Article IV reports for large EMEs provided a more balanced discussion that acknowledged the risks of fiscal or credit expansion. They tended to support the stimulus programs that had already been undertaken following the Lehman collapse, while highlighting the risks of ongoing fiscal or credit expansions, and several of them appropriately urged an exit from such expansion. In some cases, these expansions, accompanied by looser credit standards, led to overheating. The expansion of public and private debt in some EMEs rendered them more vulnerable to capital flow volatility even as such volatility was rising.

Finally, greater differentiation could have been exercised in recommending fiscal stimulus during 2008–09 to euro area economies taking into account their different fiscal and current account positions. This differentiation was particularly important in light of the constraints to pursuing countercyclical policies imposed by the architecture of the currency union, which could not be changed at that time. Without such changes, however, the onus of contributing to the global stimulus should have been placed on the most creditworthy economies in the currency union.17

### B. Financial Sector Surveillance Following the Crisis

In the crisis aftermath, the IMF was given a bigger role in financial sector surveillance. The IMF’s main vehicle for multilateral financial surveillance, the Global Financial Stability Report (GFSR), reflected the IMF’s evolving views on lessons from the crisis and recommended policies to boost financial resiliency. The GFSR has become “a basic reference point on financial sector issues,” according to one prominent interviewed official. In addition, the IMF membership agreed to make the FSSA component of the FSAP mandatory for the 25 (subsequently 29) most systemically important financial centers. Finally, the G20 called on the IMF to collaborate with other international organizations, regulatory bodies, and standard-setting agencies to develop recommendations to strengthen supervisory, regulatory, and macro-prudential frameworks—inter alia by becoming a full member of the FSB. These three interrelated aspects of the IMF’s financial sector surveillance are discussed below.

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17IMF staff members indicated that the need for reforms to the currency union was conveyed in informal discussions with euro area authorities. More recently, IMF staff, Allard and others (2013), discussed issues relating to the architecture of the currency union.

### Financial sector analysis in the GFSR and other IMF documents

Before the crisis, the IMF was largely of the mindset that minimal regulation and light-touch supervision would suffice to bring about financial stability, since financial markets were self-stabilizing. IMF documents showed a tendency to applaud financial innovations that increasingly relied on structured instruments, such as collateralized debt obligations used in mortgage-backed securities, which contributed to higher leverage in financial institutions.

Staff views evolved with the crisis. A number of Board papers between early 2008 and early 2009 crystallized staff thinking on the causes of the crisis and on lessons for financial regulation and the global architecture needed for financial stability (IMF, 2008, 2009a, 2009b, and 2009c). As the crisis unfolded, the IMF began to warn that growing weaknesses in major financial institutions posed a serious risk to global financial stability, and to recognize the need for quick action to address these institutions’ deteriorating solvency. The IMF estimated the cost of the banking crisis and highlighted the urgency of bank recapitalization, raising these issues before many country authorities had acknowledged the scope of the losses and the fragility of their financial sectors.

In diagnosing the causes of the crisis, the IMF emphasized market failures, insufficient regulatory and supervisory resources and powers, and deficiencies in the coordination of policies across countries. The IMF consequently recommended a reform agenda involving greater transparency and information disclosure to address market failures; expansion of the regulatory and supervisory perimeter together with empowerment of supervisory and regulatory agencies through strengthening their capacity, mandate, and authority; and greater international collaboration and coordination in the regulation and supervision of interconnected financial institutions.

Beyond these core strategies, the IMF provided detailed assessments of an extensive array of relevant regulatory and supervisory concerns. It advocated making financial institutions more transparent, less complex, and less leveraged—a turnaround from its pre-crisis views (IEO, 2011). Thus the IMF supported proposed reforms to enhance capital and liquidity buffers, strengthen oversight over shadow banking, limit systemic risks from the use of over-the-counter derivatives, and strengthen the means to resolve systemically important financial institutions. On several occasions, the IMF criticized the pace of implementation of the financial sector reform agenda and highlighted the nature of prevailing risks. Finally, the IMF engaged in research and
policy work on macro-financial linkages and the potential for macro-prudential policies and tools to contribute to financial stability. Nevertheless, more effort is needed to operationalize these efforts by better integrating the analysis and messages of the WEO and the GFSR and in the bilateral context (see below).

