An evaluation of IMF surveillance of the euro area

BY JEAN PISANI-FERRY, ANDRÉ SAPIR AND GUNTRAM B. WOLFF

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An evaluation of IMF surveillance of the euro area: final report

Jean Pisani-Ferry, André Sapir and Guntram B. Wolff

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About this report

This report evaluates International Monetary Fund surveillance of the euro area in the years before the financial crisis and during 2008-10. It is based extensively on an external consultants' background study requested and funded by the IMF for its 2011 Triennial Surveillance Review. In preparing this report, the authors had access to relevant IMF documents and conducted in-depth interviews with IMF management, board and staff, and with selected European policymakers. For a list of interviewees, see Appendix I.

The authors are grateful to IMF staff, especially from the European and Strategy, Policy, and Review Departments, for very fruitful interaction in the preparation of this report (special thanks go to Michelle Shannon and Claire Waysand). They wish to thank all the interlocutors from the IMF Board, management and staff, from member countries, and from European institutions, as well as colleagues from academia and think tanks, for having shared their time and thoughts. Finally they wish to thank Christophe Gouardo and Mouhamadou Sy for excellent research assistance.

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Foreword

The euro-area crisis has exposed deep deficiencies in the governance of Economic and Monetary Union on two separate levels. One is crisis management and resolution. In the absence of treaty-based mechanisms to manage and resolve sovereign debt crises, it took several months – after the start of what was initially the Greek crisis – for the euro area to put in place instruments which, although useful, are still proving insufficient to extinguish the fire.

The second deficiency concerns crisis prevention. Although surveillance mechanisms were in place before the crisis they failed to detect, let alone prevent, the build-up of imbalances to unsustainable levels, even in the area of public finance, which was their main focus. The failings of European surveillance have been recognised by the European authorities, and are in the process of being corrected with the introduction of new rules and procedures aimed at tightening existing surveillance and widening its scope to imbalances outside the fiscal area.

Crisis prevention in, and surveillance of, the euro area are not only the responsibility of European authorities. As members of the International Monetary Fund, all euro-area countries are also subject to regular bilateral IMF surveillance conducted under Article IV of the IMF's Articles of Agreement. In addition, although not an IMF member, the currency union as such is subject to regular IMF surveillance.

In June 2007, the IMF's new bilateral surveillance framework clarified that country surveillance should focus on assessing if members' policies promote domestic and external stability. This meant focusing mainly on monetary, fiscal, financial and exchange rate policies, and assessing the risks and vulnerabilities. Compared to EU surveillance, IMF surveillance was therefore broader, because it encompassed not only fiscal policy, the main focus of EU surveillance, but also external stability, the once-traditional focus of IMF surveillance, monetary and financial policies. In addition, the Fund was not bound by treaty-based procedures like the European Stability and Growth Pact.

Because of its broader approach and because it covered not only individual euro-area countries but also the euro area as a whole, IMF surveillance was in principle better

equipped than EU surveillance to detect the build-up of unsustainable imbalances in euro-area countries, and to assess the risks they posed for the euro area as a whole. In addition the IMF had two comparative advantages over EU institutions in terms of surveillance. First, the risk of institutional capture was, in principle, lower for the IMF, owing to its distance from European capitals. Second, the IMF had not only a far longer experience of surveillance going back several decades, but also a much richer one owing to the size and diversity of its membership. In particular, because of its vast experience with crises in emerging economies, the IMF was ideally placed to recognise that the kind of credit booms, large current account deficits and major external indebtedness that arose in some euro-area countries would eventually lead to significant turbulence.

Despite these potential advantages, we find that IMF surveillance suffered from severe shortcomings in the run-up to the financial crisis. We cannot say with precision if these shortcomings were more or less severe than those of EU surveillance since in this report we only investigated IMF surveillance. It may well be that, despite institutional differences, Brussels and Washington shared an equal blindness to unsustainable imbalances, or an equal difficulty in convincing national governments to act when such imbalances were pointed out to them.

Some of this blindness must be ascribed to the economics profession in general rather than simply to European or global institutions. In the case of the IMF it is especially disappointing that surveillance did not sufficiently (1) integrate surveillance of the euro area and its individual members in a way that would have permitted the detection of potential negative spillovers between national policies; (2) take advantage of its position as an outsider to criticise the governance of the euro area; and (3) question the mind-set that 'Europe is different' and draw on its experience with emerging countries that pursued unsustainable policies and suffered the consequences.

We also find that since the start of the financial crisis in 2008, the IMF has much improved its surveillance of the euro area. It correctly proposed policy actions to counter depression risks and warned about problems looming in the banking sector at a time when Europeans were in denial. By the time the sovereign debt crisis hit the currency union in early 2010, the IMF was ready to play an active and influential role in the management of the crisis, the design of new crisis management and resolution mechanisms and broader reform of EMU architecture. The slow European response and divisions among member states meant the IMF's unusual activism was indispensable.

