INTERNATIONAL MONETARY FUND

2011 Triennial Surveillance Review—Report of the External Advisory Group

August 31, 2011

2011 Triennial Surveillance Review
Report of the External Advisory Group
(August 31, 2011)

This report was prepared by the External Advisory Group (EAG) for the 2011 Triennial Surveillance Review (TSR). The Group comprised the following members: Shankar Acharya, Marc Antoine Autheman, Kemal Dervis, Martin Hellwig, Takatoshi Ito, David Li, Pedro Malan, Stephen Pickford, Chukwuma Charles Soludo, Umayya Toukan, and Edwin Truman.

The EAG was set up to provide an independent check on staff's analysis and recommendations which are set out in the 2011 Triennial Surveillance Review—Overview Paper. The EAG contributed in written form and met twice during the course of the Triennial Surveillance Review (TSR)—on April 18 and July 29, 2011—to discuss the direction, emerging findings, and recommendations of the review.

The views expressed in this report are those of the EAG and do not necessarily reflect those of the IMF or IMF policy.

1. **Members consider the review comprehensive and balanced**. Over the past three years, the IMF has made progress in strengthening surveillance in the wake of the crisis. Nonetheless, we support the TSR findings that surveillance remains too fragmented, risk assessments need further strengthening, financial sector surveillance needs to be better integrated in regular surveillance work, progress must continue to be made to ensure a broad and transparent surveillance of external positions, traction is uneven across members and progress on these areas should be a key priority going forward. We broadly endorse the recommendations, but suggest going further in some areas, and we highlight challenges in others.

Findings and Recommendations

A. Recognizing interconnections, fostering integration

2. **We underscore the need to make progress towards more integrated surveillance**. This should be done across three different dimensions—across countries and levels of surveillance (country, regional, global), across sectors (e.g. macro and financial), and across surveillance products:

- **We see further efforts to step up cross-country work as a high priority and also support recommendations to conduct more top-down analysis** (Recommendation 1). The IMF should strive to provide countries with persuasive policy advice drawing on experience of how other *comparable* countries have dealt with similar issues. Going further than the TSR recommendations, we think that management should set clear targets on cross-country work in Article IV consultations, for example by mandating that at least one special study for each country exploit cross-country work, to help create the right internal incentives to get the work done.

- **There is clearly a need for the IMF to invest more in the analysis of spillovers, particularly outward spillovers**. Looking ahead it is important to establish a framework and a work plan, to ensure that this type of analysis gets done and that it is informative to policymakers. In this context, we support regularizing spillover analysis. In particular, work on spillovers can form a bridge between the domestic focus of bilateral surveillance and multilateral surveillance; increase the IMF's credibility through the focus on major economies; contribute to traction and legitimacy through consultations with affected economies; and provide more in-depth quantitative analysis to better inform policy debates. Recent results of spillover analysis have also thrown light on some important policy issues (e.g. about the impact of QE2 or renminbi appreciation). Discussions of spillover analyses with both the member country concerned and those affected is central to the capacity of the Fund to act as a mediator and help resolve the "prisoners' dilemma" inherent in international decision making. On *inward spillovers*, greater clustering of economies with similar issues (e.g. commodity producers) would be useful in highlighting policy responses.

- **The IMF should ensure that its macroeconomic analysis encompasses all issues relevant for stability**. In particular, there is a need to ensure fuller integration of traditional macro-economic analysis with financial sector (see below) and structural issues. Overall, we think that a *careful integration of employment and macro-stability relevant social issues into regular surveillance* is warranted, also as a way to increase traction. Some members strongly recommend that surveillance should do more to systematically consider the macroeconomic implications of inequality (e.g., the role of income distribution on policies to extend home ownership, or the implications of limited safety nets for the ability of the economy to cope with sustained downturns). Others feel that the IMF should strictly limit itself to macro-critical aspects, and avoid spreading itself too thin. On issues outside its central competence, we all agree that the IMF should work with and be informed by others, e.g. ILO and the World Bank.

- **Though demanding, we support the idea of a consolidated report to integrate systemic risk analysis and policy messages into a single document for top-level policy makers as proposed by IMFC**. This would cover global prospects, policies, spillovers and risks. A majority of members think this would be useful for enhancing traction and consistency and forcing staff integration of various issues and perspectives. However, some members point to the implementation challenges, especially given the IMF's internal organization, and the different emphases and audiences of the current Fund products. In addition, some of us see merit in having different products as a way to better reflect a diversity of views. However, most of us think that, while recognizing uncertainties, a diversity of views and existing policy debates, the Fund has to come with a clear assessment and message which, in principle, could be helped by a single report. The onus should be placed on the producers of the report to ensure important issues do not fall through the cracks. At a minimum, there should be a short synthesis report, of no more than 25 pages, that distills the main messages from the various reports for policy makers.

