries, MCM participation seemed to make little difference in terms of the coverage of financial sector issues or macrofinancial links (Figures 3(a)(b)). In contrast, the coverage tended to increase in the case of non-systemic countries when the Article IV consultation team included an MCM economist.

Figure 3. Coverage in Article IV, With or Without MCM Participation
(In percent of all paragraphs)

(a) Financial sector issues

(b) Macrofinancial links



Source: Author's estimates based on Article IV staff reports.

42. Case studies suggest that, in some emerging market economies, some officials questioned the relevance of the issues identified by IMF staff. For example, Thai officials regarded those covered in IMF financial surveillance as replications from other countries. Observers in Brazil characterized the Fund's approach to be focusing too much on fragilities when the system largely remained resilient while failing to pay sufficient attention to larger issues, such as the dominance of public financial intermediaries and the stability implications of perennially high interest rates. Another often-voiced criticism was the tendency for IMF surveillance to focus more on the banking sector, with less attention to insurance, capital market, and longer-term structural

[29] Stedman (2018) notes that MCM staff participated in about half of the Article IV missions during 2013–17.

issues. Even in Singapore, which is an advanced economy included in the Macrofinancial Pilot, officials noted that the coverage had improved but surveillance was still not giving sufficient attention to macrofinancial linkages, nonbank sectors, and cross-border flows.

43. In LICs, officials complained more often about the insufficient attention financial sector issues received in Article IV surveillance, especially those related to financial deepening and inclusion. Although bona fide development issues are primarily the responsibility of the World Bank, the Fund has been aware of the adverse implications of financial shallowness for financial stability and macroeconomic policy effectiveness (e.g., IMF, 2012b) and these developmental issues are supposed to be covered by financial surveillance. Even so, officials in these countries considered that these issues received inadequate attention, possibly reflecting the lack of reliable data or the IMF staff's deference to the World Bank. These officials also highlighted the need for the IMF to be more engaged in cutting-edge issues, such as fintech and cyber security issues as new financial technologies were developing rapidly even in LICs.

B. Quality

44. Most officials interviewed for the evaluation generally gave high marks for the quality of IMF financial surveillance, particularly in the systemic countries receiving intense attention. Many officials, especially in advanced countries, recognized the conscious efforts being made on the part of the Fund to strengthen the analysis of financial sector issues. Some officials, including in the United States, even went so far as to suggest that the quality of IMF surveillance was better than that of surveillance done by other institutions—though not approaching the level of national agencies that could draw on a deep pool of high quality, dedicated experts. There were greater concerns about the quality of advice in some emerging markets with high regulatory capacity, emanating from inappropriate focus or lack of understanding of local conditions.

45. Despite several instances of successful implementation, macrofinancial integration was not seen as a strength. Some officials complained about a lack of transparency in the Fund's attempts to integrate macroeconomic and financial analysis, perhaps given the absence of a well-accepted theoretical framework. One interviewee thought that the assumed feedbacks in the IMF's analysis were a "black box."

46. Officials tended to be most critical of IMF financial surveillance when the IMF's assessment differed from their own diagnosis. For example, in some European countries, officials thought that the Fund's preoccupation with the linkage between non-performing loans (NPLs) and bank lending was over-done as, in their view, NPLs were manageable for most banks and firm-level characteristics were largely responsible for the stagnation in credit expansion (Anderson, 2018b; Landau, 2018).[30] In Thailand, officials viewed the IMF's advice to adjust the loan-to-value (LTV) ratio in response to cutting interest rates as reflective of its lack of

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[30] In Italy, the authorities believed that the Fund's advice of accelerating the disposal of NPLs would have risked creating capital shortfalls, with adverse effects on credit. See Anderson (2018b).

understanding of the Thai economy, where significant parts of the population do not have access to financial institutions. In Mexico (De Bolle, 2018) and the United Kingdom (Miles, 2018), officials considered the respective FSAP recommendations on unifying the supervisory framework and the mode of supervising small firms as not evidence-based, and not well suited for their own jurisdictions.