At the same time we question the wisdom of the IMF continuing to play this 'insider' role, given the need for the institution to maintain a balance between all of its

members. On this, it is useful to make the following point, although our study only covers surveillance and therefore does not include financial assistance programmes: in August 2011, EU countries accounted for nearly two-thirds of all IMF outstanding loans, with the euro area alone accounting for 44 percent. These figures – which are set to increase further as planned loan disbursements take place – are much in excess of the share of EU or euro-area countries in the IMF's capital, which makes them, in a sense, net borrowers from other IMF members.

In such circumstances, it becomes all the more important that IMF surveillance of euro-area member states meets the highest standards of objectivity and impartiality, and is based on clear criteria. We therefore recommend that the IMF regains its role of 'trusted outside advisor' which requires not only some distance from its European interlocutors, but also better surveillance, with the IMF fully exploiting its comparative advantages and seeking better traction for its policy advice. In particular, we recommend that the IMF better integrates its surveillance across policy areas and countries within the euro area and better exploits its global position by improving its view of the interconnectedness of policy challenges across the euro area and globally. This would provide added value to the new, enhanced EU surveillance mechanism.

Some of our findings and recommendations about IMF surveillance are probably also relevant precisely for the new EU surveillance framework. Indeed, although we have not conducted a review of the pre-crisis EU surveillance framework, one suspects that it shared some of the weaknesses of IMF surveillance identified in our report. In addition, IMF surveillance has some features that EU surveillance is now taking on board (such as the surveillance of current-account imbalances and financial fragilities) or may do well to adopt (such as the surveillance of euro-area policies in addition to national policies).

Jean Pisani-Ferry, André Sapir and Guntram B. Wolff
Bruegel, August 2011

Executive summary

This report provides an independent evaluation of recent International Monetary Fund surveillance of the euro area. It focuses on the euro area as a whole and on four countries severely hit by the recent economic and financial crisis, namely Greece, Ireland, Portugal and Spain.

Given that this report is the first to evaluate IMF surveillance of the euro area, it begins with a discussion of the institutional and economic framework of the surveillance and the difficulties it creates. On the institutional side the report acknowledges that the organisation of the euro area make surveillance by the IMF particularly complicated. With no common external representation (and no IMF membership) and an internal economic governance at three different levels (national, euro area and EU), the euro area is a complex entity. Regular IMF surveillance, conducted through Article IV reports, therefore involves a euro-area report addressing euro area and EU policies, and individual euro-area country reports covering national policies. On the economic side, surveillance is made difficult by the traditional focus of IMF surveillance on nominal exchange rates as the main channel through which external stability, the ultimate goal of surveillance, can be endangered. Overall, the IMF has not yet found a way to ensure the desirable degree of consistency between its euro area-wide and national reports.

Against this background, the report assesses IMF surveillance of the euro area before the economic and financial crisis erupted in full force in September 2008 and afterwards.

As far as the period before the crisis is concerned the report finds that:

- The IMF issued a number of strong and relevant policy recommendations, whose follow-up was unfortunately not always ensured.
- In general IMF surveillance was process-driven rather than analysis-driven, with insufficient integration of national and euro area-wide analyses and recommendations. As a result, it often failed to identify spillovers between euro-area countries.
- Rather than fully exploiting its comparative advantage based on its international experience in crisis-prone countries, the IMF fell victim to a 'Europe is different'

mindset and failed to address issues such as divergence of unit labour costs, capital flows and the resulting large imbalances in country-level current-accounts.

- Eagerness to play a role in the complex European policy process reduced the IMF's effectiveness as an independent and critical observer of the euro area. Vulnerabilities that proved to be consequential after the crisis erupted were not always spotted beforehand. When they were, the Fund often failed to keep the focus on them and to press forcefully for policy responses.
- In general, IMF surveillance failed to take fully into account the implications of being in a currency union both for national policies and for the governance of the euro area, whose weaknesses were not fundamentally criticised. However, the Fund correctly identified some weaknesses of the European integration process, most notably of the EU financial supervision and resolution framework.

Regarding surveillance of the euro area during the 2008-10 crises, the report finds that:

- IMF surveillance became much more intense. Regular surveillance also became more relevant, although it continued to suffer some weaknesses, in particular the division between euro area-wide and national Article IV reports.
- Besides conducting regular surveillance, the IMF provided advice to national and euro-area authorities in real time and at an accelerated pace as the crisis unfolded, quickly recognising the nature and magnitude of the problems facing the euro area and abandoning earlier complacency.
- The Fund rightly assessed the magnitude of the economic downturn and urged a strong macroeconomic response. However, it did not sufficiently differentiate the advice for fiscal stimulus across countries, thereby contributing to later vulnerabilities, in particular in Spain.
- The Fund early on advocated a vigorous response to deal with distressed banks. This was a positive contribution to the debate in Europe, which was slow to address the issue.
- The Fund was an important contributor in the search for a crisis management and resolution framework by pushing for more comprehensive and bolder solutions.
- In the debate on the reform of the governance of EMU, the Fund contributed on some issues but was not a major contributor to the rethink of the European policy framework.

The report makes a number of recommendations to improve IMF surveillance of the euro area:

- The IMF surveillance mandate for currency unions needs to be re-interpreted in order to recognise that instability in a currency union involves other channels than

the nominal exchange rate, the normal channel in surveillance of IMF members. A revision of the 2007 decision on surveillance would help in this respect, but there is room for improvement within the existing legal framework.

