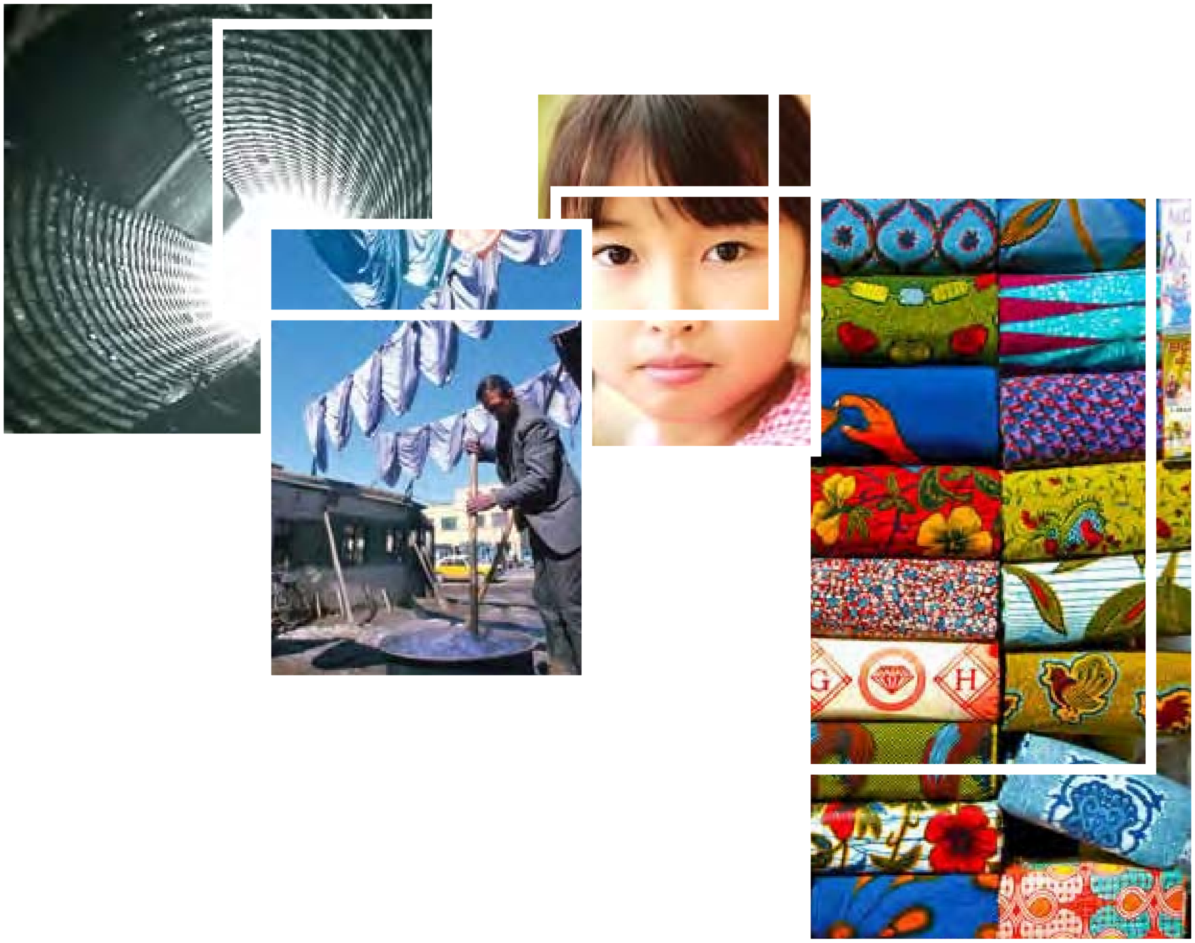


Economic Surveillance

Surveillance is the catch-all term encompassing the process by which the IMF oversees the international monetary system and global economic developments, and monitors the economic and financial policies of its 188 member countries. As part of this annual financial health check, known as surveillance, the IMF highlights possible risks to stability and advises on the necessary policy adjustments. In this way, it helps the international monetary system serve its essential purpose of facilitating the exchange of goods, services, and capital among countries, thereby sustaining sound economic growth.

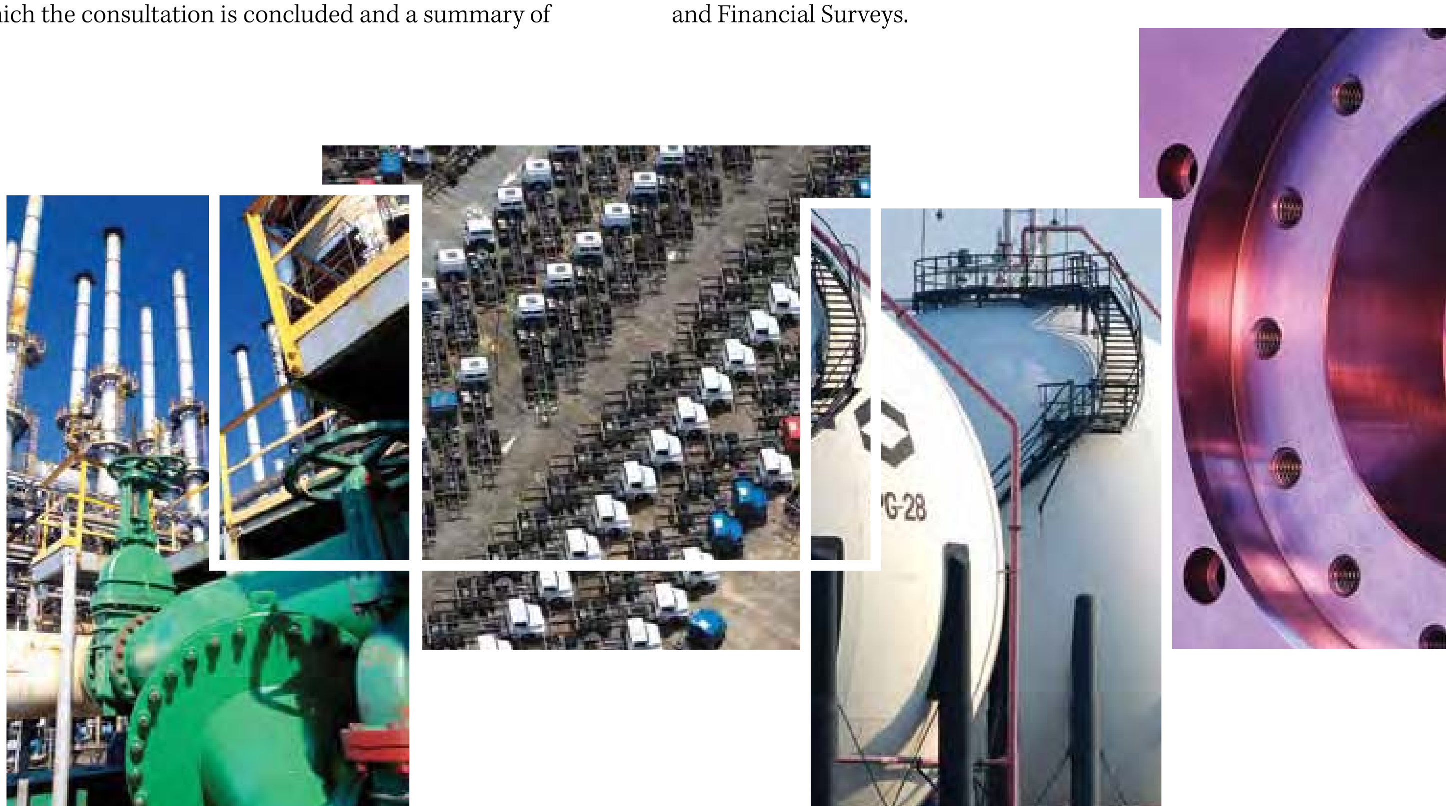
There are two main aspects to the IMF's surveillance: **bilateral surveillance**, or the appraisal of and advice on the policies of each member country, and **multilateral surveillance**, or oversight of the world economy. By integrating bilateral and multilateral surveillance, the IMF can ensure more comprehensive, consistent analysis of "spillovers"—how one country's policies may affect other countries.