47. A range of views were expressed by officials on the quality of the IMF's human resources engaged in financial surveillance. Those in major countries, including China, the United Kingdom, and the United States, were typically pleased with the quality of staff assigned to the financial surveillance of their countries. British and U.S. officials in particular expressed their opinion that perhaps top-notch staff were assigned to their countries, given their significance as global financial centers. Officials in non-English-speaking countries, however, tended to complain more about the lack of country-specific knowledge displayed by IMF staff, even though they too recognized the staff's generally high professional quality. In many countries, officials complained about the high turnover of staff assigned to their countries, which they said had diminished the technical quality of the work. This was a particular problem with FSAPs—perhaps understandably given their low frequency—but also often a problem for Article IV surveillance.

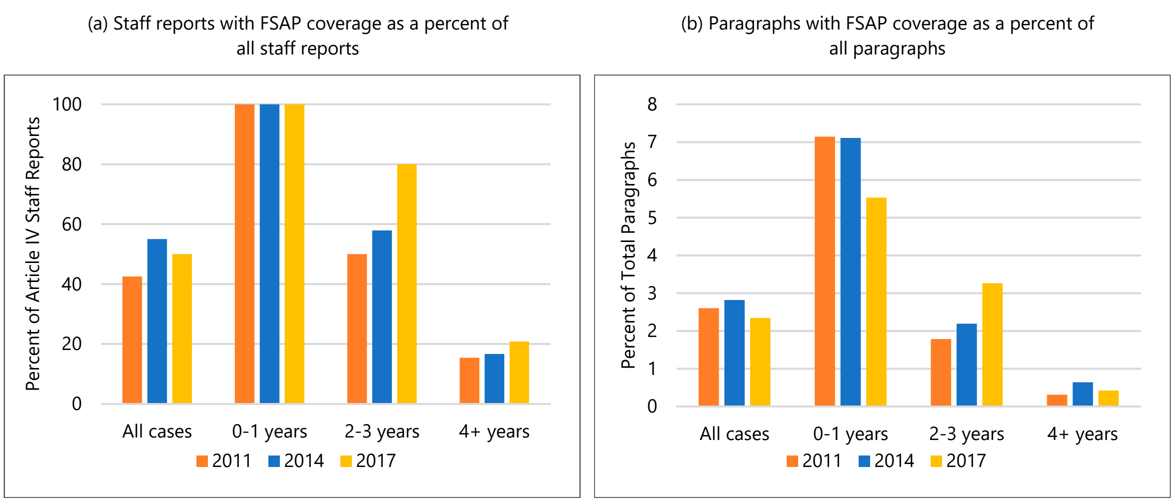
48. Asked whether IMF human resources had improved, the authorities judged the quality of staff working on large advanced markets to have been good for a long time and therefore saw little noticeable difference over time. This is consistent with the earlier observation that the coverage of financial sector issues, including macrofinancial links, was high to begin with in these countries (see Figure 2). In some of the other countries, including Mexico and Singapore, officials considered the financial sector expertise of IMF staff assigned to their countries to be inferior to theirs, even while acknowledging a noticeable improvement in the quality of surveillance. Similar observations were made by officials of developing markets about IMF staff's lack of financial sector experience. There was a broad consensus across the membership that the quality of staff varied from country to country, as well as from mission to mission even within the same country.

49. Officials generally considered the quality of financial analysis in FSAPs to be higher than that in Article IV surveillance. A review of Article IV staff reports clearly shows that the analysis of financial sector issues became deeper and more comprehensive when there was either a concurrent or recent FSAP mission to the country. Ninety-three percent of the staff respondents to the IEO survey who had worked on countries with recent FSAPs stated that FSAPs had played a role in the latest Article IV consultation, either "significantly" or "to some extent." As one of the best practice cases, the Netherlands in 2017 saw the two teams sharing a senior member and the FSAP mission chief participating in some of the Article IV discussions. As a result, the financial sector coverage in the Article IV report was deep and extensive, with 43 percent and 14 percent of all paragraphs referring to financial sector issues and macrofinancial links, respectively; the

discussion also closely mirrored the findings of the FSSA.[31] What was done in the Netherlands, along with the new interdepartmental review process, has been institutionalized.