- The IMF's relationship with the euro area should be redefined. The Fund should take notice of the EU's institutional constraints but should not be bound by them. It should gradually give up the role of a major player in the euro area institutional game adopted at the height of the sovereign debt crisis, and revert to its normal role of trusted external advisor, including on euro area institutional reforms.
- IMF surveillance should be restructured in order to improve the consistency of national and euro area-wide surveillance and ensure better effectiveness. In particular the euro area Article IV report should be done away with and replaced by a Euro Area Surveillance Report (EASR) combining the main results of the national Article IV reports and of the euro area mission. It should address all major intra euro-area spillovers and examine linkages between the euro area and the rest of the world.
- The EASR would be an important factor in ensuring better traction for IMF advice to the euro area and its member countries.
- Financial-sector surveillance and risk assessment should feature prominently in national Article IV reports and in the EASR.

1. Introduction

„… die Eule der Minerva beginnt erst mit der einbrechenden Dämmerung ihren Flug.“[1]

1 **The purpose of this report is to provide an independent view of the Fund's surveillance of the euro area in recent years,** with a particular focus on the euro area as a whole and on the countries that ended up either requesting financial assistance from the Fund (Greece, Ireland, Portugal) or were adversely affected by bond market developments (Spain). The aim is to assess IMF surveillance of the euro area and of its individual member states in the run-up to the global financial crisis and during the period 2008-10. Special focus is placed on how the Fund took into account the implications of currency union membership[2].

2 **This report is the first attempt to evaluate the IMF's surveillance of the euro area and of a currency union.** The 2008 Triennial Review included a review of IMF surveillance of the European Union in general, but not focusing on the euro area specifically[3]. The Independent Evaluation Office has not yet produced a report specifically on the euro area. For this reason our report also touches upon the institutional framework of the euro area itself and IMF surveillance of currency unions, and examines how these two frameworks interact with one another.

3 **Effective surveillance of the euro area is made difficult by the complicated institutional set-up of the euro area, and the IMF has to cope with this difficulty.** The euro area is a unique construction, with a complex decision-making process involving numerous actors. While monetary policy is in the hands of one central authority, the European Central Bank (ECB), national authorities are in charge of most other policies, which are coordinated by different Council formations. The euro area as such is not a member of the IMF but all its members are. However regular IMF surveillance through Article IV consultations and reports covers both individual member states and the euro area[4].

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1. Georg Friedrich Hegel, *Grundlinien der Philosophie des Rechts*, Frankfurt/Main, 1972, S. 14, original published in 1821. In English: "...the Owl of Minerva takes flight only as the dusk begins to fall".
2. The purpose follows the agreed terms of reference.
3. Watson (2008).
4. The euro-area Article IV is technically not an Article IV in its own rights.

4 **Our assessment of IMF surveillance takes into account the effectiveness of communication to national and euro-area authorities.** An important part of effective surveillance, besides the analysis and appropriateness of recommendations, concerns the effectiveness with which recommendations are transmitted to authorities and trigger a policy debate among recipient policymakers and the wider policy community. This issue is of particular relevance for the euro area, because its complex governance and the overlap of responsibilities make it difficult for the IMF to effectively deliver advice and trigger action at the euro-area and national levels.

5 **Our assessment does not, however, explore to what extent IMF advice was followed in terms of policy action by the recipient authorities.** An important issue when assessing the overall impact of surveillance should be to examine to what extent national and euro-area policymakers take on board and act on advice given to them. Unfortunately, the evaluation of actual policy response could not be done within the short time frame given to the authors of this study.

6 **Economic policy mistakes are easier to spot with the benefit of hindsight than in real time.** Just as the owl of Minerva comes too late to warn, some of our criticisms of Fund surveillance are made possible by the fact that some issues now fully in the open were difficult to monitor in real time. Some data are also more accurate today than they were at the time when surveillance was carried out. Some of our criticisms may therefore sound unfairly harsh to those who were trying to give the best policy advice possible in real time. Although we are fully aware of our informational advantage, we deem it nevertheless important to highlight where policy recommendations proved to be right or wrong given the state of our knowledge today. When possible, we tried to assess to what extent policy recommendations were appropriate or not on the basis of information available at the time.

7 **The report is meant to cover IMF surveillance during the period 2008-10.** However, we have gone back to earlier documents to assess if vulnerabilities that came to the fore in the period 2008-10 had been already detected in earlier documents.

8 **This report examines IMF surveillance in a broad sense, as carried out through the usual institutional channels and through more informal channels.** Formal channels include both multilateral reports (especially the World Economic Outlook and Global Financial Stability reports) and bilateral reports (especially Article IV reports and Financial Sector Assessment Programme (FSAP) reports). Informal channels include initiatives taken by Fund management to convey policy messages to

national and European authorities, which grew in importance after the beginning of the economic and financial crisis in September 2008.

9 **Our assessment is based on published and unpublished written material as well as on interviews at the IMF and in Europe.** To form a comprehensive view, we analysed the published Article IV and multilateral surveillance documents as well as those unpublished documents that were made available to us. Moreover, we interviewed a large number of IMF staff, management and executive directors, as well as senior policymakers throughout Europe and the US.

