2 IMF FINANCIAL SURVEILLANCE: EVOLUTION AND CHALLENGES

The goals and outputs of IMF financial surveillance have greatly expanded in the aftermath of the GFC with clear priority given to jurisdictions with systemically important financial sectors.[2] For decades, the IMF's responsibilities and attention to financial systems increased gradually in response to periodic financial crises and a growing recognition that open capital accounts and financial liberalization tend to magnify contagion and spillovers. After the GFC, financial surveillance became more widely accepted as a central element of IMF work, enshrined in Board decisions and expanded activities, and a critical contributor to achieving the IMF's overall mandate. The GFC also made clear the need to focus financial surveillance on the countries with systemically important financial sectors, including those where the crisis originated.

Financial crises have largely driven the evolution of IMF financial surveillance. In response to the sequence of crises in emerging market economies (EMEs) in the 1990s, IMF surveillance greatly expanded the coverage of financial sector policies and conditions. These crises demonstrated increasing interconnections between financial vulnerabilities, economic activity and balance of payments, and the risk of spillovers. The IMF responded to these crises, particularly the 1997 East Asian crisis, by launching new vehicles to assess financial sector policies and conditions: the FSAP, the *GFSR*, and the Vulnerability Exercise for EMEs (VEE).[3] These instruments paid particular attention to EMEs, seen as the main potential source of financial instability. The IMF also increased coverage of financial sector policies and conditions in Article IV consultations, as laid out in successive operational guidance notes for staff (e.g., IMF, 1997, 2002b, and 2005).

The FSAP was launched in 1999 jointly with the World Bank as a voluntary diagnostic tool. Its main goals were to identify financial stability and development challenges and to report on compliance with agreed standards and codes. The IMF summarizes the conclusions of each FSAP in a Financial System Stability Assessment (FSSA), which includes recommendations to be followed up on in subsequent Article IV consultations. In 2002, the *GFSR* replaced an earlier flagship report (the *International Capital Markets Report*), with a greater focus on assessing global financial markets and identifying vulnerabilities "that could pose a risk to financial market stability and sustained market access by emerging market borrowers" (IMF, 2002a).

In response to the GFC, the IMF launched many initiatives to expand and strengthen financial surveillance to better advise member countries of vulnerabilities and risks, and to foster greater resilience. Among these initiatives were: making FSAPs mandatory at least every five years for jurisdictions with systemically important financial sectors (currently 29 jurisdictions, the S29,

[2] This chapter draws on Takagi (2018) and Stedman (2018).

[3] The VEE is an internal exercise initiated in 2001 to identify EMEs vulnerable to an external or internal crisis in the following 6–12 months for discussion between IMF staff and Management.

are identified by the IMF as such)[4]; invigorating efforts to integrate financial and macrofinancial analysis in bilateral and multilateral surveillance; enhancing cooperation with the FSB and SSBs to promote reforms and monitor agreed standards; conducting the EWE jointly with the FSB to explore financial tail risks to the global economy; expanding the vulnerability exercise to cover risks in advanced economies (AEs) and low-income countries (LICs); and taking steps to enhance financial skills and expertise among IMF staff, through both training and recruitment.

The 2012 Integrated Surveillance Decision (ISD) expanded the responsibilities of IMF surveillance with respect to members' financial policies (IMF, 2012a). The ISD made it clear that IMF staff should explore financial sector issues relevant for domestic stability as well as for their potential for outward spillovers, which are now discussed in Article IV consultations regardless of whether they occur through the balance of payments channel.[5]

The 2012 Financial Surveillance Strategy, launched following the adoption of the ISD, called for a more integrated view on financial risks across IMF products and instruments. It identified three strategic priorities: to strengthen the analytical underpinnings of macrofinancial risk assessments and policy advice, to upgrade the instruments and products of financial surveillance, and to engage more actively with stakeholders to improve traction (IMF, 2012b). In implementing the 2012 Strategy, the IMF has focused its resources and attention on the S29, and it has sought to mainstream macrofinancial analysis into Article IV consultations across the membership. The IEO surveys suggest that the strategy is well understood and broadly supported by the Executive Board and IMF staff.

The IMF has also tried to address organizational impediments and cognitive biases that hindered its performance in the run-up to the GFC. Among the initiatives to mitigate silo behavior and to facilitate "connecting the dots," the Surveillance Committee and the Financial Surveillance Group meet periodically to, respectively, ensure the consistency of surveillance messages and promote discussion of financial sector issues. Also, FSAP teams prepare Financial Stability Policy Notes that are the basis for early interdepartmental feedback on preliminary assessments and recommendations. Further, the IMF has taken measures to counter groupthink and intellectual capture, including involving external experts in the periodic reviews of surveillance and working more closely with other institutions with overlapping mandates.