50. In general, case studies suggest that the synergy between the FSAP and Article IV has improved in almost all countries. Even so, FSSAs tend to be cited in Article IV reports for only a few years. For example, while 100 percent of the staff reports made some reference to the FSAP when the assessment had been conducted in the same or previous year, the percentage progressively declined thereafter to 20 percent or less when the latest FSAP had been conducted four or more years earlier (Figure 4(a)). The same tendency was observed for the amount of space devoted to the FSAP in Article IV staff reports, with the number of paragraphs containing FSAP references declining from 5–7 percent of total when the latest FSAP had been conducted in the same or previous year to less than one percent when they were four or more years old (Figure 4(b)).

Figure 4. References to the Financial Sector Assessment Program in Article IV Staff Reports, by the Length of Time Since the Last FSAP



Source: Author's estimates based on Article IV staff reports.

C. Impact

51. Notwithstanding the favorable overall judgment of quality, officials generally did not consider that IMF surveillance identified risks or issues unknown to them or caused them to fundamentally change their view, especially in countries with high regulatory capacity. This is not

[31] An MCM technical assistance activity could also serve a similar purpose. For example, the 2014 Article IV consultation with Bhutan benefited from a pilot initiative on Enhancing Financial Sector Surveillance, which was provided as technical assistance by MCM and World Bank staff. The staff report for the 2014 Article IV consultation with Bhutan, as a result, had an in-depth and comprehensive coverage of financial sector issues and macrofinancial links, with 35 percent and 16 percent of paragraphs covering respective topics—an unusual feat for a low-income, financially underdeveloped country.

surprising. The financial sectors of these countries are under scrutiny not only by them but also by a large number of market participants and analysts; IMF staff generally does not have access to the supervisory data that the authorities possess with the same granularity; and their central banks and supervisory agencies have a far larger number of qualified individuals dedicated to these tasks. In general, the FSAP was thought to have more technical substance than Article IV surveillance, given the former's highly specialized and labor-intensive nature. Even then, whatever the authorities initially considered was the FSAP's capacity to shed fresh light on issues has diminished over time, as regulatory systems and capacity have strengthened across the membership during the past decade (see also Caprio, 2018).

52. Even so, officials interviewed identified a number of ways in which they benefited from IMF surveillance. First, many noted that Fund surveillance helped facilitate domestic policymaking even in countries with high capacity. They cited instances in which Fund advice had deepened their own thinking, brought global perspectives, provided additional policy options, validated their own analysis, or simply provided a sounding board. Likewise, officials in several countries, including the United States, appreciated the IMF's contribution to fostering inter-agency dialogue within their own governments.

53. Second, most officials, including those in advanced countries, believed that, regardless of the (lack of) substantive value-added of IMF surveillance, the Fund's pronouncements still mattered, not least because of its credibility as an independent and neutral assessor. For example, given this credibility, some officials counted on the Fund to provide credible outside support for difficult reforms in the face of domestic political resistance.

54. Third, many saw the value of IMF surveillance, not in terms of what they themselves gained, but in terms of what was communicated to the authorities of other countries, the markets, and the public. For example, Singaporean officials valued the FSAP as a vehicle to obtain supervisory information on the home countries of the foreign banks operating in their country. Likewise, U.S. officials viewed the role of IMF surveillance almost entirely as that of informing the public and markets of its assessment of developments in the U.S. financial system. Many officials stated that IMF reports were often the first port of call on financial issues in other countries.

55. Finally, officials in countries with less sophisticated financial systems appreciated the knowledge-transfer aspect of IMF financial surveillance, especially the FSAP. Even officials in China, which is a country with an abundance of human resources, valued the IMF's technical support in providing them with an analytical toolkit that could be applied to their country.