10 **The amount of material available for us to examine was extremely large.** It was necessary for us to focus on a limited number of key episodes of economic policymaking in the euro area. This particularly applies to the 2008-10 period, when a significant part of IMF surveillance took place through interaction with policymakers outside the regular Article IV surveillance process.

11 **The report is structured as follows.** The next section reviews the IMF surveillance mandate, in particular with respect to the euro area. Section 3 assesses the performance of IMF surveillance in identifying and warning about risks in the run-up to the crisis, before the Lehman Brothers collapse. Section 4 assesses IMF advice on a number of key economic policy issues during the crisis. Section 5 concludes with a number of proposals on how to improve IMF surveillance of the euro area.

2. Legal and institutional issues surrounding IMF surveillance

12 **The two main modalities of IMF surveillance are multilateral and bilateral.** The first refers to the Fund's responsibility to oversee the international monetary system and the second to its responsibility to oversee the compliance of each member with its obligations under the Articles of Agreement. As a large entity with a significant role in the global economy and within the international monetary system, the euro area is subject to both multilateral and bilateral surveillance. In practice, multilateral surveillance takes place mostly through the publication of Fund reports. The Fund has two main flagship publications, the *World Economic Outlook* (WEO) and the *Global Financial Stability Report* (GFSR). Recently, the *Fiscal Monitor* was added as a global flagship publication. For the euro area, the bi-annual *Regional Economic Outlook* (REO) for Europe complements the WEO/GFSR, even though it is not strictly speaking part of surveillance. Bilateral surveillance centres on Article IV consultations and discussions of the IMF Executive Board of a staff report[5].

13 **Legal provisions for surveillance emphasise the exchange rate as a channel of interaction with the rest of the world.** Article IV specifies the obligations of members with respect to exchange rate stability in order to fulfill "the essential purpose of the international monetary system [which] is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth." Section (1) spells out in some detail the general obligations of members. It indicates that they include conducting their "economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability" and promoting stability "by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions". These two requirements are generally referred to as aiming at *domestic stability*. Furthermore, and importantly, the same section of Article IV indicates that IMF members "avoid manipulating exchange rates or the in-

5. Article IV of the IMF's Articles of Agreement defines the obligations of IMF Members.

ternational monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage" and "follow exchange policies compatible with their undertakings under Article IV, Section 1". This requirement refers specifically to the exchange rate and the balance of payments, in other words *external stability*[6]. Section (3) forms the basis of bilateral surveillance, giving the Fund the responsibility to oversee the compliance of each member with their general obligations. Box 1 discusses what an Article IV mission involves.

14 **The IMF executive board adopted a new decision on bilateral surveillance over members' policies in 2007. Under the new decision, the concept of external stability explicitly became the overarching principle of surveillance.** The 2007 decision corrected the previously exclusive focus on exchange-rate policy and instead promoted a broader concept of external stability. Domestic stability was designated as an objective in itself and as a necessary condition for external stability. External stability was further defined in a companion paper and the Executive Board endorsed the following definition[7]: external stability has been achieved when the balance of payments position does not, and is not likely to, give rise to disruptive adjustments in exchange rates. A balance of payments position is broadly in line with its equilibrium, according to the companion paper, when the "(i) underlying current account is broadly in line with its equilibrium (which (...) is equivalent to there being no fundamental exchange rate misalignment), and (ii) the capital and financial account does not create risks of abrupt shifts in capital flows". In other words, the assessment of the balance of payments flows should also take into account the stocks, in particular the net external asset position. Thus, the assessment should consider the current account as well as the capital and financial accounts.

BOX 1: ARTICLE IV MISSIONS

Article IV of the International Monetary Fund's Articles of Agreement forms the legal basis of its formal surveillance mandate. Although this surveillance leads to the systematic publication of many high-visibility reports and publications, it is a continuous process involving regular interaction with authorities.

Article IV Consultations are the main tool through which the IMF operationalises its bilateral surveillance mandate with the aim of evaluating and advising on the economic policies of each member state. In principle, Article IV Consultations follow

6. The distinction between domestic and external stability is however not explicitly made in the Articles of Agreement.
7. IMF (2007) 'Review of the 1977 Decision – Proposal for a new decision', companion paper, May 22.

a twelve-month cycle, even though longer consultation cycles are also possible under certain conditions. The periodic reviews that are carried out for countries under an IMF programme are distinct from the Article IV Consultation process.

There are typically three stages in an Article IV Consultation: (1) a preparation phase, taking place mostly within the Fund itself, (2) the Article IV Mission, consisting of a staff visit to the country under surveillance and ending with a Concluding Statement, and (3) preparation of reports for management and the Executive Board. The culmination of this last stage is the discussion of the staff report by the Executive Board, and its publication if the member country agrees. Several documents are produced during each of these stages, though only the final Staff Report and the staff's concluding statement are often made public.