The centerpiece of bilateral surveillance is the so-called Article IV consultation, named after the article of the IMF's Articles of Agreement that requires a review of economic developments and policies in each of the IMF's 188 member countries. The consultations cover a range of issues considered to be of macrocritical importance—fiscal, financial, foreign exchange, monetary, and structural—focusing on risks and vulnerabilities and policy responses. Hundreds of IMF economists are involved in the Article IV process.

The consultations are a two-way policy dialogue with the country authorities, rather than the IMF assessing a country. The IMF team typically meets with government and central bank officials, as well as other stakeholders such as parliamentarians, business representatives, civil society, and labor unions, to help evaluate the country's economic policies and direction. The staff presents a report to the IMF's Executive Board, normally for discussion, after which the consultation is concluded and a summary of the meeting is transmitted to the country's authorities. In the vast majority of cases, the Board's assessment is published as a press release, along with the Staff Reports, with agreement of the member country in question. In FY2015, the IMF conducted 131 Article IV consultations (see Web Table 2.1).

The IMF has also conducted financial sector surveillance since the Asian crisis, with special emphasis on the need to strengthen it following the 2008 global financial crisis.

Multilateral surveillance involves monitoring global and regional economic trends and analyzing spillovers from members' policies onto the global economy. The flagship reports on multilateral surveillance are published twice a year: the *World Economic Outlook* (WEO), *Global Financial Stability Report* (GFSR), and *Fiscal Monitor* (FM). The WEO provides detailed analysis of the state of the world economy, addressing issues of pressing interest, such as the current global financial turmoil and economic downturn. The GFSR provides an up-to-date assessment of global financial markets and prospects, and highlights imbalances and vulnerabilities that could pose risks to financial market stability. The FM updates medium-term fiscal projections and assesses developments in public finances. The IMF also publishes *Regional Economic Outlook* (REO) reports, as part of its World Economic and Financial Surveys.



BILATERAL SURVEILLANCE

The Article IV Process: The Annual Economic Policy Assessment

The Article IV process unfolds over a period of several months, beginning with an internal review of key policy issues and surveillance priorities across departments and management, set out in a briefing document known as the Policy Note.

The Policy Note elaborates on key economic policy directions and recommendations to be discussed with the government. Review of the Policy Note with other departments to build consensus about a country ahead of the consultation culminates in a Policy Consultation Meeting, and then the Policy Note goes to IMF management for approval. After Policy Note approval, the team travels to the country for its meetings with government officials and stakeholders. Upon returning to IMF Headquarters, a Staff Report is prepared that again proceeds through departmental and management review before being considered by the IMF Executive Board.

TAKING STOCK OF THE SURVEILLANCE PROCESS

The 2014 Triennial Surveillance Review

The latest major review of IMF surveillance practices and effectiveness, known as the Triennial Surveillance Review (TSR), was completed in September 2014. The findings and recommendations were informed by diverse analyses and perspectives, including: surveys of stakeholders; a review of recent IMF surveillance products; staff background studies; and extensive external inputs—analytical studies, commentaries, interviews with stakeholders, and a consultation with civil society. The review also received input and scrutiny from an independent External Advisory Group and benefited from independent commentaries.

The Executive Board discussed the TSR in September 2014.

The overarching theme of the 2014 TSR was how to tailor surveillance to support sustainable growth in a still deeply interconnected postcrisis world.

The review found that significant progress has been made since 2011 but stressed that strengthening surveillance is an ongoing and dynamic process. Accordingly, the review focused on ways to build on recent reforms while continuing to adapt surveillance to the challenges developing across the membership.

Three key themes emerged from the review:

First, the review identified scope to further integrate and deepen risk and spillover analysis, particularly to build a deeper understanding of how risks map across

countries and spillovers spread across sectors. **Second, the review highlighted the need for policy advice to be more tailored and expert,** including in new policy areas such as macroprudential and macro-structural analysis, and deliver more cohesive analysis and advice that better leverages the IMF's knowledge of cross-country experiences.

Third, the review emphasized the importance of looking beyond analytical approaches and tools to achieve greater impact. The review concluded that, despite making good strides, the IMF still has room for more client-focused, yet candid, communication, while evenhandedness remains a critical ingredient for legitimacy and effective surveillance.

The Executive Board supported the main conclusions and most of the recommendations of the review. Accordingly, it endorsed five operational priorities for 2014–19: (1) risks and spillovers; (2) macro-financial surveillance; (3) macrocritical structural policy advice; (4) cohesive and expert policy advice; and (5) a client-focused approach to surveillance.

The Managing Director issued an Action Plan for Strengthening Surveillance in December 2014, with specific proposals in each of these priority areas. In particular, the plan includes actions to revive and adapt balance sheet analysis, fully embed macro-financial analysis in surveillance, and lay the groundwork for stronger and more focused structural policy advice.

Given that implementation of surveillance reforms will take some time, the Executive Board agreed to move from a three- to a five-year surveillance review cycle. Accordingly, the next regular comprehensive surveillance review is scheduled to take place in 2019.