As a consequence of these multiple initiatives, the scope, coverage, and intensity of IMF financial surveillance has greatly expanded. Over 300 FSAPs have been completed since the program was launched in 1999, covering 75 percent of the membership. Macrofinancial analysis has been integrated, at least to some extent, in most Article IV consultations. And the *GFSR* and the EWE have become increasingly respected as premier sources of insight on the global financial system. Financial surveillance is now well established and accepted by the membership and IMF staff as a core element of the Fund's activities.

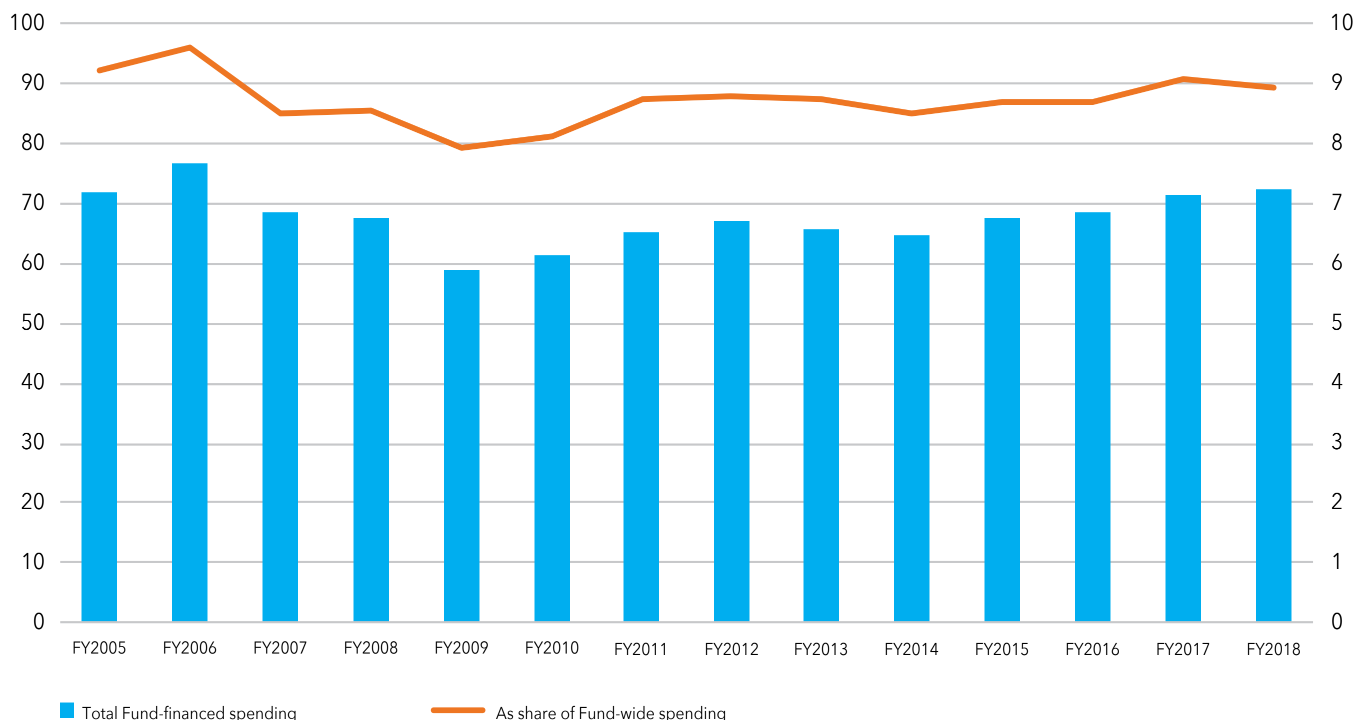
The sustained expansion of the scope, products, and activities of financial surveillance has been helped by a moderate increase in resources in recent years (Stedman, 2018). Total resources going to financial surveillance across the IMF are not tracked separately, so we assessed changes in the resource envelope by looking at personnel spending by the Monetary and Capital Markets Department (MCM) and spending by area and other functional departments on the

[4] The S29 are identified by a complicated exercise weighing countries' financial system size and interconnectedness. This list is reviewed every five years. Currently, the S29 are: Australia, Austria, Belgium, Brazil, Canada, China, Denmark, Finland, France, Germany, Hong Kong SAR, India, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Norway, Poland, Russia, Singapore, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. For the purposes of this evaluation, the euro area is treated as part of the S29.

[5] The ISD expanded the perimeter of financial surveillance beyond the 2007 Decision on Bilateral Surveillance. This decision 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" (IMF, 2007), but had implicitly limited the examination of outward spillovers only to those operating through the balance of payments channel (IMF, 2010a). Thus, in practice, effective integration of financial sector issues and policies had remained a challenge (IMF, 2010b).