The preparation phase

The Article IV Consultation process begins with the preparation of a Draft Policy Note by the relevant area department, which leads the process. Information collected as part of the continuous surveillance process, discussions with other Fund departments and early consultations with the country authorities provide the material for the Draft Policy Note. This incorporates a preliminary analysis of the country's economic situation and policies, and outlines the Fund's proposed positions on major issues. Having been submitted to management for approval, the document is cleared by the Strategy, Policy and Review (SPR) department of the IMF. The final Policy Note provides a summary analysis of the economic situation and sets the agenda.

The Article IV Mission

During the Article IV Mission, a small team of IMF staff members visits the country for a period of approximately two weeks. The team is headed by a senior staff member, the Mission Chief, from the relevant area department. The other members of the Mission team are selected from the area department and the functional departments depending on the issues requiring special attention (a country with budgetary troubles, for example, could expect a staff member from the Fiscal Affairs Department). In general, a Mission team comprises four to six people.

The Article IV Mission consists of meetings with policy makers and officials, academics and think tanks, and representatives of the private sector and civil society (such as trade unions), depending on the issues under scrutiny. The primary contact is often the Ministry of Finance or the Central Bank. The meetings are

designed to collect and verify information and statistical data and acquire through discussions a deeper understanding of policy issues and objectives. During this process, the Mission team presents the IMF's view on what the most pressing policy questions are and provides advice on how to address them. At the end of the Mission, the Fund may publish a 'Concluding Statement' summarising its views and recommendations.

The final stage

Following the Article IV Mission, the Mission team prepares the Staff Report for the Executive Board. This report, after having been cleared by the Executive Board and after removal of market-sensitive information or information that may reveal policies prematurely, is what is commonly referred to as the 'Article IV'. Its exact structure changes with time and the country under surveillance. In general, however, it contains the following sections:

- An Executive Summary;
- Context: short summary of the current economic situation (focus on short-term issues);
- The Economic Outlook: detailed presentation of the economy, often containing a large number of charts and figures. The presentation may be organised by topic;
- Policy Discussion: policy recommendations derived from the analysis in the preceding section. This section tends to be more theoretical than the Economic Outlook. It may also be organised by topic;
- Staff Appraisal: this section, which often forms the basis of the Executive Summary, presents the IMF staff's overall appraisal and policy advice.

Before publication, the report is discussed in depth by the Fund's Executive Board. Most, if not all, of the Executive Directors will express their positions with respect to the Fund's appraisal and highlight issues for discussion. At the end of the Executive Board discussion, a 'Summing Up' – containing the Board's views, including disagreements – is prepared for approval before being transmitted to the country under surveillance. This document forms the basis, along with the main Report, for the 'Public Information Notice' that is released at the same time. The minutes of the Executive Board Meeting, however, are not made public.

Note: This box draws on official IMF documents and: Arriazu, Crow, Thygesen (1999) *External evaluation of IMF surveillance: report by a group of independent experts*, International Monetary Fund, Washington DC

15 **Within this framework, surveillance of the euro area raises two types of difficulties. One is institutional: the euro area as such is not a member of the Fund, whereas constituent member countries are.** This is important from a legal standpoint, but also because surveillance is a collaborative process based on dialogue between Fund staff and national authorities – as mentioned in one interview for this report, "it takes two to do surveillance". The solution here is that bilateral Article IV consultations are conducted with all euro-area member states and are supplemented by discussions with EU institutions responsible for common policies in the area. The Fund started conducting euro area-wide Article IV missions in 1999 with the aim of monitoring monetary and exchange rate policy. Consistent with legal constraints, the IMF Decisions No. 11846-(98/125), 12899-(02/119), 14062 (08/15) state that results from euro-area surveillance are an integral part of the surveillance of the individual member states. In practice, however, the surveillance processes and documents were *not* integrated[8]. National Article IV reports continued to constitute the core of the IMF's surveillance. The focus of the euro-area surveillance was ECB policy and discussions with the European Commission on broad economic policies, including in the areas of macroeconomics, trade and competition policy, and on issues related to the Stability and Growth Pact and the financial supervisory framework. The euro-area Article IV documents rarely discuss national problems that could have significant implications for the euro area in aggregate, as national discussions are part of the national Article IVs. At the same time, monetary and exchange rate developments ceased to be part of the national Article IVs[9]. **In effect, surveillance was split into two parts: one addressing policies conducted by euro-area authorities, and one addressing national policies. In the process, the issue of overall consistency and spillovers within the euro-area fell out of sight.**

16 **The other difficulty is economic in nature: members of the euro area no longer have a nominal exchange rate, and the euro area is not directly responsible for policies aiming at domestic stability.** The problem was directly addressed on the occasion of the 2007 decision. For the euro area, as for other currency unions, it was decided that external stability would be assessed at the level both of the currency union as a whole and of its individual members. According to this approach, members of a currency union have the same obligations under Article IV as all Fund members, even though they have delegated certain policies to union-level institutions[10].

8. There were some attempts in the direction, for example a call to several countries to introduce fiscal councils to foster self-compliance with the Stability and Growth Pact. These initiatives were, however, partial at best.
9. Real effective exchange-rate developments based on inflation data were discussed in national Article IVs, though not systematically.
10. See IMF (2007), ibid (p8) and also IMF (1998) *The European Economic and Monetary Union and the International*

External stability of a currency union is to be assessed as a function of both the exchange-rate policies of the union and of the domestic policies of its members. The Article IV consultations in a currency union therefore involve a combination of bilateral discussions with individual member states on the policies conducted at their level as well as discussions with union-level institutions for the common policies for which they are responsible[11].