Box 2.1 Injecting the financial perspective

A key element of the Triennial Surveillance Review (TSR) was macro-financial surveillance—a big-picture view of national and regional financial issues. The review determined that more could be done to incorporate this area of work into the IMF's core macroeconomic analysis. It recommended that macro-financial surveillance be mainstreamed with better tools and new practices. It also called for strengthened surveillance of macroprudential policies.

The Managing Director's Action Plan for Strengthening Surveillance, which accompanied the TSR, pointed to the need for greater understanding of macro-financial linkages. The plan committed to undertaking a focused effort to identify themes in this area for diverse countries, and to provide interdepartmental support to develop and reflect this analysis in Article IV consultations with the aim of developing leading practices into Fund analysis and policy advice. This initiative will be supported by increased efforts to disseminate user-friendly toolkits to supplement the IMF's analytical work.

The plan also undertook to build capacity in area departments and identify networks of internal macro-financial experts to support the diffusion of learning practices across IMF staff, including through a training program and by sharing good practices.

To strengthen macroprudential surveillance, a guidance note was prepared for staff based on the 2013 Executive Board paper on "Key Aspects of Macroprudential Policy" and on country experiences. The note details a range of macroprudential tools and discusses the implementation of macroprudential policies, including in low-income countries.

The IMF continues to deepen its financial sector surveillance and integrate it more systematically into the Fund's macroeconomic analysis, including through focused efforts in recently completed and upcoming Article IV consultations with a sample range of IMF member countries.

Review of Financial Sector Assessments

The Financial Sector Assessment Program (FSAP) is an element that informs IMF surveillance in the area of financial sector stability. Established in 1999, the FSAP assessment is an in-depth analysis of a country's financial sector and in recent years became an integral part of surveillance for members with systemically important financial sectors, that is, in which financial instability could have a major impact on other countries.

In developing and emerging market countries, FSAP assessments are usually conducted jointly with the World Bank and include two components: a financial stability assessment that is the main responsibility of the IMF, and a financial development assessment that is overseen by the World Bank. At the IMF, in addition to the FSAP report, the staff produces a Financial System Stability Assessment report, which focuses on issues of relevance to IMF surveillance and is discussed by the IMF Executive Board, normally together with a country's Article IV consultation's staff report.

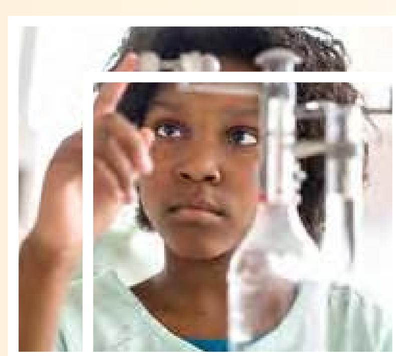
The IMF's policy on FSAPs is assessed every five years, and the latest review took place in September 2014. A core purpose of this review was to assess far-reaching reforms put in place after the 2009 review, including clarification of the respective roles of the IMF and World Bank and the introduction of an optional modular approach. In 2010, the financial stability assessment under the FSAP became a mandatory part of Article IV consultations for 25 members with systemically important financial sectors—to take place every five years. That number was expanded to 29 jurisdictions in 2013. For all other jurisdictions, FSAP participation continues to be voluntary.

In its assessment of the 2014 review, the Executive Board agreed that the 2009 reforms had considerably improved the FSAP, strengthening the focus, effectiveness, and traction of the assessments.

The Board said that a clearer definition of content had proved effective in disciplining and focusing assessments, and the delineation of Fund and Bank responsibilities had bolstered institutional accountability. The analysis of vulnerabilities has benefited from the introduction of a Risk Assessment Matrix, the expansion of stress tests to cover a broader set of risks, the ongoing progress in the analysis of spillovers, and the coverage of macroprudential frameworks and financial safety nets.

Going forward, the Board encouraged further improvements in the risk assessment, including by expanding the coverage of stress tests to the nonbank sector and strengthening the analysis of interconnectedness, cross-border exposures, and spillovers. It supported more systematic evaluations of institutional arrangements for micro and macroprudential supervision and financial safety nets, and asked staff to explore ways to focus standards assessments on key areas critical to financial stability.

On the matter of mandatory financial stability assessments, Executive Directors recognized that this prioritization may limit the availability of FSAP assessments to nonsystemic countries because of Fund resource constraints. They agreed that for such cases other forms of engagement should be used, including improved coverage of financial sector issues in Article IV consultations and multi-topic technical assistance.



The wider impact of large economies

The IMF's "Third Pilot External Sector Report"—issued in June 2014—presented a multilaterally consistent assessment of the largest economies' external sector positions and policies for 2013 and the first part of 2014.

The report integrated the analysis from the IMF's bilateral and multilateral surveillance to provide a consistent assessment of exchange rates, current accounts, reserves, capital flows, and external balance sheets. Together with the Spillover Report and Article IV consultations (with their heightened focus on spillovers),

the External Sector Report was part of a continuous effort to ensure that the IMF is in a good position to address the possible effects of spillovers from members' policies on global stability, and to monitor the stability of members' external sectors in a comprehensive manner.

The Executive Board discussed the report in an informal session, and no decisions were made.

Implications of monetary policy normalization

The report determined that external sector dynamics in 2013 were shaped by several interrelated developments. A stronger though uneven recovery in advanced economies began, resulting in first steps toward monetary policy normalization. The beginning of the exit from unconventional monetary policy in the United States initiated a tightening of global financial conditions and a round of capital flow volatility and substantial emerging market depreciations. With a subsequent recovery of demand for emerging market assets, supported in part by policy responses, many emerging market currencies strengthened again.

The report found that over a number of years, the global pattern of current account balances has narrowed but also rotated gradually into a new composition. The relative importance of excess imbalances of the world's largest economies has diminished. Among other economies, some cases of new excess imbalances have emerged, and in the past few years cases of excess deficits have grown in terms of number and size.

Policy actions to narrow excess imbalances

The report stated that policy actions required to further narrow excess imbalances varied but included medium-term fiscal consolidation, limiting financial excesses, structural reforms to facilitate adjustment in deficit economies, and various policies that support stronger domestic demand in surplus economies. More broadly, the report said, policy actions are needed on both sides of excess imbalances. Many economies have their own roles to play, and policy adjustments by all would be mutually supporting, with benefits in terms of growth and reducing financial risks.

How policies spill over to affect other economies

As part of the broad effort to strengthen the surveillance process, the IMF has implemented more systematic coverage of spillovers from member countries' economic and financial policies. The process—growing out of the Integrated Surveillance Decision adopted in 2012—takes place in the context of the Article IV consultations. It aims to better integrate bilateral and multilateral surveillance.

