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ABSTRACT

The International Monetary Fund has significantly improved its surveillance of the EU and the euro area, along the lines suggested by the Fund's 2011 Triennial Surveillance Review and in application of its 2012 Integrated Surveillance Decision. Nonetheless, there is still margin for further enhancing IMF surveillance of the EU and the euro area. This report by the Task Force on IMF Issues of the International Relations Committee of the European System of Central Banks was prepared with the aim of contributing to the preparation of and debate on the 2014 IMF Triennial Surveillance Review.

JEL code: F42, F53.

Keywords: IMF, surveillance, international financial architecture, Bretton Woods, international organisation

EXECUTIVE SUMMARY

This report by the Task Force on IMF Issues of the International Relations Committee of the European System of Central Banks was prepared with the aim of contributing to the preparation of and debate on the 2014 IMF Triennial Surveillance Review.[1]

The International Monetary Fund has significantly improved its surveillance of the EU and the euro area, along the lines suggested by the Fund's 2011 TSR and in application of its 2012 Integrated Surveillance Decision. Overall, messages have become more consistent and focused, and linkages and spillovers among members are better accounted for. There is better integration of surveillance at the bilateral and euro area-wide levels and with multilateral exercises such the External Sector Reports and Spillover Reports. The IMF has also significantly improved its analysis of risks, with risk assessment matrices used in almost all EU Article IV reports; the coverage of financial stability issues has been expanded; and Article IV reports and national Financial Sector Assessment Programmes are now integrated. The Fund has been active in making suggestions on the institutional architecture of EMU, advocating more financial and fiscal integration and backing the creation of a European banking union.

Nonetheless, there is still margin for further enhancing IMF surveillance of the EU and the euro area. Focusing on the priority areas singled out by the 2011 TSR, there is scope to improve the analysis of: (i) interconnections, through a strengthened analysis of spillovers from shocks and policies; (ii) risks, by improving communication and being mindful of its pro-cyclicality; (iii) financial stability issues, by being more specific in proposals and further linking the financial and external sector analysis; (iv) external stability, through deeper analysis of rebalancing within the euro area and employing more gross balance sheet analysis; and (v) traction, by fostering the involvement of the pertinent authorities at the different stages of the surveillance process and increasing accountability on past advice.

The report includes two case studies. The first one assesses IMF surveillance of the EMU institutional framework and the second one looks into IMF external sector surveillance in the EU.

The report concludes with the main recommendation to transform the IMF Euro Area Policies Report into a more comprehensive IMF Euro Area Surveillance Report, which could cover: a strengthened analysis of spillovers (positive and negative) to better understand the impact of shocks and policy decisions; a mapping of the main interlinkages and spillover channels between euro area countries; a deeper technical analysis of the European policy framework, building for instance on IMF staff material prepared on European fiscal union and banking union; the inclusion of references to the Macroeconomic Imbalances Procedure to juxtapose it with the IMF's own assessment of extra- and intra-euro area imbalances; and more considerations of the euro area-wide macroeconomic policy mix and the importance of structural policies in a monetary union. Enhancements along these lines would be facilitated by a better alignment with the European policy timetable, which in turn could also enhance the traction of such a report and entail more extensive consultations with euro area authorities.

Other recommendations made in the report are (i) to provide appropriate coverage of issues relating to banking supervision and the Single Supervisory Mechanism; (ii) to provide stronger and more

1 The report was finalised prior to the discussion of the 2014 TSR by the IMF Executive Board. Following publication of the IMF staff documents relating to the 2014 TSR, references to these documents have been included in the report where relevant.

clearly formulated policy recommendations on structural reforms, including their estimated impact; (iii) to take more account of the pro-cyclical effects when communicating its risk assessment analysis and place greater focus on policy recommendations to address the risks identified; (iv) to expand the Fund's gross external balance sheet analysis and link vulnerabilities to gross external balance sheets to the domestic sectoral accounts; (v) to provide greater feedback between external analysis and recommendations on financial regulation; and (vi) to include a box on the quality of past IMF advice and the authorities' response to it.

1 INTRODUCTION

In response to the well-documented shortcomings of its pre-crisis approach to surveillance[2], the IMF has taken a number of steps in recent years to strengthen its framework and toolkit for surveillance purposes. A key focus in this regard has been operationalising the priorities identified in the 2011 Triennial Surveillance Review (TSR), namely (i) interconnectedness; (ii) risk assessment; (iii) financial stability; (iv) external stability; (v) and traction. In addition, the legal basis for surveillance has been updated with the adoption in 2012 of the Integrated Surveillance Decision (ISD), which enables the IMF to survey all policies that are relevant both for a member's external and domestic stability, as well as to address inward and outward spillovers and cross-country policy interactions. Members are now "encouraged"[3] to take into account the impact of their policies on the rest of the world. The adoption of the Financial Surveillance Strategy was also an important step towards improving risk identification and policy analysis in the financial sector, and fostering an integrated view of financial sector risks in products and instruments.

In 2014 the IMF conducted a new TSR, which was structured around three themes[4]: (1) integrating and deepening risk and spillover analysis; (2) more tailored and expert policy advice; and (3) achieving greater impact. Regarding the first theme, the TSR found that there was still significant scope to explore synergies between bilateral and multilateral surveillance. Moreover, IMF staff saw a need to deepen the understanding of how risks map across countries and how spillovers spread across sectors. As to the second theme, attention is drawn to the importance of tailoring advice to country circumstances. Also, Fund staff saw merit in continuing to build the IMF's understanding of macro-prudential policy and highlighting the implications of macro-critical structural reforms. Turning to the third theme, staff underlined the need for more client-focused and candid communication.[5] As to the way forward, IMF staff suggested that the IMF Managing Director prepare an action plan, which should be supported by a revised surveillance guidance note. Moreover, it proposed to move comprehensive surveillance reviews to a five-year cycle (next due in 2019), to be complemented by an interim progress report after 2½–3 years.[6]

The aim of this report is to contribute to the debate on the 2014 TSR.[7] Specifically, the report examines how surveillance of the EU and euro area has changed since the 2011 TSR and how it could be further improved under the new surveillance framework. Thus, the report assesses inter alia whether surveillance has become more integrated across its various levels and whether analysis of linkages and risks across sectors and countries has improved. Overall, the report takes an EU-wide view of the Fund's surveillance, although a substantial part of the analysis and recommendations is made for the specific case of the euro area. Given that the euro area's governance has been significantly reinforced in the past few years, increasing the influence of the European level in policy-making, some differentiation is called for between the way in which surveillance of euro area countries is being conducted and the approach that is applied to other EU countries and non-EU ones. The Fund's views as an independent adviser can help enhance the policies and framework of the EU and the euro area. The report offers candid and concrete recommendations aimed at keeping the Fund's surveillance of the EU, the euro area and their member states relevant.

2 For a summary, see Box 1 in IMF (2011).
3 Members are under no obligation to follow the IMF recommendations on policies producing outward spillovers.
4 See IMF (2014a).
5 See annex 1 for a more detailed overview of the recommendations by IMF staff.
6 See annex 2 for an excerpt from the Summing Up of the IMF Executive Board discussion of 26 September 2014 of the 2014 Triennial Surveillance Review.
7 The report was finalised prior to the discussion of the 2014 TSR by the IMF Executive Board. Following publication of the IMF staff documents relating to the 2014 TSR, references to these documents have been included in the report where relevant.

The report is structured as follows. Section 2 describes the IMF framework for surveying the EU and the euro area and discusses how it interacts with the EU/euro area's own surveillance framework, which has been substantially reformed in the recent past. Section 3 reviews the performance of the Fund's post-crisis surveillance of the euro area and the EU in each of the five surveillance priority areas mentioned above. Section 4 looks at the specificities of IMF surveillance of the institutional design of EMU, identifying the main areas where it could be improved. Section 5 turns to the external sector surveillance of the EU, reviewing progress and making the case for enhanced gross balance sheet analysis. Section 6 concludes and presents the main recommendations of the report.

2 IMF SURVEILLANCE OF THE EU AND THE EURO AREA: THE FRAMEWORK

2.1 A NEW LEGAL FRAMEWORK

A new legal framework for IMF surveillance was put in place with the adoption of the ISD in 2012. The legal basis for Fund surveillance is set out in Article IV of the IMF's Articles of Agreement, which distinguishes between bilateral and multilateral surveillance[8]. The ISD has updated the surveillance framework by enabling the IMF to engage more effectively with members on their domestic economic and financial policies and making Article IV bilateral consultations a vehicle for multilateral surveillance as well. In particular, the ISD allows the IMF to discuss with its members the full range of spillovers from their policies when these may have a significant impact on global stability.