56. The flip side of these positive aspects of IMF bilateral financial surveillance is the potential adverse impact of any negative assessment, especially in emerging markets that depend on foreign borrowing. According to the IEO survey, 46 percent of the staff respondents considered the market sensitivity of financial surveillance to be greater than that of other forms of IMF surveillance and recognized the need to be careful in discussing sensitive topics in staff

documents.[32] Among the officials interviewed for this evaluation, some in emerging markets stated that the IMF's assessments could sometimes be unjustifiably blunt even when they were not based on correct understanding of local conditions. They expressed concern that an incorrect assessment of the countries' compliance with international codes, for example, could adversely affect foreign investor sentiment and jeopardize their access to international funding markets.

57. The policy impact of IMF financial surveillance varied from country to country. In Ghana, Kenya, and Nigeria, many FSAP recommendations were adopted, with effective follow-up by subsequent Article IV consultations, which included consolidated and risk-based supervision (Nigeria), central bank independence (Kenya), and stress testing methodologies (Ghana). In Thailand, Article IV surveillance helped identify the build-up of risks in the non-bank sector and called for better supervision through changes in the legal framework. In almost all countries, the FSAP was cited as having contributed to subsequent reforms.[33] British and U.S. officials interviewed were virtually alone in stating that IMF surveillance had no impact on their policies.[34]

V. Conclusion

58. The IMF has been making concerted efforts to strengthen its financial surveillance since the aftermath of the Mexican crisis in the mid-1990s, with numerous initiatives and other institutional innovations. Following the global financial crisis in 2008, the IMF's efforts have moved beyond expanding the coverage of financial sector issues in surveillance to intensifying its focus on better integrating macroeconomic and financial analysis. Macrofinancial integration has become an institutional priority, with the launch of a pilot initiative in 2014 and the issuance of a new Staff Guidance Note in 2015.

59. Focusing on bilateral aspects, this paper has generally provided a positive assessment of the fruits of these sustained efforts, confirming that the overall coverage of financial sector issues and macrofinancial linkages has indeed expanded over the recent decade especially in non-systemic countries (the coverage was high to begin with in systemic countries) and, in the views of most officials interviewed, the quality has also improved. Even so, there is a sense that coverage remains uneven, and the recent refocusing of attention on systemic countries has to some degree come at the expense of non-systemic countries, given the increasingly binding resource constraints. Much of the coverage of macrofinancial links in Article IV consultations is

[32] An additional 27 percent agreed that financial surveillance could be market-sensitive but no more than other forms of surveillance. Combined, 73 percent of the staff respondents recognized the possibility that a candid assessment of financial sector vulnerabilities and risks could heighten market tensions or even trigger a crisis.

[33] Officials were quick to add that, in many instances, measures were already under consideration at the time of the FSAP and that one should not necessarily see a strong direct link between the FSAP and the specific measures implemented subsequently.

[34] Even British and U.S. officials acknowledged that the earlier FSAPs had foreshadowed (if not directly shaped) the course of regulatory reforms in subsequent years.

limited and pro forma, except when they benefit from a concurrent or recent FSAP or related technical assistance activity. The paper concludes that macrofinancial integration in bilateral surveillance remains a work in progress despite recent improvements, a view repeated by the succession of internal reviews over the past decade.

60. Effective surveillance is ultimately hampered by difficulties fundamental to the very nature of financial surveillance, not least data gaps and the absence of a well-established, quantifiable model of real-financial linkages. Even so, IMF staff has worked hard to overcome these obstacles to identify risks and vulnerabilities and to explore the macroeconomic impact of financial sector developments, especially in large systemic countries. The authorities of these countries express general satisfaction with the quality of the IMF's financial sector analysis, even though they do not find that Fund surveillance necessarily identifies risks or issues unknown to them or changes their views on core issues. Those in smaller countries appreciate the useful roles of IMF financial surveillance but are more likely to complain that the staff lacks requisite financial sector expertise or country-specific knowledge.