The spillover reports—begun in 2011—are issued on an annual basis, with the 2014 report issued in July 2014 after an Executive Board informal session.

Box 2.2 Assessing risks to the global economy

The Early Warning Exercise (EWE) is an important element of the IMF's surveillance toolkit. It combines analysis of economic, financial, fiscal, and external risks as well as cross-sector and cross-border spillovers. The EWE is conducted semiannually, in close coordination with the IMF's flagship publications: the *World Economic Outlook*, *Global Financial Stability Report*, and *Fiscal Monitor*.

The EWE examines unlikely, but plausible, risks that would necessitate policy recommendations that could differ from those related to baseline projections presented in the flagships. However, it does not attempt to predict crises. Rather, it seeks to identify the vulnerabilities and triggers that could precipitate systemic crises, and identifies risk-mitigating policies, including those that would require international cooperation. The EWE is prepared in collaboration with the Financial Stability Board, which represents experts and policymakers from financial supervisory agencies and central banks in member countries.

Each EWE is discussed by the IMF Executive Board, after which it is presented to senior officials during the IMF–World Bank Spring and Annual Meetings. The findings are considered market sensitive and are not released publicly.

The reports allow the IMF to discuss with its members the full range of spillovers from their policies on domestic and global stability, and encourage discussion of spillover-related issues in multilateral forums to foster policy attention and dialogue. Until 2013, the reports focused on the external effects of domestic policies in five systemically important economies: China, euro area, Japan, the United Kingdom, and the United States.

Beginning with the 2014 report, the IMF shifted to a more thematic approach, focusing on key issues chosen on their relevance from a spillover perspective.

The 2014 report stated that global spillovers had entered a new phase.

With crisis-related spillovers and risks fading, changing growth patterns had become the main source of spillovers in the global economy.

The paper highlighted two key trends:

First, the paper pointed to signs of self-sustaining recovery in some advanced economies—led by the United States and United Kingdom—that indicated that the unwinding of exceptional monetary accommodation will proceed and lead to a tightening of global financial conditions in the coming years. However, the paper said, an uneven recovery suggested that normalization will proceed at different times in different countries, with possible spillover implications.

Second, the report underlined that growth in emerging markets was slowing on a broad basis since its precrisis peak and could carry noticeable spillover effects at the global level, with a gradual, synchronized, and protracted slowdown likely to weigh on global growth through trade as well as finance.

The report also described how key spillover risks can intersect and interact. It said the two risks highlighted in the report can be interrelated because markets may reassess growth prospects in emerging markets amid renewed bouts of financial turbulence and capital outflows. The report described a downside scenario of sharply tighter financial conditions alongside a further weakening of emerging market growth that could lower output by about 2 percent.

The paper stated that the 2014 spillover risks warranted stronger policy action at both the national and global levels.

Stronger actions at the national level in both source and recipient countries of spillovers would align with better outcomes at the global level. With incentive problems and tradeoffs, the report said, stronger national actions alone might not be sufficient to address spillover consequences. That meant that collaboration took on renewed importance in mitigating potential downside risks and providing support for more vulnerable economies, if certain key risks were to materialize.

The 2016 Spillover Report is to be incorporated into the *World Economic Outlook* as part of broader initiatives to streamline, mainstream, and integrate the various strands of IMF work.

Macroeconomic developments in low-income developing countries

The IMF released a new report addressing trends in low-income developing countries (LIDCs) during 2014 in order to broaden the institution's analysis of a group of nations that represents an increasingly dynamic part of the global economy.

The 2014 report examined the strong economic performance achieved by the bulk of LIDCs since 2000 and assessed their short-term prospects. It also analyzed the economic risks and vulnerabilities they face amid an uneven global recovery and the evolution of their public debt levels in recent years.

The Executive Board discussed the report in an informal session. The report is to be produced on an annual basis.

The key messages of the 2014 report included the following:

Most LIDCs have recorded strong economic growth over the past 15 years, but based primarily on factor accumulation rather than productivity growth. Growth has been faster than in previous decades and on par with growth performance in emerging markets. This performance has been underpinned by external factors, sound macroeconomic management, and wide-ranging market-oriented reforms. But growth has not been very deep or transformative. In addition, many countries affected by conflict and fragile states failed to increase the level of output per capita.

The share of LIDCs that are assessed to be highly vulnerable declined slightly to about 10 percent of the total, and most are fragile states. Weak fiscal positions are typically the most important source of vulnerability. Analysis of selected shock scenarios flags the significant adverse impact on LIDCs of a protracted period of slower growth in advanced and emerging market economies. To enhance resilience, policy actions to rebuild fiscal and external buffers are a priority in many countries. As frontier market economies expand their links to the global financial system, they face new risks: rapid credit growth and the expansion of foreign credit warrant close monitoring in some cases.

Public debt is at relatively low levels in a majority of LIDCs, but fiscal institutions should be strengthened to pre-empt the buildup of new imbalances. Strong growth, low interest rates, and comprehensive external debt relief have contributed to relatively low levels of public debt. Nevertheless, in a third of LIDCs, debt levels are high and/or have increased significantly in recent years. The changing external financial landscape has enabled an increasing number of LIDCs to access international financial markets and nontraditional official creditors have also significantly expanded their provision of project finance. Countries tapping new sources of funding need to give attention to where these funds go and how efficiently they are used. Also, with new risks such as bunching of repayments and rollover risk, efforts to strengthen public debt management are an imperative.

Global Housing Watch: On the Front Lines of Crisis Prevention

Housing is an essential sector of every country's economy. But it also can be a source of instability for financial institutions and countries—witness the roots of the 2008 global financial crisis in advanced economy housing markets. As a result, understanding the drivers of housing price cycles, and how to moderate these cycles, has become important for economic stability and for the work of the IMF.

As research and policy advice in this area has become more central to the IMF, an effort has been made to bring together the institution's work in this area. This enables IMF economists to better keep track of boom and bust cycles worldwide, and to work together with policymakers to take early action to address housing booms.

Among the IMF's initiatives in this area are the following:

Global Housing Watch: A web page was launched in 2014 to help track developments across housing markets, enable more transparent cross-country and historical comparisons, and discuss the policy tools being developed to address market cycles. The page features the Global House Price Index, which is a compilation of average housing prices in different countries to highlight global prices trends. These data give IMF country teams an indication of how their country compares on these metrics to other countries.

"Cluster Report on Housing Recoveries": The November 2014 paper, produced by the European Department, on the experiences of Denmark, Ireland, the Netherlands, and Spain, covered countries that experienced large declines in housing prices in recent years and shared a similar institutional environment. It explored how policies can best support economic recovery in the wake of a price bust.