17 **The balance of payments at a country level remains an element of surveillance but the acceptable threshold was increased.** It was decided that in view of the importance of individual members' balances of payments for their domestic stability and the external stability of the union, Article IV assessment of the policies of a member of a currency union should always include an evaluation of developments in its balance of payments. Consistent with the purpose of forming an integrated financial market where savings and investment decisions are disconnected and where intra-union currency risk is absent, it was considered that the thresholds at which balance of payments imbalances become disruptive are higher in a currency union. Nevertheless, the possibility of balance of payment pressures within a currency union was acknowledged and it was mentioned that these pressures "may be either transmitted to the external stability of the union, or reflected back onto the member in the form of a need for adjustment"[12].

18 **Although the conceptual framework provided by the 2007 decision with respect to the concept of external stability in a currency union is sensible, its implementation in the euro area may have been inadequate.** The decision makes it clear that external stability, the organising principle of surveillance, depends both on exchange-rate stability of the union and on domestic stability of individual members of the currency union. Yet by focusing on the external stability of the euro area as a whole, surveillance of domestic stability seems to have ignored spillover effects of country-level developments onto other euro-area members[13]. As the nominal exchange-rate channel, which is prominent in the 2007 decision, was absent, there was a tendency to overlook intra euro-area imbalances and the

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Monetary Fund – Main issues relating to rights and obligations of EMU Members in the Fund: "When conducting surveillance, the Fund considers the policies of the union-level institutions as being conducted on behalf of the currency union's members".

11. Ibid and IMF (2005) *Fund surveillance over members of a currency union*, 21 December 2005.
12. IMF (2007), ibid., p11, paragraph 25.
13. "Surveillance at the level of individual currency union members examines their domestic policies and assesses the extent to which these policies promote their own domestic stability, which in turn fosters the domestic and external stability of the union" (2007 companion paper). The focus on external stability may have rendered intra-currency area imbalances not of primary concern. At the extreme, the current crisis for example could be considered of little relevance to IMF surveillance. Indeed, the euro-area exchange rate is stable and euro-area

possibility that national policies or developments could constitute a threat to the stability of the partner countries and the union as a whole. The overall approach therefore reinforced the original division of labour between national and euro area-wide Article IVs and made it even more difficult for the Fund to focus on spillovers within the area[14].

19 **In our view the concept of external stability is well-suited in the context of the euro area, provided that other channels of instability, which do not involve the nominal exchange rate, are recognised.** What happened during the crisis is that some national policies failed to comply with the objectives of internal and external stability and this had negative repercussions on other euro-area countries and the on euro area as a whole[15]. We will come back to this issue in the conclusion.

balance of payments is close to equilibrium. While national economic situations are not stable, this absence of domestic stability is not resulting in nominal exchange rate instability and is therefore not of concern for a narrow interpretation of external stability.

14. Watson (2008) already noted in his report on IMF surveillance in Europe that "spillovers within the euro area also need clarifying" (p21).
15. Watson (2008) already stressed that "the analysis of persistent imbalances and inflation in the euro area have not been placed in a clear analytical framework and mapped convincingly to financial dynamics and adjustment capacity at the level of the euro area." (p4).

3. Pre-Lehman IMF surveillance of the euro area

20 **IMF surveillance of the euro area suffered from similar problems to the IMF's surveillance in general before the crisis.** The IMF's Independent Evaluation Office (IEO) has highlighted the fundamental problems of IMF surveillance in the run-up to the crisis in a recent report[16]. There was too much confidence in the inherent stability of the private economy and the financial system. In Europe as in the US there was the general mind-set that a better distribution of risk had reduced volatility in the financial system. Light-touch regulation was the order of the day and it was generally believed that monetary policy could deal with market corrections ('Greenspan-put'). For the Fund, it was very difficult to fundamentally oppose this view and it also fell victim to it in its surveillance of the euro area. The diagnosis of the underlying problems was often wrong, neglecting the feedback loops in the financial system, the links between the real and financial economy, and the systemic aspects of the financial sector. The build-up of leverage as well as stock-flow problems were not sufficiently recognised. **This report does not analyse surveillance in general but focuses on the aspects of surveillance specific to the euro area.**

3.1 Surveillance of euro-area member states

21 **For several member states of the euro area, the Fund issued strong and relevant policy recommendations.** For example, in the case of Portugal, strong warnings about weak fundamentals were given[17]. This included clear warnings about weak productivity, current-account deficits, private-sector debt, and the necessity of significant adjustments to labour markets. These warnings were issued despite significant pushback from national authorities[18]. In the case of Greece, significant

16. IEO (2011), IMF performance in the run-up to the financial and economic crisis, IMF surveillance in 2004-7, Evaluation report, Washington D.C., International Monetary Fund. Also see, IMF (2009), Initial lessons of the crisis, SPR-report. And IMF (2009), Initial lessons of the crisis for the global architecture and the IMF, SPR-report, http://www.imf.org/external/np/pp/eng/2009/021809.pdf.
17. 2007 Article IV staff report.
18. As evidenced by different interviews.

problems in fiscal management were identified in a 2006 report[19]. Some issues in Spain were also rightly identified. For example, the Fund issued warnings about the risks associated with private sector indebtedness and general warnings about lost competitiveness. In 2004, important warnings about the tax deductibility of mortgages that were further fuelling the housing boom were given. Ireland was warned about housing market bubbles.

