

Use of FSAP Results in Article IV Surveillance

This annex presents the analysis supporting the findings in Chapter 5, section on “Surveillance,” of the main report. The evidence is drawn from the detailed reviews of the 25 case studies and is structured around four evaluation questions: (1) Have FSAPs provided a good basis for their use in Article IV surveillance? (2) What has been the resulting coverage of findings in Article IV reports? (3) How was the integration of key FSAP findings into the overall macroeconomic assessment? and (4) What was the extent of financial sector surveillance after the FSAP?

Have FSAPs Provided a Good Basis for Their Use in Article IV Surveillance?

The evaluation criteria for case analysis comprised the following tests (the questions of the desk review matrix used are in parentheses):¹

- (1) Have FSAP results been articulated in a way that facilitates use in Article IV surveillance? More specifically:
 - Have findings and recommendations been clear, usable, prioritized, with a view to consequence? (Questions: 31, 33, 34, and 35)
 - Has there been an overall assessment of the financial sector? (questions: 8 and 20)
- (2) Have domestic and external or global economic conditions fed into the financial sector assessment? (Questions: 15, 16, 17, and 18)

The results from the reviews of the 25 case studies show that:

- Over 80 percent of cases reviewed showed that FSAPs articulated findings well, with a general assessment of the financial sector standing, facilitating the use in Article IV surveillance. Findings and recommendations are generally

clear and usable. Moreover, nearly half of the cases had a very clearly articulated overall assessment, with a good sense of consequence and priorities.

- Over 80 percent of cases reviewed showed that domestic and external conditions fed into the FSAP’s analysis, with a third of cases showing a very clear and strong linkage to the financial sector assessment.

In good practice cases, the FSAP’s articulation of the overall assessment has a comprehensive view of the structure, standing and trends in the financial sector. It sometimes presents also a body of analysis (including sectoral linkages, externalities, and potential spillovers) that facilitates the formulation of a broader assessment of macroeconomic vulnerabilities and a more comprehensive policy framework for recommendations (e.g., Costa Rica).

The instances where the FSAPs have fallen short of good practice involve an overall assessment that is not clearly conveyed or that lacks a clear indication of macro consequence and prioritization (e.g., Kazakhstan, Philippines). In these cases, there is a shift of what should be part of the FSAP’s expert analysis onto the Article IV team.

What Has Been the Coverage of Findings in Article IV Reports?

The analysis covered desk review questions 50 and 51.

Over 80 percent of Article IV reports make a good coverage of FSAP results, and about half of the cases present many of the good practice characteristics. The good practice coverage of FSAP results in Article IV has a clear reporting of the main findings and recommendations, the importance and consequence of findings, and the associated priorities. It also presents the interplay of these findings with the nonfinancial sector (e.g., Japan), including potential fiscal liabilities, impact on or of monetary and exchange rate policy, and corporate and household sector implications. But in some instances the coverage

¹See Annex 3 for the template of the desk review matrix.

Box A6.1. What Makes a Good Integration of FSAP Findings into the Overall Macroeconomic Assessment?

This box presents the key characteristics of good integration of the financial sector assessment into the overall macroeconomic assessment. Ultimately, a good integration is one that results in a greater understanding of macro/systemic vulnerabilities, a more comprehensive stability assessment, and a broader policy recommendation framework. We present here some good practice examples on the various characteristics.

- *Macro/financial/structural linkages are identified.* For example, in the assessment of Japan's macroeconomic situation, a framework with four inter-linked pillars was considered, consisting of the financial and corporate sectors, and the monetary and fiscal frameworks.
- *Externalities are a key element of the assessment.* In the case of Japan, the analysis highlights the feedback effects from bank reforms (via improved lending position) to supporting the economic recovery, and from economic recovery (and strengthen regulation) to supporting the resolution of balance sheet problems. Thus, complementarities of policies are emphasized, leading to an assessment of the need for simultaneous adoption.
- *Risks and vulnerabilities are evaluated in a systemic manner.* For example, in Costa Rica, the implications of the exchange rate regime on dollarization and financial vulnerabilities are explicitly

addressed. In Korea, the interplay of risks and vulnerabilities between the corporate and financial sectors is explicitly analyzed, considering potential externalities.