The ISD also provides the basis for better surveillance of monetary unions, although it does not completely take account of the strengthening of the EU/EMU decision-making structures. Indeed, the paragraph in the ISD concerning currency unions is little changed compared to the 2007 Decision on the Bilateral Surveillance over Members Policies. The text has been improved by placing emphasis on ensuring not only the *balance of payments stability* of the union, but also its *domestic stability*. Helpfully, in translating the ISD into operational guidance for the surveillance of currency unions, staff are explicitly advised to assess the extent to which economic and financial polices at the level of the currency union (exchange rate, monetary, fiscal and financial sector policies) are promoting the union's domestic and balance of payments stability and global stability. On the treatment of the euro area, the ISD repeats the 2007 Decision in explicitly noting that members of currency unions "remain subject to all of their obligations under Article IV section 1, and accordingly, each member is accountable for those policies that are conducted by union level institutions on its behalf" (ISD, paragraph 8). This corresponds to the fact that countries themselves retain all the resulting rights and obligations of IMF membership, while the institutional reality is also characterised by an independent central bank and joint decision-making in some policy areas. None of the European institutions or fora are members of the IMF, and their cooperation with the Fund is not mandatory.

2.2 SURVEILLANCE IN PRACTICE: BILATERAL, REGIONAL AND MULTILATERAL

The IMF conducts consultations with individual EU Member States, resulting in country reports covering national policies, as well as with the euro area as a whole. The IMF also conducts a Financial System Assessment Programme (FSAP) every five years for those EU countries with systemic financial systems[9], and upon request for the rest of the EU members. In addition, a first EU FSAP was concluded in March 2013.

For the euro area, the modalities for conducting IMF surveillance were formalised with the introduction of the euro[10]. The euro area does not have an Article IV consultation in its own right since the euro area as such is not a member of the IMF. Instead, IMF staff semi-annually exchange views with staff of the ECB, the European Commission and other European institutions and bodies[11]

8 Article IV, Section 1 provides that each member shall "*undertake to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates"*. It thus directs the Fund to give heightened scrutiny to members' exchange rate policies. Section 3(a) requires the Fund to *"oversee the international monetary system in order to ensure its effective operation"* and forms the basis for the Fund's multilateral surveillance.

9 These countries are Austria, Belgium, Denmark, Finland, France, Germany, Italy, Ireland, Luxembourg, the Netherlands, Poland, Spain, Sweden and the United Kingdom.

10 IMF Decision No. 12846-(98/125) and IMF Decision No. 12899-(02/119), as amended by IMF Decision No. 14062-(08/15).

11 The ECB has been granted observer status at selected IMF Executive Board meetings (IMF Decision 11875-99/1). Moreover, both the ECB and the European Commission hold observer status at the IMFC.

and prepare an annual report on euro area policies to complement and better inform the Article IV consultations with individual euro area countries. This subordinates the surveillance of the euro area as a whole to that of each of its members.

In practice, euro area surveillance follows a dual track, as there is no surveillance exercise of the euro area as an integrated economy involving both union and national authorities simultaneously. Rather, there are consultations with individual euro area members plus a consultation on the policies of the ECB and the European Commission, which forms an input into the national reports (19 annual reports in total). There is no comprehensive discussion of all euro area policy elements with the relevant national and union-wide authorities.

As part of its multilateral surveillance, the IMF also analyses developments in the EU and the euro area in its World Economic Outlook (WEO), Global Financial Stability Report (GFSR) and Fiscal Monitor. Since 2011 the Fund has also produced annual Spillover Reports, examining outward spillovers from the five economies whose policies most significantly affect the stability of the global financial system. Two of these economies are the euro area and the UK. The IMF's European Regional Economic Outlook was discontinued in 2011 and the Fund has since experimented with products focused on narrower groups of countries. In 2013 it initiated clustered consultations with Denmark, Finland, Norway and Sweden, resulting in the Nordic Regional Report, produced a cluster report on the German-Central European supply chain and launched a report entitled "Central, Eastern and South-Eastern Europe – Regional Economic Issues". In 2014, it has conducted a clustered consultation with the Baltic States and plans to produce inter alia a cross-country report on housing busts, drawing on the experiences and policy responses of Denmark, Ireland, the Netherlands and Spain.

2.3 THE EU AND IMF SURVEILLANCE FRAMEWORKS: POTENTIAL SCOPE FOR TENSIONS AND CROSS-FERTILISATION

The recent crisis has led to successive reforms of the surveillance framework of the EU and the euro area. As discussed in Box 1, new surveillance systems for Member States' budgetary and economic policies, as well as a new financial supervisory architecture mainly affecting euro area countries, have been established. A clear calendar has been established in the context of the EU Semester, during which policy recommendations are formulated at the European level and addressed to the national level. This reinforced EU surveillance framework has thus far not led to any specific changes in the way the IMF conducts its surveillance of EU Member States.

The interplay between the reinforced EU and the current IMF surveillance frameworks might entail specific challenges for both EU Member States and the IMF going forward. Firstly, with economic governance increasingly exercised at different levels (national, joint national, euro area and EU), the degree of complexity surrounding policy formulation has definitely increased. This requires the IMF to internalise these new EU/euro area processes properly in its surveillance, and may complicate Fund surveillance or even become a source of inconsistencies between assessments made in national and euro area surveillance reports. Secondly, there are differences in the scope, focus, enforcement mechanisms and traction of the two surveillance frameworks. Fund surveillance is of a cooperative nature, and its leverage is based on peer pressure and the potential impact on capital markets.[12] On the other hand, EU surveillance is a continuous process, embedded in a so-called EU Semester, with monitoring of implementation in the second semester of the year and legally binding procedures for dealing with fiscal and macroeconomic imbalances (SGP and MIP), both of which can impose

12 21 EU Member States are currently on an annual Article IV cycle.

sanctions in the event of non-compliance. Hence, IMF surveillance usually results in broader, more strategic policy guidance, in contrast with the EU's more detailed country-specific recommendations under its surveillance calendar. While this does not necessarily lead to differences in policy advice, tensions may arise if contrasting policy recommendations are made due to differences in views on the effectiveness of certain policy tools in given circumstances (e.g. the size of fiscal multipliers, recourse to fiscal devaluation, the use of currency depreciation to regain competitiveness, the benefits of frontloading versus backloading adjustment measures). Furthermore, individual EU countries may on occasion not be legally in a position to follow IMF policy advice if it is not in line with EU rules.

Nevertheless, the IMF and EU surveillance frameworks can also work as useful complements. In fact, the IMF can play a useful role as an independent, trusted, external adviser. The Fund has a comparative advantage given the breadth of its expertise, the wealth of its experience across countries and over time, and an approach that is driven first and foremost by economic analysis, with less institutional constraints. As such, the IMF has an important role to play in providing an additional external perspective in addition to the European view from within. As European processes are inevitably affected by diverging interests between national governments and EU authorities, being a non-European participant in the surveillance process should give the Fund more freedom and objectivity. IMF recommendations can be an encouragement for euro area members to collectively deliberate and seek, if warranted, a change in common policies.

Box 1

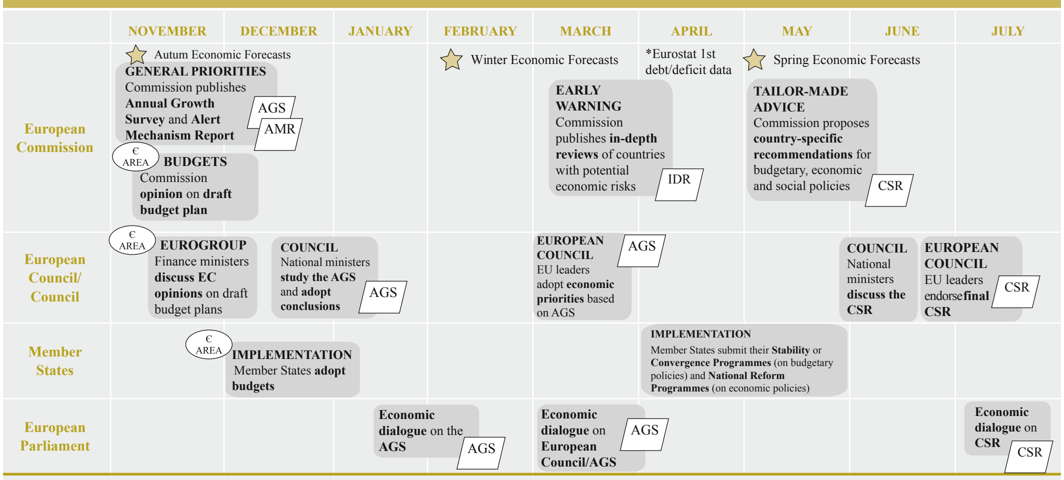
THE EU/EURO AREA SURVEILLANCE FRAMEWORK

The recent crisis has led to successive reforms of the EU's surveillance framework, strengthening existing surveillance mechanisms for Member States' budgetary and economic policies and introducing new ones, notably the "six-pack" legislation which entered into force in December 2011. The main mechanisms for budgetary and economic surveillance systems are integrated in the European Semester, the EU's first-half round of assessments of Stability, Convergence and National Reform Programmes, which culminate in the adoption of country-specific recommendations. The annual starting point of the overall fiscal surveillance cycle is the Commission's Annual Growth Survey in November, which sets out the key economic priorities for fiscal and macroeconomic policies. The Stability and Growth Pact (SGP) has been reformed, by introducing stricter rules and enforcement mechanisms in the preventive and corrective arms of the SGP. In addition, fiscal surveillance has been further strengthened by requiring euro area Member States to submit their draft budgetary plans for assessment by the Commission by 15 October. These assessments are then discussed by euro area finance ministers. The Commission also has the ability to request Member States whose plans do not comply with the rules of the SGP to resubmit a revised budgetary plan. As part of these reforms a specific mechanism for the surveillance of national macroeconomic policies has been established, the so-called Macroeconomic Imbalances Procedure (MIP). The MIP operates alongside the SGP to identify, prevent and correct macroeconomic imbalances in EU Member States. The annual starting point of the MIP is the Alert Mechanism Report (AMR). Based on a scoreboard of indicators, this identifies countries where a closer analysis of potential imbalances (in-depth review) is deemed necessary. If excessive imbalances are detected, the corrective arm of the MIP – the Excessive Imbalance Procedure (EIP) – can be triggered and financial sanctions could ultimately be applied to euro area countries.