Conference on Housing Markets, Financial Stability, and Growth: This event in Bangalore, India, in December 2014 provided a forum for discussing crucial macroeconomic topics related to housing markets. Cohosted with the Indian Institute of Management, the conference addressed such issues as macroprudential policies, the drivers of house prices, and housing markets and monetary policy. In a related blog post, IMF Deputy Managing Director Min Zhu highlighted the challenges of housing price booms in emerging markets; the article was one of the most widely read items on the IMF blog, *iMFdirect*.

Conference on Housing Markets and the Macroeconomy: Cosponsored by the IMF, Deutsche Bundesbank, and the German Research Foundation, this June 2014 gathering examined the challenges housing markets present for monetary policy and financial stability.

The Role of Trade in the Work of the IMF

Trade has become an essential element of the policy agenda to spur global growth. A revival of trade growth, which has been slowing in recent years, has the potential to significantly affect growth in individual economies and the global economy as a whole. Trade-related reforms can enhance the benefits of other economic reforms, spurring increased growth.

That was a core message of the IMF's five-yearly review of the role of trade in the work of the IMF, during which the IMF takes stock of the changing trends in trade and trade policy, and discusses key issues for the institution's work agenda. The review, discussed by the Executive Board in February 2015, followed Board-endorsed recommendations and an implementation plan arising from the 2009 IEO evaluation of IMF Involvement in International Trade Policy Issues.

Implications of a changing trade landscape

The staff paper provided a broad overview of the role of trade and trade policy issues in the work of the IMF over the past five years and discussed how to integrate and make operational the implications of the changing global trade landscape, including the changing drivers of trade—such as global value chains—and the movement of the focus of trade policy from multilateral rounds to regional and multilateral deals.

During the Board's discussion, Executive Directors broadly agreed with the paper's main findings, noting that there are potentially large global gains to be derived from further trade liberalization and integration.

Tailoring surveillance to countries' needs

Directors emphasized that the IMF's work on trade should remain within the institution's mandate, addressing trade issues deemed macrocritical and taking into account resource constraints and limited trade expertise. This would require careful prioritization and continued collaboration with other international institutions, including the World Trade Organization and the World Bank.

They also emphasized that coverage of trade issues should be tailored to the needs of individual countries, and agreed that better embedding trade in the IMF's surveillance work would require a concerted effort on several fronts.

For advanced economies, a key issue would be the implications of their efforts to pioneer and advance new trade policy areas such as services, regulations, and investment.

For emerging market economies, traditional liberalization and anchoring to global supply chains still provide benefits. For low-income countries, greater integration requires sustained efforts to reduce trade costs, including upgrading trade infrastructures and improving economic institutions both at national and regional levels, supported by relevant technical assistance.

POLICY ADVICE

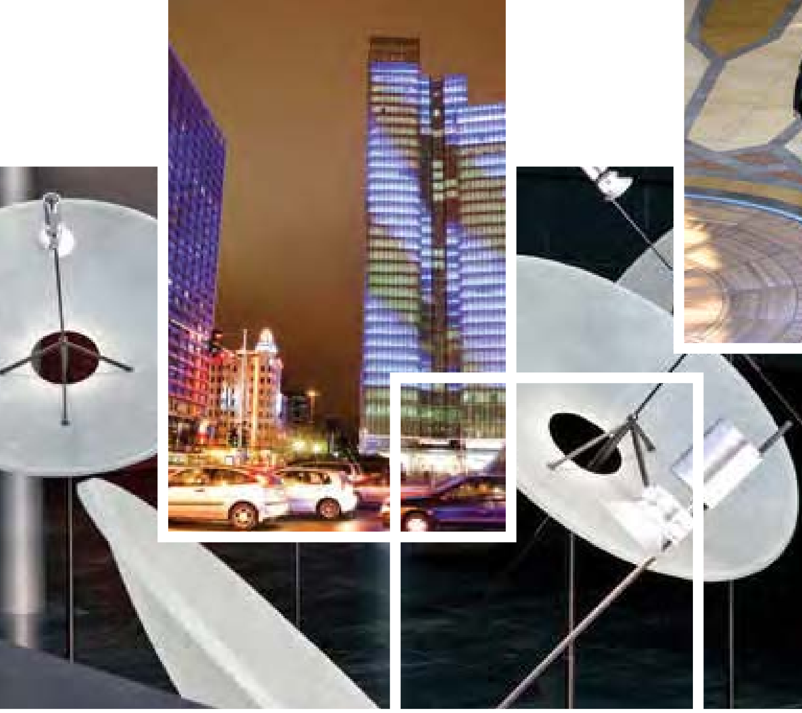
From Banking to Sovereign Stress: Implications for Public Debt

An increasing amount of IMF research has been conducted in recent years on the linkages between banks and sovereign debt, particularly since the global financial crisis of 2008. The period witnessed accumulated banking sector vulnerabilities, which in some cases triggered full-blown banking crises that contributed to significant increases in public debt, partly resulting from government interventions.

A staff paper, "From Banking to Sovereign Stress: Implications for Public Debt," was published in March 2015 after an informal session for Executive Directors. The paper explored how banking sector developments and characteristics influence the propagation of risks from the banking sector to sovereign debt, including how they affect the extent of fiscal costs of banking crises.

An interdepartmental study

The paper was prepared by an interdepartmental team from the Strategy Policy and Review Department, Fiscal Affairs Department, Monetary and Capital Markets Department, and Research Department. It presented new empirical work on the ways in which banking sector developments can affect macroeconomic and fiscal outcomes.



Systemic banking crises have contributed to large increases in public debt.

Over the period 2007–11, the median increase in public debt four years after the beginning of a crisis was 12 percentage points of GDP. And in many countries, public debt increased by more than 20 percentage points of GDP.

The paper found several factors that affect the bank-sovereign link. These include the extent of banks' balance sheet expansion, leverage, and reliance on wholesale external funding; the strength of precrisis institutional settings and crisis resolution policies; and the extent of banks' holdings of their own government debt—also known as "home bias."

The paper proposed practices and policies for fiscal authorities to help manage the risks and enhance crisis preparedness. It determined that efforts to strengthen financial sector regulation and supervision are the preferred approach to preserve the health of the banking sector and minimize the risk that taxpayer funds may be exposed to losses due to banks' failures. In this respect, policy priorities should include macroprudential measures aimed at: (1) reducing excessive procyclicality in banking systems; (2) higher bank loss-absorbing capacities; and (3) effective resolution powers and planning.