FIGURE 1. MCM PERSONNEL SPENDING, FY2005–18

(In millions of 2017 U.S. dollars—left scale; and as a share of Fund-wide personnel expenses—right scale)



Sources: IEO calculations; IMF, Office of Budget and Planning, FACTS.

Note: Excludes travel and externally-financed resources, which are mainly used to fund capacity development work. For the years prior to the creation of the Monetary and Capital Markets Department (MCM) the figure shows the sum of spending by its predecessor departments (International Capital Markets and Monetary and Financial Systems).

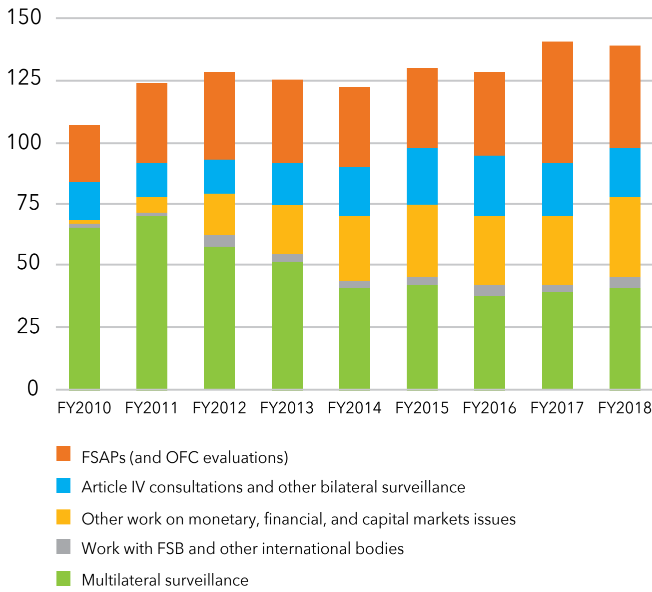
macrofinancial pilot (since FY2014).[6] As shown in Figure 1, MCM resources declined as part of the overall downsizing of the IMF in the years just prior to the GFC. MCM's budget was rebuilt following the crisis, particularly during FY2014–18. Figure 2, based on detailed data by output, shows that MCM spending specifically on surveillance activities has increased by the equivalent of around 10–20 full-time staff-years (FTEs) since 2012. Much of this increase went to costly FSAPs in the five most systemically important financial centers (S5, i.e., China, the euro area, Japan, the United Kingdom, and the United States) and to the *GFSR*, while resources for cooperation with other international organizations were cut back. There may also have been some increase in area department resources applied to financial surveillance, particularly in the context of launching the macrofinancial pilot, but attention to financial surveillance has competed with a variety of demands on area departments in recent years.

However, overall resources for financial surveillance seem barely back to their pre-GFC levels. MCM's personnel spending is now at about the same level as in the mid-2000s, both in real dollar terms and as a share of the Fund-financed IMF budget (about 9 percent).[7] Further, resources for financial surveillance face constraints going forward. Support

[6] During the past five years, MCM's FTE envelope for surveillance rose from 125 to 140 FTEs (FTE represents the cost of an average full-time employee which during the evaluation period stood at about US$300,000). In addition, during the past three years, other departments (primarily area departments) directed 20–25 FTEs to a pilot program to support the mainstreaming of macrofinancial analysis into Article IV consultations (although part of these resources may have been redirected from other financial surveillance work). Spending on multilateral surveillance declined from FY2010 to FY2014 as cooperation with other international organizations was cut back or reclassified, but resources for the *GFSR* increased from 20 FTEs in FY2012 to 28 FTEs in FY2018.

[7] Excludes travel and externally-financed resources, which are mainly used to fund capacity development work.

FIGURE 2. MCM PERSONNEL SPENDING ON SURVEILLANCE, FY2010–18
(FTEs)



Sources: IEO calculations; IMF, Office of Budget and Planning (Time Reporting System and Time Reporting for Analytic Cost and Expenditure System).
Note: Personnel spending (excluding travel) on Fund-financed activities identified by IEO as related to surveillance. Fund-financed capacity development comprised about 65 FTEs, and lending work about 7 FTEs in FY2018. FSAPs = Financial Sector Assessment Program exercises; FSB = Financial Stability Board; FTE = full-time [staff] equivalent; OFC = offshore financial center.

for the macrofinancial pilot was expected to be phased out as this analysis becomes a standard component of Article IV consultations. And as part of a budget streamlining effort, the IMF has recently taken steps to control costs of financial surveillance along with other activities. In May 2018, Management decided to cap the resources available for individual FSAPs and to limit the analytical chapters of the *GFSR* to one per issue. The future path of overall resources for financial surveillance thus remains unclear, despite the expanded responsibilities and importance of these activities to the IMF's mission.