The move in these directions was gradual, and in some areas further analysis and a possible rethinking of positions may be needed. During 2008–09, the IMF seemed timid in its analysis and critique of elements of Basel II. Its analysis, particularly during this period, underplayed the role of governance weaknesses in regulatory agencies, which in some countries had led to lax enforcement even when regulators had the authority to act. As important, the IMF’s analysis did not give sufficient weight to how regulatory and supervisory deficiencies had shaped the incentives and actions of decision makers within financial institutions prior to the crisis. Its analysis and advice along these dimensions improved over time, but even in the later period it did not focus enough on the governance of supervisory and regulatory agencies. This is particularly important given the emphasis on granting these agencies greater authority.

**Mandatory financial stability assessments**

The FSAP program was launched after the East Asian crisis to assist member countries identify weaknesses in their financial sectors and to provide recommendations on how to address them. The IMF is principally responsible for the assessment of financial stability issues, which is presented in the FSSA report that is discussed by the IMF Board alongside the country’s regular Article IV consultation report. The Article IV report is expected to integrate the FSSA findings and recommendations into the macroeconomic framework.

In September 2010, the Board made FSSAs a mandatory part of the IMF’s bilateral surveillance for the world’s top 25 systemic financial centers every five years (see IMF, 2010). By mid-2014, 24 of the original 25 jurisdictions had undergone financial stability assessments under the FSAP. A review of a sample of FSSAs that was conducted for this evaluation indicates that these assessments can be a useful tool for assessing risks to financial and macroeconomic stability. It found that the recommendations in the FSSAs were reflected in the corresponding Article IV reports, and that subsequent Article IV consultations followed up on the issues raised in the FSSAs. The review found, however, that there is still room for improvement in how the staff integrates its financial sector and macroeconomic analysis. This finding is consistent with a June 2014 report of an IMF staff working group, which noted that the range and analytical quality of financial sector issues covered in Article IVs varies widely, and that they are often treated as add-ons. Also, the recent FSAP review (IMF, 2014d) noted that the evaluation of financial sector oversight and supervisory effectiveness in FSAPs is often driven by identified gaps in formal compliance with established international standards rather than by the impact of these gaps on systemic risk.

More than any other instrument available to the IMF, FSSAs have the potential to detect emerging financial risks in time to act upon them. But recent experience with financial sector developments raises the question of whether with their current frequency, FSSAs are adequately placed to detect and warn about emerging vulnerabilities in time to act upon them. The IMF Board has discussed a staff proposal to conduct mandatory FSSAs every three years, but consensus could not be reached. IMF staff notes that under the current resource envelope and allocation mechanism, some (non-systemic) countries may have to wait more than a decade between FSAPs (IMF, 2014d). To address such concerns, the June 2014 IMF staff working group report recommended strengthening the capacity of area departments to conduct financial sector surveillance. Such mainstreaming of financial surveillance into the regular Article IV surveillance would increase country coverage and still provide sufficient depth for most countries. But this is a process that would take many years, and only experience will tell whether it will be effective.

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19 In 2013, Denmark, Finland, Norway, and Poland were added to the list of countries for which FSSAs are mandatory.

20 Seven FSSAs were reviewed: for Brazil, China, France, India, Italy, Switzerland, and the United States.

21 Another challenge that requires continuous attention is to enhance candor in FSSAs for systemic financial centers; this is complicated by concerns about the possible systemic consequences of negative findings. IEO (2011) recommended that the five-year interval for mandatory FSSAs be reconsidered once sufficient information became available on how rapidly the assessments become outdated. The IEO emphasized the need to prioritize the country coverage and periodicity of FSSAs according to risks and systemic importance.