Approaches for fiscal authorities

On the fiscal side, the paper suggested that although the specific policy recommendations to deal with banking sector risks depend on country-specific circumstances, fiscal authorities should:

Have in place an institutional framework that strengthens the ability to identify and monitor risks emanating from the banking sector.

Develop fiscal buffers during banking booms that would allow for appropriately sized countercyclical policies during downturns. The adoption of fiscal rules that constrain the spending of unsustainable increases in tax revenue associated with credit booms, including particular reliance on real estate–related sources of revenues, would be beneficial in this regard.

Balance the benefits and risks associated with reliance on domestic banks as a source of public financing. Excessive reliance on domestic bank financing may lead to distortions, a false sense of debt sustainability, and a deeper bank-sovereign nexus.

Consider tax policies that reduce the bias toward debt financing and the attractiveness of leverage. Removing tax incentives to borrow and introducing a Financial Stability Contribution tax could lower banking sector risks and help build fiscal buffers when vulnerabilities increase.

The Cross-Border Impact of Banking Crises

Developing an effective framework for cross-border resolution is an important priority in international regulatory reform. Large bank failures during the global financial crisis highlighted the need for tools to resolve "too-big-to-fail" institutions.

A key achievement in the reform agenda has been the establishment of an international standard for the resolution of systemically important financial institutions.

The Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions has established an agreed set of principles and best practices, and FSB member countries have committed to implement the rules by the end of 2015. The Key Attributes call for

countries to put in place resolution regimes that give the authorities comprehensive resolution powers while establishing effective mechanisms for cross-border cooperation and for the allocation of losses to private stakeholders.

A progress report prepared by the IMF Monetary and Capital Markets and Legal Departments and released in June 2014 described the status of efforts to put the rules in place. The Executive Board discussed the paper in an informal session.

The paper determined that considerable additional work remains to establish an effective regime for cross-border resolution. Areas in need of attention include:

- **National resolution regimes:** Several jurisdictions have adopted far-reaching legal reforms, but the reforms are complex and progress has been mixed overall. While some countries have made progress, many still lack comprehensive resolution powers for banks and other financial institutions, and effective mechanisms for the recognition of foreign resolution measures.

- **Firm-specific operational resolution strategies:** Reaching agreement between home and host supervisors on how to resolve systemic, cross-border institutions has been difficult, in particular because of legal impediments to cross-border cooperation and the complexities of operational and financial structures.

- **Loss absorbency:** The Key Attributes call for the burden of bank failure to fall on private creditors of banks. The credibility of this commitment depends on ensuring that banks have sufficient liabilities to absorb losses without destabilizing the financial system. The FSB is expected to finalize a new standard on total loss-absorbing capacity for global systemically important banks later this year.

- **Harmonization of creditor hierarchies:** Differences across countries in the ranking of creditor claims in liquidation or resolution is an important impediment to the cooperative resolution of cross-border bank failures.

- **Use of public funds:** The risk that public funds will be needed to preserve financial stability cannot be ruled out and creates powerful incentives for unilateral action that can undermine cooperation. Achieving prior agreement on the location of buffers and loss allocation, resolution strategies, and aligning group structure accordingly will be critical.

- **Smaller jurisdictions/entities:** Many cross-border banks are not globally systemic, but their resolution, if disorderly, could undermine financial stability in home and host countries. Reforms to resolution frameworks will need to take account of the different degrees of complexity of financial systems and ensure that incentives are aligned so that resolution strategies can minimize financial stability risks in small as well as core jurisdictions for the entity in resolution.

Sovereign Debt Restructuring

In May 2013, the Executive Board discussed a staff paper, "Sovereign Debt Restructuring—Recent Developments and Implications for the IMF's Legal and Policy Framework," and endorsed a work program focused on strengthening market-based approaches to resolving sovereign debt crises. The program comprised four elements: (1) reforming the IMF's lending framework; (2) strengthening collective action clauses in sovereign bond contracts; (3) reviewing the framework for official sector involvement; and (4) assessing the effectiveness of the IMF's lending-into-arrears policy.

On the lending framework, in June 2014 the Board discussed the staff paper "The IMF's Lending Framework and Sovereign Debt—Preliminary Considerations." The primary focus of the paper was the Fund's exceptional access framework—the context in which the IMF most likely will have to make difficult judgments about whether a member's debt is sustainable (with high probability). With the principal objective of reducing the costs of crisis resolution for creditors and debtors, and for the system as a whole, the paper presented two possible directions for reforms: the introduction of a "debt reprofiling" option to make the lending framework more flexible where debt is assessed as sustainable but not with high probability, and the elimination of the systemic exemption.

No decision was made on the suggested reforms, but the Board asked staff to prepare an additional paper to be discussed in FY2016.

On collective action clauses, in October 2014 the Board discussed the staff paper "Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring." The paper contained recommendations to further improve the contractual, market-based approach to dealing with collective action problems.

The Board endorsed the key features of modified pari passu and enhanced collective action clauses in international sovereign bond contracts to reduce their vulnerability to holdout creditors in case of a debt restructuring. The recommended reforms resulted from a process of consultation with public and private stakeholders. The Board also supported an active role for the IMF in promoting the inclusion of these provisions in new international sovereign bond issuances. However, the Board also noted that a large portion of the significant stock of outstanding international sovereign bonds, which do not contain the new clauses, will only mature in the next 10 years and could pose a risk to orderly restructurings.

The Board encouraged staff to engage in further discussions with stakeholders on ways to minimize this remaining risk to orderly restructurings and looked forward to periodic progress reports on the status of inclusion of the proposed contractual provisions in international sovereign bonds. Since October 2014, several member countries have incorporated modified clauses that include the key features endorsed by the IMF in new bond issuances.

Work on official sector involvement and the lending-into-arrears policy is expected to follow the Board's discussion of the "lending framework" paper in FY2016.

Spillovers in International Corporate Taxation

The world is focusing on cross-border tax issues, with work in this area receiving greatly increased attention. In May 2014, IMF staff issued a paper, "Spillovers in International Corporate Taxation," which received considerable notice.

The paper, which was discussed by the Executive Board in an informal session, explored the nature, significance, and policy implications of spillovers—the effects of one country's rules and practices on others—with a focus on developing countries.

The paper complemented initiatives focused on reducing tax avoidance by multinational corporations, particularly the G20–Organisation for Economic Co-operation and Development (OECD) project on Base Erosion and Profit Shifting (BEPS). The spillover paper drew on IMF experience with broader international tax issues across the membership, including experience gained through technical assistance.