The surveillance framework for the euro area has been further reinforced by the “two-pack” regulations, which entered into force in May 2013. These allow the Commission to decide to subject a euro area country to “enhanced surveillance” if it is experiencing or facing serious difficulties with respect to its financial stability which are likely to have adverse spillover effects on other euro area countries. If a euro area country’s economic and financial situation is having a significant adverse effect on the financial stability of the euro area, it can be asked to prepare a draft macroeconomic adjustment programme. Furthermore, countries formerly covered by an EU-IMF financial assistance programme are subject to post-programme surveillance (PPS). This is a complement to the regular EU economic country surveillance, and designed to ensure that Member States exiting financial assistance programmes maintain financial stability and fiscal sustainability.

Moreover, a new financial supervisory architecture has been established. This includes the European Systemic Risk Board (ESRB) for macro-prudential oversight of the financial system and three European supervisory authorities (ESAs): the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). Furthermore, the European Parliament and the EU Council have agreed on harmonised underlying legal frameworks for both bank recovery and resolution (BRRD) and national deposit guarantee schemes (DGS) across the EU. In June 2012, the EU Heads of State and Government committed to the creation of a European banking union. The banking union is specifically for euro area countries, although it is also open to all non-euro EU Member States who opt to join. It consists of a single supervisory mechanism (SSM) for banks under the exclusive responsibility of the ECB and a single resolution mechanism (SRM) with a single resolution Board and Fund. This new architecture should encourage deeper cross-border banking integration and foster a more stable financial system.

The European Semester



Glossary: **AGS:** Annual Growth Survey (general economic priorities for the EU). **AMR:** Alert Mechanism Report (screening system for economic risks). **CSR:** Country Specific Recommendations. **IDR:** In-depth Review.

Source: European Commission DG ECFIN.

3 EFFECTIVE IMPLEMENTATION OF THE INTEGRATED SURVEILLANCE FRAMEWORK

Overall, the IMF has made good progress in implementing the new surveillance framework, although there is scope for further improvement. This section looks at whether the IMF has effectively implemented changes to its surveillance framework in each of the five priority areas identified in the 2011 TSR[13]: (i) interconnectedness, (ii) risk assessment, (iii) financial sector, (iv) external stability and (v) traction.

3.1 INTERCONNECTEDNESS

3.1.1 ECONOMIC AND FINANCIAL LINKAGES

Cross-border spillover analyses are now included in bilateral surveillance of EU countries. Coverage of spillovers has become a mainstream feature of post-crisis surveillance in the EU, with inward spillovers considered for all countries at varying depths. Moreover, an analysis of outward spillovers has been included in more than half of all reports, including those for gatekeeper countries and regional anchors (such as the UK and Germany), as well as for peripheral economies where outward spillovers have had, or potentially could have, systemic effects on the euro area or the EU as a whole. Efforts to take advantage of the evolving analytical framework for spillovers and draw lessons from cross-country experiences have been mixed. For example, while the coordination of the Swedish Article IV consultation with the Nordic Regional Report is a good illustration of regional clustering, experimentation along these lines has been limited, with cross-country analyses more generally cited in less than half of the reports.

Moreover, for individual euro area countries, national surveillance is now far better informed by regional surveillance. Analyses in national Article IV and FSSA reports are systematically informed by, and put into the context of, the main economic and financial developments within the euro area as a whole (e.g. growth prospects for the Union). Where relevant, national surveillance also considers the economic and financial developments in core, stressed and closely linked euro area countries (e.g. comparisons of unit labour costs).

However, the analysis of interactions between euro area countries has been included in integrated surveillance products to a limited extent only, exemplified by the 2013 report on euro area policies. In addition, only a minor attempt was made to examine the impact of different scenarios on the euro area as a whole in the last Spillover Report (stabilisation of the euro area, protracted slowdown and rebalancing). As such, there is scope to go further than the current general summing up of spillovers within the euro area and better integrate the analysis carried out for country surveillance into monetary union surveillance products. Building on the example of the last Spillover Report, there should also be some analysis of positive inward spillovers, in addition to the negative shocks most commonly examined in countries' reports.

In multilateral reports such as the WEO and the GFSR, thematic chapters or sections usually provide in-depth analysis of specific issues (e.g. the banking, corporate and sovereign nexus). However, in the April 2014 WEO and GFSR reports, the identification of key vulnerabilities and challenges for the euro area focused mainly on a narrow selection of countries with a fluctuating perimeter.

13 This is done by reviewing the Article IV reports prepared for EU Member States in 2013. These related to Austria, Belgium, Bulgaria, the Czech Republic, Estonia, France, Germany, Greece, Hungary, Italy, Lithuania, Malta, the Netherlands, Poland, Slovakia, Slovenia, Spain, Sweden and the UK. The timeframe reflects the fact that the note providing guidance to staff on bilateral and multilateral surveillance in an Article IV context was issued in October 2012 (following the adoption of the ISD in July 2012), and that the ISD applies to Article IV consultations completed by the Executive Board from 18 January 2013 onwards. It is worth noting, however, that substantial adjustments had already occurred since the beginning of the crisis and before the 2011 TSR.

Consequently, the discussion of developments was confined to the interaction between core and stressed countries. A pertinent question is whether there is merit in better reflecting the differences within the euro area as a whole.

3.1.2 POLICY LINKAGES

There has been an improvement in the treatment of policy interconnectedness within the euro area. Policy advice to countries appears more intrinsically linked to the main economic and financial developments in the euro area, and more cognisant of the euro area economic and financial policy framework as well. Staff now clearly distinguish between policies within the field of competence of European authorities (e.g. monetary policy), those under the responsibility of national governments (e.g. fiscal adjustment and structural reforms to boost competitiveness) and those within the EU framework (e.g. the Stability and Growth Pact).[14] Similarly, policy advice on financial issues now takes into account developments in the EU/euro area (e.g. the upcoming balance sheet assessment) and at the national level (e.g. the nature of insolvency regimes) in the context of a profound reshaping of European regulation and supervision.

Nevertheless, better tailored and more concrete policy proposals could be presented. This would mean more discussion with authorities on how EU/euro area membership affects vulnerabilities and policy options, including, e.g., the case of euro area monetary policy coping with different national macroeconomic conditions and the role of national macroprudential policies within the euro area. It could also mean providing authorities with better "maps" of financial and real linkages within the Union, as already suggested. Without prejudice to the domestic stability objective, the policy options suggested to authorities could also be qualified by the outward spillovers they potentially generate. For example, the exercise in the 2013 UK Article IV report, where outward growth and financial spillovers from the UK reform package are presented, should become more systematic.

Going forward, it will be important to provide appropriate coverage of issues relating to banking supervision and the SSM. Moreover, in line with the Fund's Integrated Surveillance Decision, due attention needs to be paid to closely linking assessments in bilateral/regional surveillance with those included in multilateral surveillance.

There is also room for improvement in making recommendations concerning the EU regulatory framework for structural issues and structural reforms more broadly, while keeping to the mandate of the IMF. Regulatory recommendations are currently rather ad hoc, which may reflect the latitude member countries have in implementing EU regulatory texts (e.g. reference to the EU Directive on Services is random and focuses on the impact of liberalisation on services markets while leaving aside broader effects on the whole economy, even for countries where significant improvements are strongly advocated[15]). There is occasional reference to relevant work by the OECD and ILO, but there is scope to make more use of insights from these institutions. The 2014 TSR will examine whether the IMF should expand advice on structural issues within its core mandate.