61. Coupled with the variable experience with MCM participation (which tended to improve financial sector coverage in Article IV consultations only in non-systemic countries), these conflicting views expressed by officials about the quality of the IMF's bilateral financial surveillance and human resources assigned to their countries imply that the supply of financial sector skills within the IMF is limited and unevenly distributed. As IMF staff had predicted when macrofinancial initiatives began in 2011, giving priority to countries with systemic financial sectors under these circumstances would inevitably lead to a sacrifice of quality in work on others (IMF, 2011).[35] To make the task even more challenging, the Fund's financial surveillance is aiming at a moving target. Its quality has undoubtedly improved, but so has the quality of institutions and human capital in member countries. Technology is also changing rapidly, constantly moving the frontier of financial surveillance. IMF financial surveillance is much like a game of catch-up, but the Fund has no choice but to be engaged to be taken seriously in a world with intense real-financial linkages.

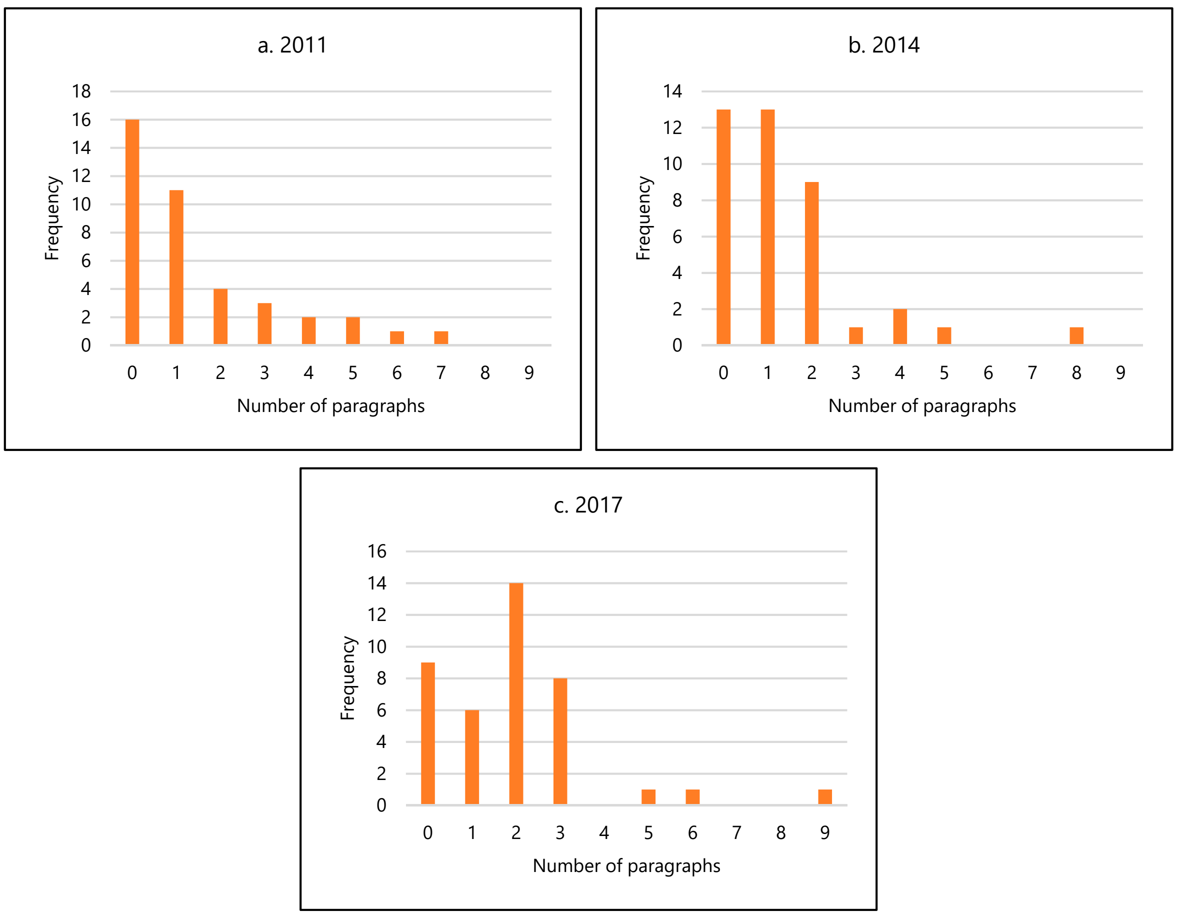
[35] The 2011 paper further noted that about 50 percent of Article IV reports for advanced countries had covered non-bank financial institutions and markets in 2010, but the proportion declined to 28 percent and 11 percent, respectively, for emerging markets and LICs, and that a broader discussion of the impact of shadow entities was virtually non-existent in these countries (IMF, 2011).