Allegations of multinational tax avoidance

The IMF study went beyond OECD BEPS to explore the broader macroeconomic and development impact of corporate tax spillovers, including wider issues of tax competition among national governments. The BEPS action plan aims—in the context of the existing, informally

agreed, international tax architecture—to alter some of the technical global guidelines and standards for taxation of cross-border activities and reduce opportunities for tax avoidance and profit shifting.

The IMF work determined that tax spillovers can have implications for macroeconomic performance.

Capital account data are clearly influenced by taxation, and considerable evidence shows that taxation powerfully affects the behavior of multinational enterprises. The results confirmed that spillover effects on corporate tax bases and rates are significant.

The analysis also found that spillovers are especially marked for *developing economies*, which typically derive a greater proportion of their revenue from corporate taxes. The paper noted that technical assistance experience provides many examples in which the sums at stake in international tax issues are large relative to countries' overall revenues—sometimes equal to 10–15 percent of total revenue.

Limiting spillovers on developing nations

The study argued that limiting adverse spillovers on developing economies requires not only capacity building, but also addressing weaknesses in domestic law and international arrangements. It made specific suggestions in areas that IMF technical assistance has found to be especially problematic for developing economies. The paper flags, for instance, the risk that countries run by signing bilateral tax treaties, such as forgone revenue from withholding taxes and base erosion through treaty shopping. It also draws attention to the ambiguities in many tax laws regarding the taxation of offshore capital gains, often related to extractive industries. And many countries fail to provide protection against excessive debt finance or manipulation of transfer pricing.

The institutional framework for addressing international tax spillovers is weak, the paper concluded, so as the strength and pervasiveness of tax spillovers become increasingly apparent, the case for an inclusive and less piecemeal approach to international tax cooperation grows.

Subsequent work and developments

At the November 2014 G20 Summit, IMF staff was asked to work with the OECD and other international organizations to better include developing countries in the BEPS decision-making and deliberative processes; staff have so engaged, through technical assistance interactions and outreach events, including an International Tax Dialogue with Developing Countries at the 2015 Spring Meetings and in the Fiscal Affairs Department's annual tax conference for Asian countries. The G20 also asked the IMF to take the lead in producing a report on "Efficient and Effective Use of Tax Incentives in Low-Income Countries," and to work with OECD staff on a report on taxation of offshore capital gains.

Assessing Reserve Adequacy

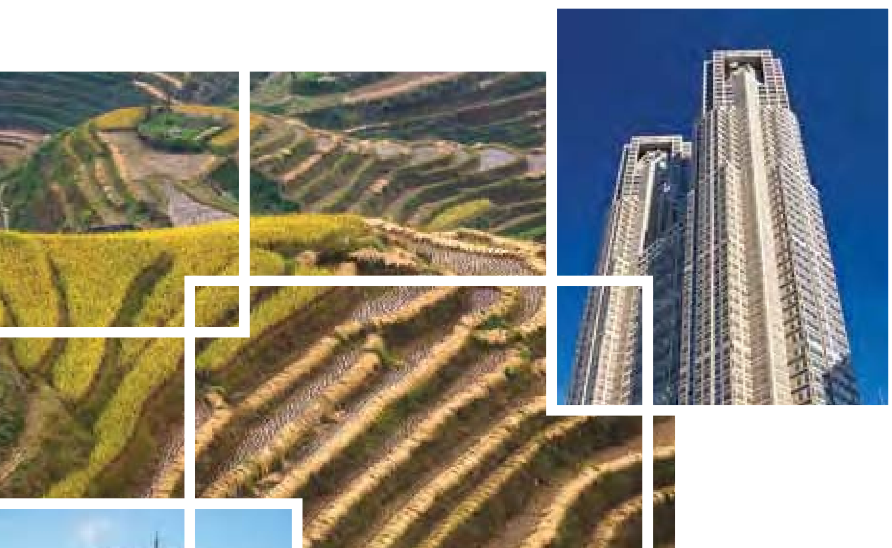
The foreign exchange reserves held by central banks occupy an important place in the policy toolkit of most economies.

Together with sound policies, they can help reduce the likelihood of balance-of-payments crises and preserve economic and financial stability.

To help support IMF's member countries, IMF staff has undertaken a series of studies on reserve adequacy, with a 2011 paper, "Assessing Reserve Adequacy," which assessed approaches to reserve accumulation, and a second paper in 2013 that explored the role of reserves in preventing and mitigating crises and considered how IMF guidance on the topic might need to be augmented. Both papers were discussed by the Executive Board.

In January 2015, the Board assessed a follow-up paper drawing on this work and outlining a framework for discussing reserve adequacy issues in the context of Article IV consultations. The paper was intended, in part, to help provide guidance on the desirable level of reserve holdings for a given country by providing tools for quantifying risks to help governments determine this level.

The new framework classifies countries based on the strength of market access, the depth and



liquidity of their markets, and the flexibility of their economies.

For each country group, the paper proposes frameworks to help assess the appropriate level of reserves based on its circumstances. To achieve this, the report also provides further reserve assessment guidance for specific country types within these categories. For example, within the set of deepening or emerging market economies, the paper refines the guidance for those with capital flow management measures, commodity-intensive countries, and dollarized economies.

In its assessment of the paper, which was released in April 2015, the Executive Board agreed that

reserves, in conjunction with sound policies and fundamentals, can bring significant benefits in reducing the likelihood of balance-of-payments crises and preserving economic and financial stability.

Most Executive Directors supported a systematic discussion of reserve adequacy issues in IMF surveillance reports, which could help enrich staff's analysis and policy advice.

Executive Directors agreed that the depth and emphasis of the discussion should depend on country circumstances and reflect the aspects that are relevant for a country's external stability as well as global stability. In this regard, they said, the discussion should reflect the adequacy of reserves for precautionary purposes, the authorities' stated precautionary and nonprecautionary objectives for holding reserves, and the cost of reserves.

To make the agreed framework operational, most Executive Directors supported the preparation of a staff guidance note, in line with management's planned response to the findings of the IEO's 2012 evaluation of "International Reserves—IMF Concerns and Country Perspectives."

Revising the Fiscal Transparency Code

Fiscal transparency is essential for effective fiscal management and accountability. It ensures that governments have an accurate picture of their fiscal position and prospects when making economic decisions, including of the long-term costs and benefits of policy changes and potential risks to public finances. It also provides legislatures, citizens, and markets with the information they need to hold governments accountable.

The IMF's new Fiscal Transparency Code and Evaluation are part of its ongoing efforts to help Fund member countries strengthen their fiscal policymaking, monitoring, and accountability. A paper approved by the Executive Board in 2014 presented the new code and evaluation that replace the 2007 Code and the related fiscal module of the IMF's Reports on the Observance of Standards and Codes initiative.