22 The working group proposed that the principal responsibility for financial surveillance and macro-financial work at the country level rest with area departments, which would therefore need to build a critical mass of macro-financial economists by training, hiring, and transferring relevant staff from other departments.
Chapter 3 • IMF Surveillance Following the Crisis

The critical concern from a global perspective is for the IMF to be able to detect emerging vulnerabilities and risks to financial stability in the systemic financial centers. The experience over the past few years indicates that these vulnerabilities and risks can emerge in a period much shorter than five years. This view is shared by IMF staff who have indicated that FSSAs conducted every five years are too infrequent to provide continuous surveillance of financial developments and macro-financial linkages. Mainstreaming of financial stability surveillance to area departments—in particular, to undertake assessments with the requisite depth needed in economies with systemic financial centers—is not a feasible objective in the short term. Nonetheless, it would not be prudent to delay strengthening surveillance in these countries. A simple perusal of the list of 29 countries raises the question of whether the program of mandatory FSSAs is appropriately targeted. From a global stability perspective, a strong case can therefore be made to increase the frequency of FSSAs for the few countries with truly systemic financial sectors.

The IMF has one of the largest combinations of talented macroeconomists and financial economists of any institution. In addition, the Monetary and Capital Markets Department (MCM) has assembled a large group of financial sector experts who have specialized experience in financial supervision and regulation. The IMF thus appears uniquely placed to combine these skill sets to produce more integrated macro-financial analyses. Since 2009, the IMF has significantly increased its efforts in this direction. Focusing these efforts initially on countries with systemically important financial centers appears appropriate and, if successful, could be expanded to other countries. It would also further enhance the quality of GFSRs.

C. Revamping the Approach to Assessing Risks and Vulnerabilities

Following the crisis, the IMF greatly expanded its framework to detect and warn about risks and vulnerabilities. The reforms included the establishment of an interdepartmental Risk Working Group to coordinate the IMF’s work on risks; the introduction of the EWE to identify tail risks and “connect the dots” between different risks and vulnerabilities; vulnerability exercises for advanced countries and for LICs to complement the vulnerability exercise for emerging markets that was in place before the crisis; spillover reports to assess the impact of outward spillovers from systemic countries; the Fiscal Monitor—a third IMF flagship report that assesses fiscal sustainability issues; a Pilot External Sector Report, which extends and deepens the earlier Consultative Group on Exchange Rates exercise; and a Tail Risk Group, composed of economists not involved in the regular risk exercises, that looks for tail risks from a fresh perspective.

Interacting with the Financial Stability Board

Chapter 2 discussed issues of coordination between the IMF and the FSB. It pointed out that staff from both organizations were satisfied with the interaction, but that it was important for the IMF to clarify responsibilities and accountabilities to ensure its independence. Also, concerns have been voiced that the two organizations were working in parallel rather than in an integrated manner. To mitigate both these concerns, the IMF should continue to build up its own capacity to assess risks and vulnerabilities in the financial sector as part of its work on FSSAs, Article IV consultations, and GFSRs. This would allow the IMF to develop methodologies that it could bring to bear in cooperating with the FSB, and would also allow for independent views on financial sector issues.

IMF risk management framework

As illustrated in Figure 2, the current system for addressing risks and vulnerabilities has three basic layers:

- Published outputs—the multilateral flagships, Regional Economic Outlooks, G20 papers, and the Article IV consultations, which cover baseline risks.
- Confidential outputs—the EWE, whose findings are presented to senior policymakers at the IMFC; and the World Economic and Market Developments and Country Matters briefings presented to the Executive Board, which are intended to cover the full gamut of baseline and tail risks.
- Analytical inputs to this work, which include the vulnerability exercises, the Global Risk Assessment Matrix, and the conclusions of the Tail Risk Group (which are restricted to Management and staff), and the spillover reports and the Pilot External Sector Report (which are published).

The objectives of the spillover and Pilot External Sector Reports in particular go well beyond providing inputs to risk assessment.