EXECUTIVE SUMMARY

In response to the Global Financial Crisis (GFC), the IMF launched many initiatives to strengthen financial surveillance to better advise member countries of vulnerabilities and risks and to foster greater resilience. Among these initiatives are: adopting decisions that gave the IMF clearer responsibilities over financial sector stability and cross-country spillovers; making periodic financial stability assessments mandatory for 29 jurisdictions determined to have systemically important financial sectors (S29); invigorating efforts to integrate financial and macroeconomic analysis in bilateral and multilateral surveillance; enhancing cooperation with the Financial Stability Board (FSB) and standard-setting bodies (SSBs) to promote reforms and monitor agreed standards; and taking steps to recruit and train greater financial expertise.

While these initiatives have not yet been tested by a major crisis, the efforts have delivered a substantial upgrade of the Fund's financial surveillance work. The Financial Sector Assessment Program (FSAP), focused on the S29, has provided high-quality in-depth assessments as countries themselves have strived to make their financial systems more resilient. The IMF has contributed to the development of stress tests and a broad range of diagnostic tools, explored new policy approaches (e.g., macroprudential tools), and brought such innovations to the broader membership. Article IV surveillance has stepped up attention to macrofinancial linkages. And the *Global Financial Stability Report* (*GFSR*) and Early Warning Exercise (EWE) are now respected as leading sources of insights on the global financial system. This has occurred as a rising share of IMF economists have acquired experience in financial sector issues.

While recognizing these achievements, this evaluation finds that the quality and impact of the IMF's financial surveillance has been uneven. The expansion of products and activities has presented the Fund with difficult trade-offs between bilateral and multilateral surveillance; between countries with systemically important financial sectors and other member countries; and between financial surveillance and other activities, including emerging macro-critical issues. Moreover, resource constraints have slowed the needed buildup of financial and macrofinancial expertise, as others have worked hard to raise their game. These are critical

issues, given the IMF's position as the only international financial institution with the mandate and ability to conduct financial and macrofinancial surveillance over a full range of countries as well as the global economy, and given that these issues are at the core of the IMF's responsibilities.

Thus, notwithstanding the real progress to date, the IMF should address a number of challenges to further strengthen the effectiveness of financial surveillance. The recommendations in this evaluation would not entail a major shift in the IMF's goals and strategy. Rather, they seek to encourage faster progress and greater traction by combining new initiatives with sustained efforts to build on ongoing work programs and a willingness to fine-tune priorities to meet changing needs.

BILATERAL SURVEILLANCE

There is still a need to strengthen financial and macrofinancial analysis in Article IV consultations, including through closer integration with the FSAP. Article IV teams do not have the breadth and depth of skills and resources to adequately identify and explore financial stability risks. While FSAP teams are better equipped for this purpose, they often lack in-depth country knowledge, and the assessments are too infrequent to detect fast-developing financial stability risks. In their planning, implementation, and follow up, FSAPs and Article IV consultations should be more systematically conducted as parts of the same process. Concretely, FSAPs could provide a periodic "deep dive" to identify key risks and vulnerabilities in the form of a new financial vulnerability matrix, while Article IV consultations could provide annual checkups to track FSAP-identified concerns, using techniques and templates suggested by the FSAP and taking care to adapt in a timely fashion to evolving circumstances. To implement such a strategy, Article IV teams for countries where financial vulnerabilities are potentially of serious concern will require a significantly increased allocation of economists from the Monetary and Capital Markets Department (MCM). In countries with no recent FSAP, Article IV teams would have to intensify their preparatory work to identify financial and macrofinancial vulnerabilities and develop policy advice, with support from MCM and other departments.

The allocation of FSAP resources should be more flexible and dynamic, and more clearly risk-based. The current approach, which requires mandatory assessments every five years for the S29, risks paying too little attention to countries that fall just outside the boundary but may face serious financial vulnerabilities, while paying too much attention to relatively low risk yet more sizable and connected financial sectors. Under an alternative approach, only the five most systemically important financial sectors (S5) would continue to be covered every five years on a mandatory basis. For the rest of the membership, each year as part of the work program discussions with the Executive Board, Management would propose a rolling list of countries that would be covered by FSAPs over the following two or three years. These countries would be identified based on criteria similar to those currently in place for prioritizing non-mandatory FSAPs, approved by the Board in the context of the 2014 FSAP review, which include financial and macroeconomic vulnerabilities and take into account the need to maintain a balance across regions and levels of financial development. This alternative approach would allow wider and more risk-based country coverage.