3.2 RISK ASSESSMENT

Turning to the assessment of risks, post-crisis surveillance in the EU has stepped up risk discussions, with risks to the baseline scenario discussed for all member countries. Risk assessment matrices (RAMs) can be found in most of the reports. Overall, it appears that RAMs for EU countries are

14 See for instance IMF (2013b) and IMF (2013c) regarding ECB measures against financial fragmentation.
15 See for instance IMF (2013c), where there is only one passing reference to the EU Directive on Services in the ED Statement and IMF (2013a).

of higher quality than in many non-EU cases. By highlighting transmission channels and assigning probabilities to the crystallisation of risks as well as the potential impacts (high, medium or low), they have provided for a sharper focus. Policy implications and responses are also covered in the bulk of cases – either in the RAMs or the main text – though their specification could be improved. Similarly, more attention should be paid to tail risks: these featured in half of the reports but, with few exceptions (notably the Greek consultation), are largely implicit. When assessing risks, the Article IV guidance note encourages staff to draw on multilateral surveillance tools and debt sustainability analyses (DSAs) where relevant. While DSAs were undertaken for three quarters of EU Member States, use of multilateral tools (e.g. the cross-reference to the 2013 Spillover Report in the German consultation) was very limited.

While candour is important for effective Fund surveillance, communication of messages has not always been as careful and coherent as warranted by the sensitivity of the issues involved. Messages could be better coordinated across surveillance products and communicated in a way that does not produce unintended market reactions. The GFSR reports of September 2011 and April and October 2013 are cases in point. The former presented estimates of losses for European banks due to exposure to sovereign risk in euro area countries under stress, whereas the latter contained estimates of corporate debt overhang in euro area countries under stress. In these reports, strong conclusions on potential losses on banks' balance sheets were drawn despite the fact that the methodology was not sufficiently robust and there were data shortcomings. These results were communicated without coordination with other (bilateral and multilateral) reports published in those years.

There is scope for taking more account of the pro-cyclical effects of communicating the IMF's risk assessment analysis and placing greater focus on policy recommendations to address the risks identified. While the Fund should try to clearly identify all pertinent risks early on and treat them carefully, it should avoid adding to pro-cyclicality by the way it communicates its assessment of countries that may already be facing difficulties. This may happen, for instance, through harsh risk assessments or by using country groupings that lump together countries under market pressure. In 2012, at the height of the euro area crisis, the euro area report contained a table on "reforms needed for selected countries" where the selected countries were Greece, Ireland, Portugal, Italy and Spain, which stood in contrast to a similar table in a previous euro area report where specific recommendations for reform were presented for almost all euro area members. Nevertheless, the Fiscal Monitor of October 2012 recognised that market reactions at that time were not justified by the long-term fundamentals of the countries under pressure.

3.3 FINANCIAL STABILITY

The widespread coverage of financial stability in the reports for EU Member States suggests that the Fund is making progress in addressing previous weaknesses in this area. Risks to the financial system and underlying vulnerabilities were considered in all of the reports reviewed, with most of them also covering macro-financial and cross-border linkages. The analysis and discussion of linkages varied however – from partial to substantive (the Swedish and UK consultations contain good examples of the latter) – and there is room for further elaboration and improvements on linkages. In terms of financial stability policies, measures were identified in each case and over half of the reports followed up on, or at least referred to, past FSAP recommendations.

The first EU-wide FSAP was an important milestone. It focused on how the EU/EMU supranational institutions interact with national institutions and put forward "high-priority recommendations" on overcoming cross-border risks and improving the financial stability framework of the Single Market. The report also contained a section on "Lessons from national FSAPs", which offered an overview of the main risks and vulnerabilities identified in national FSAPs of EU countries. Some of the recommendations, e.g. on banking union, have provided important input for actual policy shaping.

Policy recommendations mostly take an appropriately international dimension, though they are often very general. Staff often emphasise the "public good" of financial stability in key financial centres and potential for outward spillovers (e.g. UK, SE and NL Article IV 2013, IT FSAP 2013). In many cases, staff reiterate that securing financial stability, including through strong supervision and macroprudential regulation, is important in an international context. Yet, due to either the sensitivity of such discussions or underdeveloped expertise and capacity, staff advice on cross-border regulatory cooperation has usually been very general. As an example, the 2013 Nordic Cluster Report simply pushes for "*cooperative regional policies, such as introducing binding macroprudential minima and clear ex ante burden-sharing arrangements*" (p. 1). No further specifics are given. An exception is the EU FSAP 2013, where staff consistently push for a supranational approach to governance arrangements to counter national bias and prevent fragmentation in the EU.

3.4 EXTERNAL STABILITY

The 2011 TSR and ISD supported a broadening out of surveillance beyond its traditional exchange rate focus as a response to the drawbacks of pre-crisis assessments. There is some evidence that this wider perspective is starting to feed into Article IV consultations in Europe, and that external stability assessments are being better integrated into the overall policy mix (the euro area consultation serves as a case in point). All the reports for Member States and the euro area have included a discussion of external competitiveness, complemented – albeit to varying degrees – by tables and graphs showing developments across a range of indicators.

The broad consistency of the current account and/or the exchange rate with medium term fundamentals was also assessed. In doing so, staff made use of the expanding set of external surveillance tools, drawing heavily on estimates derived from the External Balance Assessment (EBA)/Consultative Group on Exchange Rates (CGER) methodologies. On the other hand, the coverage of the capital and financial account in the main text of the reports was somewhat sporadic, as was the commentary on reserve adequacy and interventions (notwithstanding that considerations on adequacy differ for reserve currency issuers). More could be done in this respect and also in relation to firm policy implications, which were lacking in a number of reports. Section 5 discusses in more depth the surveillance of the external sector in the EU and euro area.

3.5 TRACTION

There is general agreement that, for IMF surveillance in the EU to be effective and relevant, the Fund has to ensure that it has adequate traction as a trusted advisor. The 2012 Fund staff guidance note for surveillance under Article IV consultations sets out that traction can be understood as having two dimensions: firstly, the extent to which authorities engage with the Fund on its analysis and recommendations, and secondly, the extent to which Fund advice is reflected in policy action.[16] However, traction has to be assessed in light of the Fund's role as one adviser among

16 IMF (2012), p. 31.

others, i.e. authorities are not obliged to translate IMF advice into policy action. Thus, traction is held to depend on high quality analysis, evenhandedness, candour and effective communication. These serve to establish trust, which is paramount for traction to develop.

The Fund has recently taken several steps to improve the traction of its advice in the EU, primarily by focusing more on issues of core interest to authorities and following up on whether its previous advice has been adopted. For example, macro-social issues have been discussed to some degree in nearly all of the reports for EU Member States and the euro area, with considerable emphasis placed on labour market developments and reforms, given their macro-critical role. In many cases, Fund staff have followed up on whether previous policy advice had been taken into consideration, though not always in a consistent way. While a detailed assessment of the authorities' response has been set out in some reports, not much more than a passing reference has been made in others (the Austrian and Maltese consultations are at the opposite end of the spectrum in this respect).

There has been an improvement in follow-up on past advice, but this has normally looked at national authorities' response to the Fund's advice and has not assessed the quality and relevance of the IMF's own analysis and recommendations. More follow-up would be helpful, including on the degree to which countries have responded to IMF advice and the quality of past advice (i.e. differences with authorities on the diagnosis, policies needed or their political viability). An innovation worth noting is the 'Point and Counterpoint to the Staff's Views' sections included in a few selected reports (inter alia, the Article IV consultations for the Netherlands and Germany). In these, Fund staff put forward and responded to a series of possible counter-arguments to their own diagnosis and recommendations. Extending this approach to all countries could be a useful way of encouraging debate and increasing the Fund's credibility. Further, customised outreach strategies could make the communication of mission conclusions more effective.

Raising the technical and political engagement in surveillance at the bilateral and euro area level could be considered. Country and European expertise could be strengthened through potentially longer country assignments or secondment of IMF staff to European institutions and national authorities in Europe and vice-versa. For the euro area, there could be more substantive discussions with the Eurogroup at an earlier stage of preparation of the euro area policies report. The IMF could also broaden its communication beyond a press event, including a presentation to the corresponding economic commissions of national and European parliaments. In addition, more use could be made of IMF surveillance reports on individual Member States in the context of country surveillance processes conducted at the European level.

Better synchronising the issuance of Fund policy recommendations with the EU/euro area policy-making cycle could allow such recommendations to feed more effectively into EU/euro area decision-making processes. For the euro area, the IMF staff reports on the euro area and several euro area countries, including France, Germany and Spain, are completed in July. Going forward, it would be useful if these reports were completed before the European Commission proposes its country-specific recommendations to euro area countries in May as part of the European Semester, or earlier still, when countries are in the process of drawing up their National Reform Programmes and Stability or Convergence Programmes.