Appendix. The Coverage of Macrofinancial Links in Article IV Staff reports

In identifying a paragraph on macrofinancial links, the following question was asked: does it explicitly link a financial sector issue to the real economy or macroeconomic policy? Examples include: (i) the impact of financial deepening on monetary policy effectiveness; (ii) the impact of financial inclusion on private sector growth; and (iii) the implications of demographics for financial stability. Even though many staff reports devote some paragraphs to discussing real estate market developments (which may be considered as a broader macrofinancial topic), this paper does not count them as macrofinancial paragraphs unless they explicitly link real estate developments to financial issues (e.g., impact on bank balance sheets or on real economic variables through their impact on some financial variables).

Histogram of paragraphs on macrofinancial links

Figure A.1. Histogram of Paragraphs with Macrofinancial Links in Article IV Staff Reports (Number=40 for each year)



Source: Author’s estimates based on Article IV consultation staff reports.

Analysis of the coverage of macrofinancial links in staff reports indicates a steady improvement from 2011 to 2017. First, the average number of paragraphs discussing such links increased from 1.48 in 2011 to 1.95 in 2017, while the median number increased from 1 to 2. Second, the sequence of histograms for paragraphs discussing macrofinancial links, from 2011 to 2017, is even more revealing of the nature of the improvement in coverage over this period (Figure A.1). Whereas, in 2011, the number of staff reports with no discussion of macrofinancial links was 16 (out of 40), the number declined to 13 in 2014 and further to 9 in 2017. This is reflected in the flattening out of the histogram from 2011 to 2017, as the mode moved rightward from 0 to 2. Even so, nine Article IV staff reports contained no paragraph discussing macrofinancial links in 2017.

Selected best practice cases

About 15 percent of the staff reports examined contained a full discussion of macrofinancial links, often supported by accompanying technical analyses in appendices or selected issues papers. For example:

- Bhutan (2014 Article IV Consultation Staff Report), para 30: "The concentration of lending in personal and real estate loans raises particular concerns. More than a quarter of the financial sector's portfolio consists of building and construction loans, followed by personal loans which constitute around 16 percent of credit outstanding. The prolonged credit boom has been associated with a run-up in real estate prices, and their recent decline may expose weaknesses in asset quality."

- Brazil (2014 Article IV Consultation Staff Report), para 24: "The widespread use of subsidized lending weakens monetary policy transmission and distorts credit markets. Introducing a direct link between the policy rate … and the subsidized lending rate … would increase the effectiveness of monetary policy. Reducing the gap … would also lower the recurrent fiscal cost arising from the cumulative stock of policy lending by government."

- Chile (2016 Article IV Consultation Staff Report), para 10-11: "The impact of downside risks materializing could be amplified through macrofinancial linkages…. Against this background, a deterioration in external growth or financing conditions could force firms to deleverage at an accelerated pace. Under the baseline of a moderate recovery, staff does not expect firms' investment plans and banks' credit supply to be constrained by high leverage, given long maturities of debt and low interest costs. However, under a risk scenario … an increase in Chile's EMBI spread by 100 basis points … would cause growth to drop by roughly 0.3 percentage points within less than one year."[1]

- Japan (2017 Article IV Consultation Staff Report), para 13: "Japan's prolonged experience with low growth and interest rates, together with underlying demographic headwinds,

[1] These statements are supported by the VAR analysis provided in an annex.

has created persistent macrofinancial challenges that, if unaddressed, could amplify shocks originating outside of the financial system.... Doubts about fiscal sustainability could lead to a jump in the sovereign risk premium, forcing abrupt fiscal adjustment with adverse feedback effects to the financial system and the real economy. Low bank profitability and demographic headwinds could pose solvency problems for regional financial institutions. Life insurers could fail to meet interest guarantees and face solvency pressures if low interest rates persist."