Transparency will strengthen fiscal surveillance

The work is part of ongoing efforts by the Fiscal Affairs Department, in cooperation with other departments, to strengthen the IMF's fiscal surveillance and capacity development.

The new code and evaluation reflect the lessons of the global financial crisis, incorporate developments in international standards, and build on feedback from stakeholder consultations.

The Fiscal Transparency Code is the global standard for disclosure of information about public finances. It consists of a set of principles built around four "pillars": (1) fiscal reporting; (2) fiscal forecasting and budgeting; (3) fiscal risk analysis and management; and (4) resource revenue management.

For each principle, the code differentiates between basic, good, and advanced practices to provide countries with clear milestones toward full compliance with the code and ensure its applicability to the full range of IMF member countries. Pillars 1–3 have been issued, and pillar 4 is expected to be finalized in FY2016. Pillar 4 will complement the first three pillars for resource-rich countries and will reflect feedback from consultations with stakeholders and the public.

Fiscal Transparency Evaluations assess country compliance with the code. They provide countries with a comprehensive assessment of their fiscal transparency practices against the standard established by the code; quantified analyses of the scale and sources of fiscal vulnerability, based on a set of fiscal transparency indicators; an accessible summary of the fiscal transparency strengths and reform practices through heat maps; and the option of a sequenced fiscal transparency action plan to help countries address those reform priorities. The evaluation also allows for modular assessments focused on the new code's individual pillars for addressing the most pressing transparency issues. Feedback from country authorities and other stakeholders on these evaluations has been very positive.

A new Fiscal Transparency Manual

A new two-volume *Fiscal Transparency Manual* is expected to be issued by end-FY2016, providing more detailed guidance on implementation of the new Fiscal Transparency Code's principles and practices. Volume I will cover the code's first three pillars and replace the 2007 *Manual on Fiscal Transparency*, while Volume II will focus on Pillar 4—covering resource revenue management—and integrate the previously separate 2007 *Guide on Resource Revenue Transparency*.

The IMF's Work with Small States

"The IMF stands ready to work with small states to help them overcome their development challenges and build a prosperous future."

IMF Deputy Managing Director Min Zhu
September 3, 2014

The IMF has 42 member countries with populations of fewer than 1.5 million, 33 of which are classified as small developing economies. In recent years, this group of developing nations has come to be known as "small states," although they also include a subcategory of "micro" states with populations under 200,000 as of 2011.

Small states do not enjoy the benefits of economies of scale, which hampers their ability to provide public goods and services, or produce goods for global trade. Their economic growth has lagged larger peers over the past decade, and micro states have seen considerable economic volatility due to climatic and other shocks. Given the special economic needs of this group of countries, the IMF has responded by reviewing how best to engage with them and provide support.

This process was launched in 2013 with a staff paper, "Macroeconomic Issues in Small States and Implications for Fund Engagement," and an associated Executive Board discussion. In May 2014, a Staff Guidance Note on the IMF's engagement with small states was issued, consolidating the lessons from the 2013 staff paper and Board discussion. Five key thematic areas identified by the acronym G.R.O.W.T.H. have been identified as central to the policy dialogue with small states: growth and job creation, resilience to shocks, overall competitiveness, workable fiscal and debt sustainability options, and thin financial sectors.

At the third United Nations International Conference on Small Island Developing States, held in Samoa in September 2014, IMF Deputy Managing Director Min Zhu pledged the IMF's continued support to those countries in their pursuit of sustainable economic development.

With many small states clustered in the Caribbean and Pacific, the IMF's regional departments and technical assistance centers play a lead role in serving small states' needs.

To better communicate with their smaller members, the IMF's Asia-Pacific Department and Western Hemisphere Department have recently launched periodic bulletins—the "Caribbean Corner" and "Asia & Pacific Small States Monitor," respectively. Following on the issuance of the Staff Guidance Note, the Asia-Pacific Department introduced a training course for mission chiefs engaged in surveillance of small states.

Policy analysis prepared by the two departments was also included in a March 2015 paper on "Macroeconomic Developments and Selected Issues in Small Developing States," prepared in collaboration with two other departments. This paper, discussed by the Board in March, provided a summary of recent developments and Fund staff projections, as well as thematic chapters on the challenges of fiscal management in small states, the impact of currency devaluations, and levels of financial inclusion.

DATA

Data and Data Standards Initiatives

The quality of data provided by member countries under the Articles of Agreement is essential to the success of IMF surveillance.

Data dissemination standards help enhance the availability of timely and comprehensive statistics, which is critical to the pursuit of sound macro-economic policies.

The Special Data Dissemination Standard (SDDS) was established in 1996 to guide members in the provision of their economic and financial data to the public. The General Data Dissemination System (GDDS), established the following year, provides a framework to help countries evaluate their needs and sets priorities for improving their statistical systems.

In 2012, the SDDS Plus was created to help address data gaps identified during the global financial crisis. The SDDS Plus is aimed at countries with systemically important financial sectors, although all SDDS subscribers are encouraged to adhere. An initial cluster of eight countries adhered to the SDDS Plus in FY2015.

There were no new subscribers to the SDDS in FY2015, with the number of subscribing economies standing at 63 as of the end of the financial year, following the graduation of eight countries to the SDDS Plus (Seychelles subscribed on May 1, 2015). The Cook Islands and Micronesia began participation in the GDDS, bringing the total number of GDDS participants to 113 at the end of the year (excluding the economies that have graduated from the GDDS to the SDDS over the years).

More than 97 percent of the IMF's member countries participate in the GDDS, SDDS, or SDDS Plus. There are 113 participants in the GDDS, 63 SDDS subscribers, and 8 SDDS Plus adherents.

The Statistics Department has partnered with the African Development Bank and the World Bank to develop and promote the so-called Open Data Platform aimed at facilitating dissemination of data (including Sustainable Development Goals) by country authorities. Several countries in Africa have already successfully implemented this new tool.

The G20 Data Gaps Initiative (DGI) was initiated after the global financial crisis, in response to a request to the IMF and FSB by the G20 Finance Ministers and Central Bank Governors (FMCG). The 20 recommendations to close data gaps were endorsed by the International Monetary and Financial Committee. Six years after the start of the project, significant progress has been made in closing the gaps. The data emerging from the DGI are seen as enhancing the support to policy work, including financial stability and debt analysis, and promoting a better understanding of domestic and international interconnectedness. In September 2014, the G20 FMCG asked the FSB Secretariat and IMF staff to report back in September 2015 with a proposal for a second phase of the DGI as well as a final progress report on the implementation of Phase 1 of the Initiative.