22 **However, the focus of surveillance sometimes appears arbitrary and important issues were left untouched.** National as well as euro-area Article IVs typically focus on one or two core issues. It is unclear, however, how the focus was chosen, and the choices in retrospect do not always reflect the most pressing policy priorities. In the case of Ireland for example, labour-market flexibility was given significant weight in the 2007 discussions[20]. This appears somewhat surprising given the comparatively high degree of labour-market flexibility in Ireland compared to other countries[21]. At the same time, the 2007 report gave banking sector problems less attention than would seem appropriate in hindsight. In Greece, problems in the area of fiscal management were downplayed in the 2007 report while they received significant attention one year earlier[22]. In Spain, there was little discussion of the housing boom and of the implications of an end to this boom for the Spanish financial system even in 2007. The problems of exceptionally high tax revenues due to a boom in tax-rich income bases were hardly mentioned[23]. Instead, the 2007 Article IV discusses the question of fiscal discipline in a decentralised economy at great length.

23 **Follow-up of previous policy recommendations was not always ensured.** In Greece, the important 2006 findings about public accounting did not find their way into the subsequent Article IV reports and did therefore not have the effect they could and should have had. In other euro-area countries, major findings in one year were not followed-up in the following year[24]. A frequent explanation given for this pattern is that the IMF did not want to make policy discussions overly repetitive and instead aimed to bring in fresh ideas. While this is certainly an important concern, it does not justify leaving out major policy problems identified earlier. In fact, such

19. IMF (2006) Greece: report on observance of standards and codes – fiscal transparency module, *IMF Country Report* No 06/49.
20. See Article IV report for Ireland of 2007.
21. Labour-market flexibility is an important issue in a monetary union; however, for Ireland it is far less important than, for example, in Spain, putting into question the way priority areas are chosen.
22. See Article IV report for Greece of 2007, published in May 2008.
23. See Article IV report for Spain of 2007.
24. For example, the Article IV of 2006 for Spain has a major discussion of labour market reforms but this is virtually absent in the 2007 report.

omissions could be perceived by national authorities as a sign that the problem had in fact diminished.

24 **The Fund did not exploit its comparative advantage deriving from international experience with crisis-prone countries.** In many respects, crises in emerging economies show similarities to current problems in some euro-area member states. The Fund was the institution best placed to recognise that credit booms, large current account deficits and large external indebtedness are eventually associated with significant turbulence. It had a clear comparative advantage with respect to the institutions responsible for EU surveillance. However the Fund fell victim to the mind-set that 'Europe is different'. It may also have been encouraged to tone down its doubts because of the weight of European countries in Fund governance[25].

3.2 The euro-area dimension of surveillance

25 **Economic linkages in monetary union were not systematically taken into account.** The analyses performed in national Article IVs rarely took into account the fact that policy action in an integrated economic area has direct consequences for other members of the euro area. Typically, the assumption made was that the euro-area context should be taken as given. While this is a useful approximation for the very small members of EMU, it is not a useful approach for the large economies and medium-sized economies. For example, policy action in Spain has direct implications for Portugal but this is rarely alluded to in either the Spanish or the Portuguese Article IVs. Problems in the governance of German public banks were raised[26], but the link between these governance problems and the fact that Landesbanks may have fuelled harmful borrowing in other parts of the euro area was not made.

26 **The Fund's surveillance failed to take account of the implications of being in monetary union.** Before the foundation of EMU, Fund discussion about the benefits and costs of being part of a monetary union were framed by the theory of optimal currency areas. After EMU foundation, central insights of this theory were not taken into account in the IMF surveillance. The Fund's structural policy advice to its members was general but almost never referred to EMU. For example, while labour market reforms were being called for in several countries, the Fund did not underline that in a common currency area such reforms are particularly needed to

25. As stated by several interviewees.
26. See for example, Article IV for Germany of 2007 and 2004, FSAP 2003 for Germany.

facilitate adjustment[27]. Growth dynamics that inherently resulted from the low real interest rates and the resulting excessive domestic demand were not identified as being unsustainable[28].

27 **Divergences in monetary union were typically interpreted in a narrow way based on a trade view.** Divergences in the euro area in terms of current accounts were almost exclusively understood as resulting from trade and competitiveness developments, thereby neglecting the financial dimension of the problem. Current-account divergences were typically looked at from the point of view of trade flows and competitiveness. Typically, it was argued that competitiveness losses produced the observed trade-flow imbalances. This analysis ignored the underlying financial flows and also failed to see that trade imbalances were often not driven by weak export performance but rather by strong import dynamics due to buoyant domestic demand[29]. While current account divergences and the resulting deterioration in net foreign financial asset positions was often mentioned in national Article IVs, the general line was that this would not constitute an immediate concern. The main reason given for this position is that in monetary union, funding for external deficits cannot dry up.