4 CASE STUDY: IMF SURVEILLANCE OF THE INSTITUTIONAL FRAMEWORK OF EMU

Over recent years, IMF surveillance of the euro area policy framework has improved. The 2011 report on euro area policies set a good example by exploring the aspects of the framework that had led to the euro area sovereign debt crisis. More recent reports usefully made connections between different elements of the framework (e.g. the 2012 report on euro area policies linked banking union with fiscal integration and fiscal consolidation under the SGP). The 2013 report on euro area policies drew attention to potential risks (likelihood and expected impact) and recommended changes to some aspects of the framework in an innovative, clear and helpful "Risk Assessment Matrix". The reports also usefully distinguished between the relative progress in different areas of the framework for the EU and the euro area.

However, there remain areas for improvement.

- *Broadening surveillance beyond aspects already present in the internal European debate.* The reports on euro area policies generally tend to confine themselves to presenting the state of the debate within Europe (the 2011 report on euro area policies is an exception and is much clearer in this regard). While there is merit in IMF staff discussing and reinforcing the policy recommendations already floated by European actors, a fresh perspective from Fund staff on the design of the European policy framework would be valuable. The Fund could also assess other aspects of the framework that are not part of the prevailing debate. For example, given the importance of structural reforms in improving economic flexibility, the assessments could go further than identifying weaknesses by questioning whether there are any common elements to these weaknesses across countries that suggest a deficiency in the framework.

- *Providing technical advice on the governance of the euro area policy framework.* The stability and performance of the euro area and its members depend in no small part on governance, i.e. the design and functioning of the EMU policy framework, which is continuing its gradual shift from national towards joint or centralised policy making. The IMF has usefully dealt with governance: notably, in 2011, IMF staff reports weighed in on discussions on strengthening the EU's fiscal policy framework, including a critical analysis of the effectiveness of the SGP and its surveillance, decision-making, and enforcement mechanisms (such as the problem with qualified majority voting in the Council). This type of advice is helpful and could be enhanced in three ways: (i) by delving deeper into some aspects, such as internal EU surveillance, building on IMF staff material prepared on fiscal union and banking union for instance; (ii) by following up on recommendations in subsequent reports to provide continuity and consistency in IMF messages, an element which is currently missing; and (iii) by taking due account of the institutional framework for reforms (as staff stress time and again, many of their proposals require garnering political support), including views on the appropriate balance of competences at the European and the national levels.

- *Fostering multiparty engagement with policy authorities.* As mentioned in section 2, the current format of euro area consultations produces dual-track surveillance – of union policies and national policies – with separate interlocutors and no single comprehensive report on the euro area.[17] Although the IMF interacts with national policy-makers at the level of the Eurogroup and the Eurogroup Working Group on the euro area policies report, this occurs at the end of

17 Also, there are mixed messages on who the IMF regards as euro area authorities. The reports on euro area policies refer explicitly to "the authorities" as being the ECB and the European Commission, but a much wider group is mentioned in a footnote in the contents pages, including EBA, the ESRB, the ESM and the European Council.

the consultation process and is a presentation of results rather than a consultation contributing to the substance of the surveillance exercise. Hence, as with national surveillance procedures, there would be merit in involving national policy-makers at the level of the Eurogroup Working Group in the consultation process at an earlier stage, with a focus on the functioning of the euro area as a whole. Such a change in procedures would require support from authorities in Europe as well as the IMF.

The euro area policies report should be transformed into a more comprehensive Euro Area Surveillance Report (as also recommended by Pisani-Ferry et al.[18]). It would continue to be produced once a year. This report would draw on the IMF's existing multilateral surveillance (WEO, GFSR, FM, Spillover Reports, External Sector Report, Early Warning Exercise (EWE)) and bilateral Article IV reports. The report could provide a mapping of the main interlinkages, risks and spillover channels between euro area countries.[19] It could also deliver a deeper technical analysis of the European policy framework, building on IMF staff material prepared on fiscal union and banking union for instance. Moreover, references to the Macroeconomic Imbalances Procedure could be included to juxtapose it with the IMF's own assessment of extra- and intra-euro area imbalances and more considerations could be given to the euro area-wide macroeconomic policy mix and the importance of structural policies in a monetary union. There would be merit in having more extensive consultations with euro area authorities on its content, which would be facilitated by better alignment with the timetable for European policy deliberations, enhancing the traction of such a report. Such a comprehensive assessment will become all the more imperative with the establishment of the Single Supervisory and Resolution Mechanisms and their integration into the IMF euro area surveillance processes.

18 J. Pisani-Ferry et al. (2011), p.40. Annex 2 summarises the main proposals of this report.
19 The request for a detailed assessment of risks consistent with the request to draw on IMF surveillance reports would contribute to enhancing the technical content of the report, and therefore its traction. This would also ensure that the report does not end up duplicating reports published by the European Commission, for instance under the Macroeconomic Imbalances Procedure.

5 CASE STUDY: EXTERNAL SECTOR SURVEILLANCE IN THE EU

The EU presents a unique macroeconomic and policy context for the IMF's external sector and financial surveillance. On the one hand, the high degree of policy integration and the presence of supranational institutions make the definition of what is "external" for EU countries blurrier than for other IMF members. Should the IMF primarily consider the aggregate external position of the EU or euro area as a whole, or should it consider the external positions of member states with each another? On the other hand, the far-reaching trade and financial openness of EU countries makes external sector analysis even more important, just as large and international financial sectors give particular importance to examining cross-border financial issues for both risk assessment and policy. This case study assesses whether the Fund's surveillance work for EU countries has been consistent with its stated goals and effective in signalling risks and policy options.

Overall the euro area external balance and the external balances of countries belonging to the euro area have been carefully scrutinised by the IMF in the past three years, as part of both bilateral and multilateral surveillance. More precisely, they have been discussed in the Euro Area Policies Consultations (2012 and 2013); the Pilot External Sector Reports (2012 and 2013); and the Article IV consultations for those euro area countries with the largest external imbalances (e.g. Germany, the Netherlands and Spain). Relatedly, surveillance of external balances in other EU countries has also been further developed since the crisis. The 2013 Pilot External Sector Report includes individual economy assessments of the UK, Sweden and Poland, each integrated with advice from Article IV consultations. Bilateral surveillance of CEE countries, e.g. Article IV Bulgaria (2013), applies the EBA methodology to current account positions, which have generally moved from large deficits to modest surplus.

A review of the treatment of external balances in the euro area reveals at least four points which are worth emphasising.

Firstly, IMF surveillance appears well balanced between analysis of the external balance of the euro area as a whole and that of individual euro area countries. This emerges clearly from the Euro Area Policies Report (2013), where the Fund takes care to link the adjustment of the euro area total current account balance recorded between 2008 and 2012 (from -1.5 to +1.2% of GDP) to the adjustment recorded in the individual member countries, and on this basis judges the overall adjustment "somewhat asymmetric", mainly driven by a sharp adjustment in the current accounts of deficit countries. This careful balancing emerges even more clearly in the 2013 Pilot External Sector Report, where in the section dedicated to the assessment of global imbalances the Fund identifies the following as a key outstanding feature: "While the Euro Area's external position appears broadly in line with medium-term fundamentals and desired policies, this masks continued wide divergences among economies."[20]

Secondly, the analysis reported in different bilateral and multilateral surveillance IMF reports is consistent and gains traction for this reason. Indeed, the estimated misalignments of the Real Effective Exchange Rate (REER) and the divergences between the cyclically adjusted current account and the "current account norm" in the Pilot External Sector Report (ESR) are frequently

20 Nevertheless, it should be noted that, for instance, the German current account surplus with the euro area has halved since 2013 and the contribution to this development from higher German imports is much larger than that from lower exports.

recalled in the Euro Area consultations as well as the Article IV consultations for countries belonging to the euro area.[21] This enhances the efficacy of the Article IV analysis by allowing it to draw on the rigorous econometric analysis underlying the Pilot External Sector Report.[22] At the same time, it is also important that the ESR take on board the results of the more in-depth country-specific analysis carried out in the external stability assessments in the Article IV country reports and that the uncertainties and methodological caveats of econometric analysis be taken sufficiently into account.

Thirdly, the policy recommendations concerning external imbalances within the euro area contained in the Euro Area Policies Reports have evolved in the past couple of years, albeit not consistently across reports. In 2012, policy recommendations aimed at resolving imbalances included a larger inflation differential between the North and the South of the euro area, generated by stronger wage increases in the North. In 2013, the report only pointed to the indirect effects of a wide set of structural reforms[23] in both surplus and deficit countries as the mechanism which would allow a rebalancing. A similar change featured in the policy recommendations in the Article IV reports on Germany published in 2012 and 2013. However, this change did not translate to the same extent across all IMF surveillance reports, suggesting that some internal debate is still going on at the Fund. In particular, the 2013 Pilot External Sector Report, beyond supporting product and labour market reforms, also recommended a period of above-target inflation rates in some surplus economies.