The scope and focus of FSAPs should be more differentiated across countries and more closely tailored to country circumstances, thereby raising value added and traction. FSAPs in jurisdictions with the largest and most sophisticated financial systems are hugely resource intensive but subject to diminishing returns. In those countries already conducting regular high-quality stress tests, FSAPs could focus on reviewing the authorities' models, designing risk scenarios, and discussing the results of the tests and critical stability risks. The FSAP advice should be fully anchored in the local circumstances and not overly reliant on off-the-shelf "international best practice" more suited in other contexts.

MULTILATERAL SURVEILLANCE AND GLOBAL FINANCIAL REGULATORY ARCHITECTURE

The traction of multilateral surveillance could be further increased through greater rigor and transparency. The *GFSR* and the EWE are widely viewed as providing valuable and sometimes pathbreaking analysis, particularly in the *GFSR*'s analytical chapters and the EWE's outside-the-box thinking. The *GFSR* is appreciated for being more candid than bilateral surveillance while generally being careful not to heighten market instability. Still, the impact of the *GFSR* could be enhanced by making the messages of Chapter 1 more convincing to country authorities. More thorough checking with in-house country experts and making the analytical and empirical background work more easily accessible would be helpful to this end. The EWE's impact could potentially be increased through broader dissemination of the analysis beyond the initial very restricted audience and closer coordination with the FSB on topic selection to achieve greater synergies, although care must be taken not to compromise the value of an already successful product.

There is room to strengthen the IMF's contribution to the global regulatory agenda in areas of its comparative advantage by working more closely with international partners. Key partners like the FSB and SSBs generally appreciate the Fund's contributions, including its analytical work and its independent and global perspective, and value its role representing countries that are not members of these organizations. In turn, the IMF respects the lead role of the FSB and SSBs in developing new rules and regulatory frameworks. Looking forward, and dependent on resource availability, the IMF could increase its contribution to assessing the impact of reforms at the country level, leveraging its FSAP and Article IV work and its macrofinancial expertise. Also, working with international partners, the IMF would be well placed to contribute to analyzing cross-border transmission channels and to developing stress tests for the global financial system, although the feasibility of this work would depend on increased access to granular data on global systemically important financial institutions (G-SIFIs).

ENHANCING TOOLS AND BUILDING EXPERTISE

To enhance its value added on financial stability issues, the IMF should intensify efforts to be a global center of excellence on financial and macrofinancial research. While the IMF cannot be expected to be at the cutting edge on all issues, it should expand research on issues within its comparative advantage, particularly on models to analyze macrofinancial linkages and cross-border spillovers and tools to identify and assess vulnerabilities and risks.

The IMF should sustain and extend efforts to develop financial expertise among its staff. A rising share of fungible macroeconomists has experience with financial sector work, but additional efforts are still needed to ensure all country teams have adequate skills. Further, the Fund seems short of deep financial expertise. A key step will be to provide more attractive career paths for financial economists that allow for continued specialization and promotion to senior managerial levels.

RESOURCES

Consideration should be given to increasing the resource envelope for financial surveillance if the Fund is to meet its goals and mandate. Uneven results in mainstreaming macrofinancial work into Article IV surveillance, competition for scarce FSAP resources, scope to increase its contribution on the global regulatory agenda, and the potential for further gains from strengthening analytical work all suggest that existing budgetary resources are under strain. The budgetary envelope for financial surveillance has increased somewhat since the 2012 Financial Surveillance Strategy was launched but it is still only around the levels of the mid-2000s, before the GFC.

The highest priority for additional resources would be to strengthen financial and macrofinancial surveillance in Article IV consultations, which would require a larger pool of financial and macrofinancial talent. Enhancing the IMF analytical toolkit would also require a (more modest) increase in resources. Expanding recruitment, training, and retention of financial economists may require financial incentives, in addition to offering better career prospects. Other recommendations need not require additional resources. It should be possible to expand coverage and increase the value added of FSAPs, provided that the number of mandatory FSAPs is greatly reduced and a more flexible approach is adopted to allocation of FSAP resources. The changes recommended to enhance the traction of multilateral surveillance could be achieved largely by some reallocation of existing resources.