- *Broader policy framework for recommendations.* In Japan, drawing on the elements described above, policy recommendations comprised broader and more rapid financial sector reforms, accelerated corporate restructuring, a more aggressive anti-deflationary stance, and a framework for medium-term fiscal consolidation. The “big-bang” policy recommendation was based on the increased effectiveness that was expected from the joint implementation, whereby, for example, monetary policy would be more effective to end deflation if banks' balance sheets problems are resolved, which in turn build on corporate restructuring.
- *Enhanced discussions with the authorities based on the broader assessment and policy recommendations.* In the case of Costa Rica, the authorities indicated that the appropriate integration of the financial sector assessment with macroeconomic conditions and policies, as well as the comprehensive scope of recommendations for reform (including monetary/exchange rate, fiscal, and financial pillars) helped to form a good, integrated platform for discussions of policy and reform needs.

of FSAP results in Article IV reports has fallen short of good practice, with a cursory presentation of findings (e.g., Romania).

How Were the Key Financial Sector Findings Integrated into the Overall Macroeconomic Assessment?

The analysis covered desk review questions 50 and 53.

In three-quarters of the cases reviewed, the overall macroeconomic assessment has benefited from the FSAP, with an enhanced assessment of the standing of the financial sector and the areas of potential macroeconomic implications (see Box A6.1). In these cases, the main FSAP findings were reported and merged into the assessment of Article IV surveillance. Moreover, in a third of cases the contribution has been significant, whereby FSAP findings contributed to shaping the overall macroeconomic assessment (i.e., not only the main messages were presented but the findings about the financial sector were well embedded into the overall appraisal).

The instances where practice has fallen short of a good integration into the overall macroeconomic assessment involve a mechanical presentation of FSAP results in the Article IV report (e.g., just a summary table of results) with little integration of the main messages (e.g., Tunisia, Romania). Typically this consisted of reporting on financial vulnerabilities but not considering potential linkages, externalities, or policy complementarities.

What Was the Extent of Financial Sector Surveillance After the FSAP?

The evaluation criteria for case analysis comprised the following tests:

- (1) Has Article IV/program work identified new vulnerabilities? (Question: 22)
- (2) Has the intensity of coverage of financial sector issues been maintained after the FSAP? (Question: 54)
- (3) Have Article IV, program, and TA activities assessed implementation of reforms? (Questions: 39 and 52)

The results from the reviews of the 25 case studies show that:

- In only a few cases, financial surveillance under Article IV or program work was able to identify new vulnerabilities or understand better the extent of some risks that were noted in the FSAP (e.g., Costa Rica). In terms of areas, these have included corporate sector vulnerabilities to interest and exchange rates (Mexico), bank vulnerabilities to interest rate risk through their holding of government bonds (Philippines), and risks stemming from links between banks and other financial institutions (e.g., investment funds). The analyses in most instances comprised new stress-testing exercises. In these cases, staff from MFD participated and contributed to the analysis.
- In over 80 percent of cases reviewed, the intensity of coverage in Article IV consultations has remained significant (excluding those with an Update and those too recent to have a subsequent Article IV cycle). Although in nearly half of the cases the intensity has waned over time (in terms of the depth and scope), there has not been a full mean reversion of the coverage of financial sector issues to that prevailing before the FSAP. But in some cases, the coverage of important issues highlighted in the FSAP was lost in time (e.g., Korea).

- With respect to tracking of progress in implementation of reforms, the general practice has been to report on measures taken by country authorities. But there has been very little appraisal of how significant those measures are to address the vulnerabilities identified in the FSAP. In terms of areas of coverage, there tends to be greater follow-up on traditional area of surveillance (e.g., issues related to exchange rate and monetary policy) and on the banking sector (as opposed to other segments of the financial system, which sometimes receive little or no coverage). In many instances, the scope of coverage has not followed the priorities assigned by the FSAP.

In nearly a quarter of the cases, the tracking was done more comprehensively and in greater depth; these either were cases where an Update took place or where MFD staff participated in the consultations. The cases that had expert assistance were also able to cover a broader spectrum of areas in the tracking of implementation under Article IV work.

Good practice in tracking of implementation of recommendations takes place under the FSAP Updates reviewed among the 25 case studies, where the assessments are the most comprehensive in scope and depth (e.g., Slovenia, Bulgaria). Updates present an overall assessment of progress, whereby the standing of the system and remaining challenges are rearticulated (see also Annex 7 on review of Updates).