Fourthly, while there is some evidence of a shift in the focus of IMF external surveillance towards gross external balance sheet positions, Article IV reports for the euro area countries have remained light on this analysis. For example, the 2013 Euro Area Report discussed private sector gross balance sheet stress and its negative impact on growth, but did not show its external dimension.[24] The IMF could examine how the resolution of domestic debt overhangs can be more complex when a high proportion of debt is ultimately owed to external creditors. A box on rebalancing talked about the need to converge on 'safe' net foreign asset positions, but there was no mention of what 'safe' gross external balance sheet positions should look like or how far euro area countries are from these. Key data indicators used could also be improved. For example, to illustrate the debt overhang in the euro area the report used gross indebtedness by sector alongside net IIPs; it would have been more informative to show the extent to which gross household, corporate, sovereign debt, etc. is associated with gross external debt. These critiques carry over to the Article IV reports of individual euro area countries. Likewise, given the size of the UK's gross external balance sheet (see Chart 2 in box 2), more could be done to explore its sustainability and the risks it poses in the face of ongoing large current account deficits. Specifically, gross positions and the potential mismatches they contain are critical to analysing the external risks arising from higher global interest rates as exceptional monetary policy is unwound. Box 2 includes a discussion of the importance of gross external balance sheet analysis.

21 The current account norm is the current account value implied by the EBA current account regression if all policy variables were at their desired level and all other regressor variables were at their actually observed values.

22 The External Balance Assessment (EBA) methodology was carefully illustrated by Phillips et al. (2013).

23 Including labour market reforms, reforms aimed at lowering regulatory barriers to entry and exit, reforms pursuing a simplification of the tax system and enhancement of competition in product markets.

24 Examples of analyses of gross external balance sheet positions can be found in the 2012 Spillover Report, which included an analysis of the different role of macroeconomic and financial shocks, and in particular of risk premia spillovers from EA sovereign risk to global bond markets. Good network analysis and shock diffusion simulations have been undertaken in Spillover Reports to analyse the role of the UK in the propagation of global financial shocks. A number of recent Article IV consultations (UK 2013, SE 2013), FSAPs (NL 2011, DE 2011, IT 2013 and EU 2013) as well as the Nordic Cluster report have paid attention to inward and outward financial spillovers.

Box 2

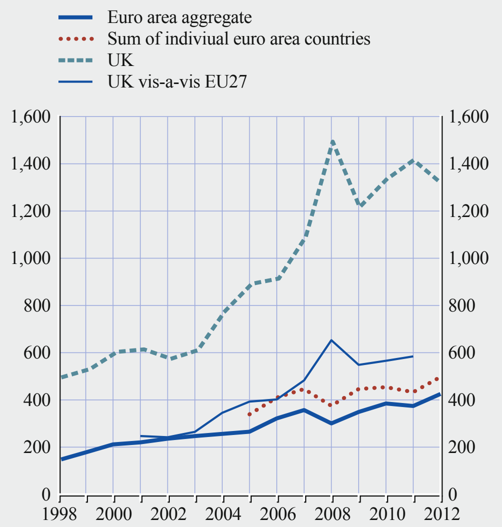
THE IMPORTANCE OF GROSS EXTERNAL BALANCE SHEET ANALYSIS

Recent literature – to which the IMF has contributed – underlines the crucial role of external balance sheets in financial stability analysis. For example, studies before the crisis (Gourinchas and Rey, 2005; Lane and Milesi-Ferretti, 2007) and since (Adrian, Moench and Shin, 2010; Catão and Milesi-Ferretti, 2013; Al-Saffar, Ridinger and Whitaker, 2013) underline that certain characteristics of national external balance sheets, such as high leverage and currency and maturity mismatches, are associated with financial stability risks and crisis vulnerability. This complements the literature on gross capital flows (see e.g. Borio and Disyatat, 2011; Shin, 2012; Shin and Bruno, 2013; Forbes and Warnock, 2012; Calderón and Kubota, 2012; Rey, 2013), which can have important effects on macroeconomic outcomes and the build-up of vulnerabilities even when net capital flows and current account balances are not large.[1]

EU countries became much more financially integrated ahead of the crisis. While net imbalances and gross cross-border financial flows have abated, the gross external positions – both assets and liabilities – have not been unwound, and if anything continue to drift higher (see chart). There is a high level of gross balance sheet interdependency among euro area economies: assets and liabilities vis-à-vis other euro area countries alone represent nearly half of total assets or liabilities. There is a similar level of interdependency between the UK, with its exceptionally large external balance sheet, and other EU countries.

This sort of financial spillover analysis obviously depends on detailed gross bilateral information on holdings of different types of assets. Often, work is supported by data on bank exposures, e.g. from the BIS consolidated and locational banking statistics and national sources, expressed in absolute terms or relative to the size of the sector or GDP.[2] Information on cross-border exposures of insurers, pension funds and asset managers is generally scarcer, yet much of the activity of these sectors should be part of (gross) international investment position (IIP) data and the Fund's new Consolidated Portfolio Investment Survey

Gross external balance sheets (a)



Sources: IMF IFS, IMF WEO (October 2013), ONS and Bank of England calculations.
(a) External assets plus liabilites as a percentage of GDP.

1 Gross capital flows include both gross capital inflows, defined as net sales of domestic financial instruments to foreign residents, and gross capital outflows, defined as net purchases of foreign financial instruments by domestic residents.
2 It should be noted, however, that the BIS Locational Statistics can deviate significantly from other sources and therefore cause misleading interpretations. Unlike national and IMF statistics, BIS data do not cover international financial institutions (such as the EBRD, the EIB and IBRD) or any other non-bank creditors (for example pension and investment funds), which play an important role in public-sector financing. Furthermore, besides loans, deposits and debt securities, BIS data also include equities, working capital, fixed assets and derivatives. The valuation of these instruments can be a significant source of discrepancies as (according to BIS methodology) actively traded instruments are valued at market rather than nominal prices.

(CPIS). The Fund's new methodology on interconnectedness and clusters is a means of applying this data to analyse potential spillovers through the global financial system, yet so far it has not been rolled out on a broad basis.

This sort of network analysis could be applied more to intra-EU analysis. There are good examples of this type of analysis, for example research at the ECB (Castrén and Kavonius, 2009) has shown that an estimated network of gross bilateral exposures provides an important tool for systemic risk analysis. By focusing on sector-level bilateral exposures, it addresses a gap in the literature. Existing studies mainly look at bilateral exposures at the firm level, such as in the interbank money markets, or at the country level, typically using cross-border banking flows data. But this sort of analysis is still hampered by sectoral financial accounts not currently providing detailed information about the specific counterparties of the instruments issued by a given sector (the so called "who-to-whom" accounts), or being adequately integrated with external accounts. Such work is required to provide a better understanding of the transmission of external shocks to the domestic real and financial sectors of the economy. The development of Statistics on Holding of Securities promoted by the ECB goes in the right direction.

In fact external surveillance needs to go beyond traditional balance of payments residency definitions. When corporate activity straddles the border, measuring exposures at the border itself may not adequately capture the strains on corporate balance sheets (Chung et al., 2014). For example, companies' overseas subsidiaries can be issuing foreign currency debt abroad while at the same time headquarters are accumulating domestic currency assets. Firms could therefore be accumulating a currency mismatch, in effect a carry trade position, even though no mismatch is captured in the official external statistics. The latest EU FSAP identifies one main risk as 'Stresses and dislocations in wholesale funding markets; adverse liquidity and refinancing conditions.' These arise from gross balance sheet positions which may not be evident from traditional balance of payments data.

Furthermore, gross balance sheet analysis can contribute to effective financial surveillance. In the euro area, the IMF has used data on the cross-border exposures of financial institutions to analyse the potential for shock transmission between core and peripheral countries (External Sector Report 2013, DE FSAP 2011, NL FSAP 2011) and more recently to assess the extent of euro area financial fragmentation (GFSR October 2012, EU FSAP 2013). Data on external assets has also helped the IMF to understand the risks of deleveraging by foreign banks in CEE countries (GFSR April 2012, Pilot External Sector Report 2013). While staff and member countries have not always agreed on the exact characterisation of risks, the use of data and quantitative tools has helped to ground the discussion. Further tools for gross balance sheet analysis, to be developed in cooperation with bodies like the BIS and FSB, could help further enhance the policy relevance of surveillance products and financial policy advice in the future.

6 CONCLUSIONS AND RECOMMENDATIONS

6.1 GENERAL ASSESSMENT

The IMF has significantly improved its surveillance of the EU and the euro area along the lines suggested by the 2011 TSR. Overall, messages have become more consistent and focused across surveillance products. For euro area countries, there is now more integration between surveillance at the bilateral and euro area-wide level, while analyses at both levels draw on multilateral exercises such as the External Sector Reports and Spillover Reports. For all EU Member States, there is better integration between Article IV reports and national FSAPs. Risk Assessment Matrices discussing risks, channels of transmission and policy options are now used in almost all EU Article IV reports. Follow-up on past advice has improved through dedicated boxes included since 2012 in most national Article IV reports. Finally, the Fund has also been very active in making suggestions on the institutional architecture of the EMU, advocating more financial and fiscal integration in each of the recent euro area reports and advising on the creation of a European banking union.