B. Risk Focus

3. **We are strongly of the view that the IMF is "paid to worry" especially about systemic risk**. In this, we echo the views of Martin Wolf in his commentary. For some of us the main goal of surveillance should be to avoid missing entirely the next big risk, and to help minimize systemic vulnerabilities. At the same time, this role has to be approached with humility, given the evolving nature of crises. We stress the need to:

- **Place the emphasis on assessing risks**. There is a need to improve the conceptual framework for risk assessment starting from a comprehensive view of risk allocation. These assessments require judgment as most relevant risks are not measurable, and can only be grasped by looking at how things fit together. Indeed, risk measurements may have only limited value as they can only be measured under the assumption that "some things remain equal" and excessive confidence in "measured" risks can create new risks.

- **Ensure analytical depth**. We support the goal of enhancing risk assessments in Article IV reports and multilateral flagships (Recommendation 2). Risk assessment matrices will not necessarily bolster risk analysis per se and care should be taken to ensure that they do not become a bureaucratic box-ticking requirement, substituting for digging deeper. Formal models and tools such as risk assessment matrices should only be seen as *starting points*, in the absence of a single integrated model for macrofinancial analysis. However, they can be of some use, including if they help make the link between risks identified at multilateral level and country level surveillance.

- **Pay more attention to balance sheets, including gross positions and leverage**. In the past, the IMF put most focus on risks stemming from flows (in particular external flows) because of the macroeconomic heritage of its standard analytical frameworks. This underestimated the connection between global balance of payments imbalances and domestic balance sheet risks and developments, and in particular, the combined risks from growing financial complexity and rising leverage. Looking ahead, more attention should go to stock variables, such as cross-country assets/liability allocation, and the implied risks, including from changes in the pricing and liquidity of these assets, and from the extent of leverage in the financial system. Of particular interest are debt stocks, both gross and net, which have an important bearing on the current crisis.

- **If established, the Managing Director's "External Risk Committee" should be used to promote "out of the box" thinking**. Setting up such an advisory group could help focus on a wider range of risks and avert the danger of risk assessments becoming routine. Views are split on the group's mandate and composition, with some noting that the risks to be covered would need to be tightly defined, while others stress the need to assess a wide range of ever-changing risks. There is agreement, though, that some shocks to the world economy are always likely to be unpredictable (e.g., nuclear accident in Japan, volcanic eruption in Iceland) or difficult to calibrate ex ante (e.g., the propagation of financial disturbances following the failure or default of a major financial institution, or the impact of political change on economic policy). There is also agreement that the committee should include experts from diverse backgrounds, that do not have vested interest in the status quo, including some from outside the financial sector. Many of us encourage the IMF to "embrace outsiders," as recommended in Martin Wolf's commentary, and to speak with a range of commentators, including those with unorthodox views.

C. Strengthening the focus on financial stability

4. **We broadly support strengthening the IMF's multilateral macro-financial role** (Recommendation 3). The IMF should step up its analysis of interconnections between financial institutions, across markets and across countries, with a focus on macro-financial linkages. The IMF has a key role to play given its near universal membership, its ability to provide an independent view, its crisis management experience, and its ability to undertake macro-financial analysis. In addition, almost all economic and financial crises have an important fiscal dimension: even if a crisis starts out in the financial sector, solutions can ultimately require government action. However, we strongly hold the view that humility about what can be achieved is important, given the lack of an agreed framework for integrating macroeconomic and financial analysis. We emphasize the following points among the recommendations put forward by staff:

- **The IMF will need to concentrate on its areas of comparative advantage**—i.e. macro-financial links and cross-border issues. As financial stability is a crowded field, the IMF will need to be clear about its role. This could be reflected in a strategic work plan. We also recommend that the IMF should continue to reach out and take advantage of synergies with other institutions, such as the FSB, and emerging national and regional risk boards.

- **Further IMF research is required**. Making progress on how to approach macro-financial linkages will be a challenge, as macroeconomics and finance have to date developed as distinct areas—each with a distinct analytical apparatus. The ultimate aim should be to develop a unified conceptual framework which draws out quantitative and qualitative analyses. A single united analytical framework may be an unrealistic near-term goal. Thus, it will be necessary to rely on a range of approaches depending on the focus.

- **Additional analysis on financial interconnections should be a priority**. Work should be stepped up on capital flows, and stocks, and on cross-border linkages including through systemic institutions (systemically important banks and nonbanks). Setting up networks of staff working on financially-connected economies would be useful and similar mechanisms may also be considered to think through non-financial risks.

- **Financial and macroeconomic analysis should be better integrated in regular surveillance.** We agree that analysis of macro-financial linkages should become more prominent in Article IV consultations and there is a strong case for more frequent financial stability assessments for major financial centers, while financial stability analysis should form a regular part of Article IV consultations in particular for these economies. There is also a need to ensure good follow up of FSAP recommendations. One member suggests abolishing the FSAP and merging it with the Article IV consultation. Others would caution against this approach as for some countries the FSAP has value beyond the stability assessments, especially on long-term structural issues.

- **On balance, there is support for the need for more and better data collection and access**. We share the view that data limitations are an impediment for effective financial stability assessment. However, some of us believe that better data alone might not materially improve the ability to detect future crises and question how the IMF will get around confidentiality concerns. Others think that developing a conceptual framework would help identify essential data and how it would be used (e.g. data on sector aggregates may reveal more about systemic risk exposures than data on individual institutions). The IMF will need to provide a strong justification for its data needs, including the costs imposed on reporters and national statistical agencies and institutions.