- Korea (2017 Article IV Consultation Staff Report), para 15: "The corporate sector as a whole is profitable and moderately leveraged, but with significant differences across groups of firms.... Liquidity and profitability are weaker for SMEs than for large firms. Moreover, profitability, solvency, liquidity and leverage positions are poorer among the conglomerates excluding the largest four compared to the top four conglomerates and other large companies. This could ultimately have an adverse impact on investment and growth."[2]

- The Netherlands (2016 Article IV Consultation Staff Report), para 14: "Households remain highly leveraged, with a sizeable share of mortgages in negative equity. [E]mpirical work suggests that financially-constrained agents tend to cut back on other forms of spending when faced with excessive mortgage repayments, thus exacerbating the pro-cyclicality of house price shocks."

- Peru (2017 Article IV Consultation Staff Report), para 6: "Banking and corporate sectors remain solid, while financial conditions are neutral with respect to growth. Bank capitalization continued to increase … and profitability remains high.... Corporate leverage has increased, especially for large firms, but debt at risk … has halved since 2014.... With financial conditions … having been neutral in 2016 … the credit slowdown appears to be primarily driven by macroeconomic conditions rather than financial shocks."[3]

- Rwanda (2010 Article IV Consultation Staff Report), para 26: "Despite repeated cuts in the policy rate and lowering of reserve requirement on bank deposits, commercial banks' lending rates remained stubbornly high. Staff analysis of monetary transmission mechanism shows that interest rate pass-through is weak in Rwanda, especially compared to its peers … which have deeper financial markets."

- South Africa (2017 Article IV Consultation Staff Report), para 18: "Feedback loops between the real, financial, and fiscal sectors could amplify the impact of these shocks. A continued low growth outlook with rising unemployment would worsen the financial

[2] These statements are supported by the technical analysis provided in a Selected Issues Paper.

[3] These statements are supported by the thorough financial stability analysis provided in an annex.

situation of households and firms, resulting in higher NPLs in banks' loan portfolios as well as portfolio rebalancing by foreign investors and domestic non-bank institutions…. Under these circumstances, banks would likely curtail credit, further exacerbating the growth downturn. Staff estimates suggest that … following a one percentage point decline in GDP growth, the NPL ratio would increase by 0.5 percentage point. This would in turn dampen credit growth by 2 percentage points."[4]

- Thailand (2010 Article IV Consultation Staff Report), para 15: "[F]inancial constraints … seem to have played a role in depriving Thailand of its dynamism. [The financial sector's] development has languished, rendering it too small to service the economy adequately…. In part, the shrinkage of the financial sector merely reflects the declining need for finance, as investment rates have subsided. But staff research suggests that the causality has also run the other way, with credit constraints inhibiting investment."

- Timor-Leste (2017 Article IV Consultation Staff Report), para 24: "Increasing access to credit can help support private sector growth. Efforts to enhance the collateral system, bankruptcy regime, and improving the credit registry information system are important to achieve greater financial deepening and inclusion. Creating a credit guarantee scheme for small and medium-sized enterprises … could help to close the SME financing gap and support economic diversification. However, the scheme should be designed and operated to limit moral hazard through a proper risk-sharing mechanism and to minimize contingent liabilities…."

- United Kingdom (2011 Article IV Consultation Staff Report), para 26: "Markets are currently pricing in at least a 50 percent probability of a first rate hike by February 2012 and a second rate hike by August 2012. [G]rowth remains vulnerable to a steep drop in house prices…. With household debt levels still elevated by historical standards … rapid interest rate hikes could also cut directly into households' disposable income (and therefore consumption), though this effect would be partially mitigated by households' higher interest income."[5]

[4] These statements are supported by the VAR analysis provided in an annex.

[5] These statements are supported by the analysis in a Selected Issues Paper.

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