Nonetheless, there remains margin for further enhancing the surveillance of the EU and the euro area in particular. As discussed in this report, there is still some way to go in implementing the 2011 TSR recommendations and making surveillance of the EU and the euro area more effective and better tailored, not least in view of the recent significant changes to the surveillance framework within the EU/euro area itself. Some concrete recommendations are set out below.

6.2 MAIN RECOMMENDATION

Transform the euro area policies report into a more comprehensive Euro Area Surveillance Report. This report would continue to be produced once a year. It would draw on the IMF's existing multilateral surveillance (WEO, GFSR, FM, Spillover Reports, External Sector Report, EWE) and bilateral surveillance reports and would include:

- A strengthened analysis of spillovers (positive and negative), to better understand the impact of shocks and policy decisions.

- A mapping of the main interlinkages and spillover channels between euro area countries, building on country reports.

- A deeper technical analysis of the European policy framework, including an analysis of potential or actual problems and risks attached to policy measures, as well as internal EU surveillance and governance mechanisms, to assess their implementation. Such work could build on staff material prepared on fiscal union and banking union, for instance.

- The inclusion of references to the Macroeconomic Imbalances Procedure to juxtapose it with the IMF's own assessment of extra- and intra-euro area imbalances.

- More considerations on the euro area-wide macroeconomic policy mix.

- More in-depth considerations on the importance of structural policies in a monetary union.

- More extensive consultations with, and engagement on the part of, euro area authorities, which will be facilitated by a better alignment with the European policy timetable, also enhancing the traction of the report.

6.3 OTHER RECOMMENDATIONS

Provide appropriate coverage of issues relating to the operation and architecture of banking union. Moreover, in line with the Fund's Integrated Surveillance Decision, due attention needs to be paid to closely linking assessments in bilateral and regional surveillance with those included in multilateral surveillance.

Provide stronger and more clearly formulated policy recommendations on structural reforms, including their estimated impact. Discussions on these issues should be systematic when they are of critical importance for the external balance of a country, which tends to more often be the case for countries participating in a monetary union. These policy recommendations should also be less general and build on cross-country analysis. The Fund should make use of insights from other organisations, especially the OECD and ILO. Furthermore, the Fund should try to quantify the effects of structural reforms in terms of impact on economic growth and, to the extent possible, both the euro area's external balance and intra-euro area balances, while recognising the difficulties of such an exercise. This would be a follow-up to the work that the IMF has already started undertaking in the context of the G20 Growth Strategies.

Take more account of the pro-cyclical effects of communicating risk assessment analysis and place greater focus on policy recommendations to address the risks identified. Risk assessments must sufficiently stress the limitations/caveats of the analysis (in terms of methodology and underlying data constraints) and their communication should take into account the unintended market consequences that they may entail, especially if likely to make headline news. While the Fund should try to identify all pertinent risks early on and treat them carefully, it should avoid its communication bringing in too much pro-cyclicality to the assessment of countries that may already face difficulties. Instead, there is room for a more countercyclical role by improving communication on medium-term risk scenarios rather than focusing on short-term risks already identified in the markets. There should also be adequate nuancing and qualification of the short-term risks identified in markets and the weight of short- and medium-term risk analysis should be geared to the policy recommendations that stem from it.

Expand the Fund´s gross external balance sheet analysis and link vulnerabilities to gross external balance sheets to the domestic sectoral accounts. This could be supported by giving greater impetus to the work stream on a 'global flow of funds' as part of the G20/IMF/FSB data gaps initiative. The Fund should not be constrained by traditional balance of payments definitions but look more at consolidated positions of companies and banks across borders. The Fund could make greater use of the available data and network analysis and shock diffusion simulations to better quantify cross-border shocks and spillovers. As a simple step forward, staff can continue to show the scale of cross-border bank exposures (e.g. based on BIS data) and complement this with its own gross international investment position and Consolidated Portfolio Investment Survey datasets for non-bank financial institutions.

Provide greater feedback between external analysis and recommendations on financial regulation. Given the recognition that financial regulation can play a key role in external positions and external imbalances, it would make sense to integrate policy advice on financial regulation with the external sector analysis. By connecting these two areas of policy advice, staff can continue to ensure consistency and play an important role in helping members work towards external and financial stability.

Include a box on the quality of past IMF advice and the authorities' response to it. Traction will be improved by following up on recommendations in subsequent reports to provide continuity and consistency of messages. The box should look at both the authorities' response to that advice – a good example would be to generalise the "Point and Counterpoint to the Staff's Views" section – and at whether and how the Fund has modified its own past advice.

ANNEXES

I RECOMMENDATIONS BY IMF STAFF IN THE 2014 TRIENNIAL SURVEILLANCE REVIEW

Further Integrating Risk and Spillover Analysis

- *Continue integration of bilateral and multilateral surveillance*. Bridge remaining gaps through REOs and cluster reports. Strengthen ISD implementation, with more systematic analysis of outward spillovers and spillbacks in systemic countries; greater quantification of the impact of spillovers on recipient countries, drawing on global risk scenarios; and discussion of policy implications.

- *Strengthen external sector assessment*. Gradually replace CGER with EBA for a broader set of countries, subject to data availability. Undertake a comprehensive assessment of the external position using a broader set of indicators than just the exchange rate. In countries where the EBA methodology is applied, discuss the contribution of domestic policies to external imbalances, and use these results in relevant policy discussions.

Deepening Risk and Spillover Analysis

- *Integrated analysis of risks and spillovers* to understand how vulnerable a country is to shocks and how they will be transmitted. Revive and modernise the balance sheet analyses; develop a GFF; and extend external debt sustainability analyses to cover external flows.

- *Mainstream macro-financial surveillance*. This could be achieved through better tools and new practices, as well as a shift in the profile of Fund economists.

- *Address data gaps*. Implement the G-20 Data Gap Initiative.

More Tailored Policy Advice

- *Strengthen surveillance of macroprudential policies* as a complement to other macroeconomic policies in advanced countries and integrated emerging markets.

- *Continue accounting for growth and sustainability implications in fiscal advice*. Undertake institutional analysis to strengthen the basis for structural fiscal balances; present fiscal advice in terms of a clear and well-justified anchor.

- *Be selective in advising on structural policies*. Recognise all macro-critical structural issues and their implications on an economy; follow principles to determine where to provide advice (cases of macro-criticality, Fund expertise, or interest from a 'critical mass' of membership, e.g. in financial deepening and labour market issues); in other areas, leverage advice from other international organisations.

Value-added Policy Advice

- *Provide more cohesive policy advice in Article IV reports* either by discussing the policy mix explicitly or structuring Article IVs reports around economic goals or themes to better capture policy interactions.

- *Better leverage expert analysis and advice*. Concerted efforts to draw on cross-country policy experiences; strengthen TA integration in surveillance; enhance collaboration with other organisations in specific areas.

Candid and Clear Two-way Communication

- *Strengthen the policy dialogue*. Expand follow-up on past policy advice beyond implementation to include a reporting on changes in Fund advice; monitor the quality of engagement and policy dialogue through targeted periodic surveys.

- *Ensure clear and candid surveillance messages*, particularly on spillovers from systemic economies; integrate key messages from the Spillover Report and the Pilot ESR into the WEO and GFSR; summarise key Fund policy messages in the GPA; undertake more targeted communications with relevant stakeholders on the underlying analysis.

Evenhandedness

- Establish a clearer understanding of how to gauge "evenhandedness of surveillance" by using equal risk-adjusted inputs to bilateral surveillance (in keeping with the Fund's principle of uniformity of treatment) where inputs are calibrated to country circumstances based on domestic and cross-country risks.

- Establish a mechanism for country authorities to report concerns, and deal with identified issues transparently.

Global Cooperation

- Appoint an expert group to explore how to strengthen the Fund's role in global cooperation, including the adequacy of its mandate for ensuring global economic and financial stability.

Source: IMF (2014a), p. 34.

2 EXCERPT FROM THE SUMMING UP OF THE IMF EXECUTIVE BOARD DISCUSSION OF 26 SEPTEMBER 2014 OF THE 2014 TRIENNIAL SURVEILLANCE REVIEW

[…]

Executive Directors welcomed the Triennial Surveillance Review (TSR) and expressed their appreciation to the staff team and all the external contributors for their invaluable inputs into this exercise. They noted that significant progress has been made in strengthening Fund surveillance since the last TSR in 2011, particularly in integrating bilateral and multilateral surveillance. Directors broadly supported the main conclusions and most of the recommendations of the review. They appreciated the focus on strengthening the implementation of recent reforms following the adoption of the Integrated Surveillance Decision (ISD), while addressing emerging challenges.