D. Taking a broader and more transparent view of external stability

5. **Our strong view is that there is a need for a broader analysis of external stability and imbalances** (Recommendation 4):

- **The analysis of external stability should encompass all relevant aspects.** It has to go beyond exchange rate policies or levels. Therefore, we support restating the guidance for external stability assessments accordingly.

- **External and domestic stability are linked**. Staff should guard against treating domestic stability and external stability as independent policy areas or concerns.

- **Exchange rates and external stability are quintessential issues for the stability of the IMS, as a whole**; they should not be treated only in the context of bilateral discussions given the importance of interconnections and externalities.

- **Overall we support publishing an analysis of external balances, including exchange rate assessments, but with a number of caveats**. We see this publication as a useful way to increase transparency, but stress that the uncertainty surrounding the estimates should be emphasized. One member is of the view that the CGER estimates should not be published (even if the range of uncertainty is also published) because of concerns about market reactions.

- **We agree with the widespread view that the IMF should focus to a greater degree on systemic stability and see merit in changes to the legal framework**. The IMF's Articles of Agreement do not necessarily prevent staff from looking at domestic policies that have an impact on global economic and financial stability. However, we agree that there are limitations in the legal framework, and some feel that there may be a strong case for amending the IMF's Articles of Agreement to expand and clarify the Fund's role and responsibilities. Some of us would favor a radical change towards norms and sanctions. As any change to the Articles is likely to take a long time, and reaching agreement on satisfactory text might be difficult, the IMF could focus in the shorter run on an integrated surveillance decision, and replace the 2007 Decision, which is clearly a source of dissatisfaction to many members for various reasons, including because it does not facilitate better integration of bilateral and multilateral surveillance.

E. Generating traction

6. **We believe that the evidence on traction should be interpreted with caution**. Results depend on how you define traction. For example, from the surveys it is not possible to distinguish cases where traction was easy because the authorities and the IMF agreed ex ante on the policy actions that were needed; from those cases where the IMF was influential in changing the authorities' view; from those where traction was difficult because the Fund's proposals were politically difficult for the authorities or produced some undesirable externalities. We think that case studies could have been helpful to dig deeper into this issue.

7. **Notwithstanding this difficulty, we are concerned that those countries most important to global economic and financial stability (large countries) appear to pay the least attention to the IMF's advice**. This may reflect the fact that, in these countries, the IMF is just one of many voices, which places a premium on saying something new and different. In other countries, the Fund might need to work on developing its position as trusted advisor. We would highlight the following:

8. **In terms of the TSR recommendations** (Recommendation 5):

- Above all else, ensuring **high quality policy advice** that fully incorporates cross-country evidence and analysis is central to improving the effectiveness of surveillance. For large countries, this may require greater resources. We stress the importance of systematic follow up on previous IMF policy advice, and encourage staff to substantially reinforce existing guidance to make follow-up a universal norm.
- A periodic **ex post assessment of the effectiveness of surveillance** in systemic economies would be useful. We believe it would provide an additional incentive for candor in these reports.
- **Continued engagement with others** (G-20, the FSB, regional bodies) is also important and should be leveraged to generate traction. At the same time, the IMF needs to be sensitive to the concerns of members that the IMF should not devote too much time to "exclusive clubs".
- The **focus on employment issues** should be sharpened. This may help strengthen the basis for the IMF's policy advice and may help the IMF have greater influence with policymakers because this is a variable that policymakers care greatly about.

9. **Going beyond the TSR recommendations, we would propose that consideration be given to the following**:

- Recognizing that the IMF has a diverse and large membership, there should be greater differentiation between countries, with **analysis focusing on "clusters" of countries** with similar features (e.g. commodity producers), rather than the current emphasis on income level. A greater emphasis on cross-country policy lessons from experience elsewhere would also help.

- **There is a need to be more open to external dissenting views** and to avoid a "one way or no way" dogma, which can reduce traction. IMF staff should go to countries aware of a possible menu of options and to be ready to discuss them with the authorities.

- The IMF should **ensure adequate relevant experience of staff on country assignments**, so that staff has the tools to offer valuable advice and **expand local offices** with staff that have good understanding of local circumstances.

- The IMF should place a high premium on suggesting **practical recommendations**, together with concrete implementation plans.

- The IMF faces a similar management challenge to other large organizations where work tends to be conducted in silos. It should aim to break these down by fostering greater **team working** across departments and greater cross-departmental **mobility** for staff.

- Finally, a strong case can be made for **greater transparency** with respect to many aspects of IMF surveillance in order to increase its credibility and traction.

F. Implementation of recommendations

10. The TSR is proposing a wide range of recommendations and the challenge will be ensuring effective implementation. This will require not only the commitment and engagement of staff and management, but also the strong support and cooperation of members, as well as effective collaboration with other institutions and fora. It will also require a realistic and clear work plan of what can be achieved, and when.