In this spirit, Directors acknowledged that the priorities set in 2011 continue to be relevant. At the same time, they stressed the need to refine, adapt, and reinforce surveillance to ensure its effectiveness and relevance in an interconnected post-crisis world. Accordingly, Directors endorsed the five operational priorities for 2014–19: (i) risks and spillovers; (ii) macro-financial surveillance; (iii) macro-critical structural policy advice; (iv) cohesive and expert policy advice; and (v) a client-focused approach to surveillance. Directors looked forward to the Managing Director's action plan, which will outline concrete measures and preliminary resource implications to take forward work in these priority areas.

Risks and spillovers. Directors saw risks and spillovers as a first order issue for the Fund, even after the crisis has subsided. They called for steadfast implementation of the ISD, particularly through more systematic analysis of outward spillovers and spillbacks in systemic countries; and greater quantification of the impact of risks and spillovers on recipient countries, including through the presentation of alternative risk scenarios in Article IV consultations. In this context, most Directors agreed that external sector assessments should be strengthened through wider use of the external balance assessment (EBA) methodology, subject to data availability, while continuing to refine the analyses and the methodology. Some Directors considered it more appropriate to address methodological shortcomings before extending the analysis to a broader group of countries, or incorporating EBA results in other surveillance activities. In further integrating surveillance, Directors underscored the need to maintain the appropriate balance between bilateral and multilateral aspects, so as not to lose sight of country-specific issues.

Directors supported efforts to deepen analyses of sources and transmission of risks. They generally saw the usefulness of national balance sheet analyses in capturing risks from gross as well as net flows, which could help deepen and further tailor risk and spillover analysis to country circumstances. Directors recognized that additional data are needed to fully support these analyses, although legal and institutional frameworks in some countries may constrain the sharing of confidential information. Further efforts by both the Fund and its members are therefore needed to address data gaps.

Macro-financial surveillance. Directors agreed that macro-financial analysis should become an integral part of Article IV consultations. They stressed that, given the complexity of the relationship between the financial sector and the real economy, it would be critical to provide the required technical support, improve analytical tools, and strengthen the macro-financial skills of Fund staff. Directors also welcomed the intention to strengthen Fund surveillance of macroprudential policies as a complement to other policies. They urged staff to build its knowledge base and draw lessons from country experiences in this area, in cooperation with other standard-setting agencies.

Structural policies. Directors emphasized the importance of recognizing all macro-critical structural issues and their macroeconomic implications. Most Directors supported establishing clearer principles for the Fund's engagement in structural issues based on macro-criticality and the Fund's expertise or interest in a 'critical mass' of the membership, leveraging the expertise of other international organizations and local experts where possible. Some others were reluctant to see any expansion of the Fund's work in non-core areas where the Fund has limited expertise.

Cohesive and expert policy advice. Directors shared the view that strengthened efforts to improve the understanding of intersectoral linkages and policy interactions would help the Fund formulate a cohesive package of advice. In this context, Directors agreed that fiscal policy advice should continue to account for its growth and sustainability implications, supported by a clear and well-justified anchor. More broadly, most Directors generally saw thematic Article IV staff reports as a way forward, particularly where they help draw out risks and sectoral interconnections relevant for the countries concerned, although a concern was expressed that taking a thematic approach runs the risk of overlooking important sectors. Directors supported further efforts to ensure continuity in Fund missions and to share cross-country policy experiences, including by better integrating technical assistance into surveillance. They also saw scope to enhance collaboration among Fund departments and with other international organizations in areas where strong expertise exists in other agencies.

Client-focused approach. Directors agreed that the impact of the Fund's policy advice depends not only on its analytical quality, but also on its candor and clarity, as well as the way it engages with its members. They noted that earlier engagement and more informal discussions with members would help better tailor policy advice to country circumstances and improve traction. At the same time, the Fund should not shy away from delivering difficult messages, particularly to systemic economies. Directors supported enhancing two-way accountability, including by monitoring changes in Fund policy advice more systematically, and a few would welcome greater scrutiny of country reports by external reviewers.

Effective communication. Directors emphasized that clear communication is integral to the Fund's overall surveillance strategy. They agreed that considerable scope exists to streamline surveillance messages, and broadly supported synthesizing policy messages in the Global Policy Agenda. In addition, most Directors saw room for merging some multilateral publications as a way to improve the effectiveness and coherence of Fund messages, with a number of Directors also suggesting a reduction in the frequency of some publications. A number of other Directors favored retaining the current suite of multilateral surveillance products for now – including the Spillover Report and the Pilot External Sector Report – noting their distinct roles in integrating bilateral and multilateral surveillance.

Global cooperation. Directors agreed that the Fund has a vital role to play in fostering global cooperation in a post-crisis world. While some Directors saw merit in the proposal to appoint an expert group to explore in depth the adequacy of the Fund's mandate for ensuring global economic and financial stability, most Directors were not convinced that now is the right time to engage in such a debate when the attention should remain on other pressing priorities.

Evenhandedness. Directors stressed the importance of tackling perceptions of a lack of evenhandedness. Many Directors were open to the idea of assessing evenhandedness in terms of the inputs to surveillance, particularly resources and the depth of analysis based on judgments about domestic and systemic risks, while also being mindful of surveillance outputs. However, a number of Directors saw a need to pay even greater attention to the outputs of surveillance, noting that differences in Fund advice for countries with similar characteristics are the main source of concerns. Directors saw merit in establishing a mechanism for authorities to report concerns about evenhandedness, allowing the Fund to better identify and understand the issues and act on them transparently.

Resources. Directors acknowledged that some of the proposals require additional resources. However, many Directors urged management to implement the Board-endorsed recommendations within a neutral resource envelope. Directors called for careful consideration of options to secure savings and efficiency gains while ensuring that the needs of the diverse members are satisfactorily met; these may include prioritization, redeployment of staff resources, and consolidation of some surveillance products. They looked forward to considering priorities and resource issues across the Fund in the context of budget discussions.

Reviews. Directors today completed the review of the implementation of Fund surveillance. Most Directors agreed that, given the time needed to effectively implement surveillance reforms and the resource-intensive review, it would be appropriate to move comprehensive reviews of Fund surveillance to a five-year cycle, with an interim progress report, although a few Directors would have preferred retaining a three-year cycle, possibly with a streamlined format. Directors considered the interim report to be an important opportunity to assess implementation, identify teething problems or any needed mid-course correction, and help shape the next surveillance review.

Source: IMF (2014b).

3 SHORTCOMINGS IN IMF SURVEILLANCE OF THE EURO AREA AND RECOMMENDATIONS FOR IMPROVEMENTS (PISANI-FERRY ET AL. (2011))

1. Shortcomings in euro area surveillance

(a) Before the crisis

Surveillance of euro area countries

- There was no follow-up on IMF recommendations.
- Rather than exploiting its comparative advantage based on its crisis experience, the IMF fell victim to a "Europe is different" mindset.

The euro area dimension of surveillance

- Economic linkages in MU were not systematically taken into account and the Fund's structural policy advice was general and almost never referred to EMU.
- The vulnerability arising from the link between high debt and competitiveness adjustment and between capital inflows and systemic risk were not highlighted.
- FSAPs did not warn appropriately and early enough about the risks in the financial system in some cases. This would draw on the IMF's existing surveillance reports, both multilateral (WEO, GFSR, EWE/VEA) and bilateral (national Article IV reports, including the reports on euro area policies).
- Multilateral surveillance provides useful guidance for national surveillance, but can spot national problems only in general terms.
- Weaknesses in the governance framework of the euro area were not fundamentally criticised.

Institutional issues

- There was insufficient integration of national and euro area analyses and recommendations. As a result, the IMF failed to identify spillovers between euro-area countries.
- The euro area reports were generally felt by European policymakers to be of little help because they were quite general and only discussed a few broad trends.

(b) During the crisis (2008-2010)

- The quality of analysis and policy recommendations increased.
- While the advice calling for fiscal expansion in the euro area in aggregate was appropriate, the Fund did not sufficiently differentiate this advice across countries and remained general, thereby contributing to later vulnerabilities.

- The IMF played a positive role in the surveillance of banks in the euro area in the crisis years. However, its role in the discussion of the Irish bank guarantees and the subsequent policy response, including the National Asset Management Agency, was limited.

- The Fund's involvement in the debate on the European policy framework was limited.

2. Main recommendations for improving IMF surveillance of the euro area

1. *Improve the legal framework*: The IMF surveillance mandate for currency unions needs to be re-interpreted to recognise that instability in a currency union involves channels other than the nominal exchange rate.

2. *Redefine the IMF's relationship with the euro area*: The Fund should revert to its role of "external adviser" to the euro area and take advantages of its external position.

3. *Restructure surveillance work to improve the consistency of national and euro area surveillance*: The euro area Article IV report should be replaced by a Euro Area Surveillance Report (EASR). It should address all major intra-euro area spillovers and linkages between the euro area and the rest of the world.

4. *Traction*: The EASR would improve traction for the IMF's advice to the euro area and its member countries.

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