28 **The link between capital inflows and systemic risk was ignored.** The large capital inflows to countries such as Spain and Ireland led to the build-up of significant financial risk. This risk was often not properly identified. For example, in the case of Ireland, national Article IVs failed to issue warnings on the vulnerability of the banking system and basically relied on the assessment of national authorities in this regard. Better data may have allowed more pertinent warnings to be issued. The interconnectedness of the financial system and the implications of national instabilities for the euro area financial system were not highlighted.

29 **The vulnerability arising from the link between high debt and competitiveness adjustment was not identified.** In monetary union, the basics of debt dynamics change as countries forgo monetary policy and the exchange rate as adjustment tools. A country with a high debt-to-GDP ratio and low competitiveness faces the challenge that adjusting competitiveness increases the real burden of debt. As a consequence, the market tolerance of what constitutes a sustainable level of debt

27. See for example Article IV reports for Spain and Portugal.
28. For example, high growth rates in Ireland were not identified as unsustainable even though they could not be explained by catching-up processes – Irish GDP was already far above the euro-area average. While paragraph 2 of the report sounds some warnings about the construction boom, the main message from paragraph 1 is high growth that is justified by fundamentals.
29. In the same vein, the interpretation typically failed to acknowledge that despite weak competitiveness, employment was high, suggesting strength of labour demand rather than a lack thereof.

is therefore likely to shift downward after what has been a learning experience. The Fund failed to warn about the potentially negative implications of having high debt and competitiveness adjustment needs.

30 **FSAPs existed on a national level only and were not designed to be used as a warning tool.** FSAPs did not warn appropriately and early enough about the risks in the financial system in some cases[30]. In the case of Ireland, the FSAP of July 2006 failed to spot the risks in the financial system. The Spanish FSAP of summer 2006 was more helpful in this regard and integrated real economy and financial developments with more success. Despite the Fund's concerns about the financial architecture of euro-area financial supervision, the FSAPs were not integrated across euro-area countries to take account of the strong financial links. There was no desire on the part of the EU to let the Fund perform an FSAP at the level of the euro area. An EU FSAP is currently being designed and scheduled for 2012.

31 **Multilateral surveillance provides useful guidance for national surveillance, but can spot national problems only in general terms.** The WEO and GFSR are excellent publications to form a view about global trends and developments. They include regional analysis that identifies broad trends. For example, the October 2007 WEO sounds some warnings about the implications of global tightening on housing markets and also points to competitiveness problems in some euro-area countries. It also points to potential vulnerabilities in the banking system. These warnings are too general to be suited for country-level policy action but constitute important messages to frame debates. The Regional Economic Outlook for Europe, which is not an official surveillance document, started only in 2007 and moves in the direction of providing more detailed analysis that can more directly shape policy action. However it does not attract much attention from policymakers at the senior level.

32 **Weaknesses in the governance framework of the euro area were not fundamentally criticised.** Before the euro was introduced, there was much debate regarding the institutions necessary to ensure that a monetary union would be viable. This debate was fuelled by leading economists from the US and Europe. It was very present in the Fund, and IMF research contributed significantly to it. Once the euro was introduced, however, the Fund stopped taking into account lessons from this debate. It is certainly a difficult balancing act to point to weaknesses in the governance framework of the euro area without fundamentally questioning the project of the euro itself. The Fund, however, chose to remain mostly silent on the

30. See also Wagner, Nancy (2010) 'IMF performance in the run-up to the crisis: bilateral surveillance on selected IMF member countries', *IEC Background Paper* BP 10/03. In some other countries, the assessment is probably different.

governance issue. It pointed to the weakness and problems of the Stability and Growth Pact (SGP), especially when it was reformed. However, it did not fundamentally raise the issue of missing surveillance in areas other than the SGP and did not raise the question of fiscal integration.

33 **In the area of financial supervision and resolution, the Fund played a leading role in emphasising the relationship between monetary and financial integration and it pushed for progress towards more policy integration.** The Fund called on the euro area to improve its governance of cross-border banking groups, to make provisions for resolution of cross-border crises and to address the question of ex-ante burden sharing and supervision. While the push was often framed in terms of cross-border banks, the Fund clearly also had large banking groups and their spillover effects in the focus of analysis[31]. Thus, in the area of financial integration, the Fund did warn European policy makers of the inadequacy of the system in place.

3.3 Institutional issues

34 **Surveillance was process-driven rather than analysis-driven and had difficulties coping with the set-up of EMU.** In addition to the economic mind-set, the way the surveillance was structured hampered effective surveillance. IMF surveillance continued to be structured in the same way as for countries outside of a monetary union[32] whereas euro area-wide surveillance largely mimicked European processes.

35 **As a result, national and euro area-wide follow-up of recommendations was not sufficiently integrated.** The different national surveillance processes were not linked to each other to reflect interdependence within the common currency area. Policy recommendations developed in the euro-area Article IVs were rarely translated into concrete country-specific policy advice. Conversely, problems identified at the national level were not generally brought to the attention of the broader euro-area policy community. For example, warnings about the dismal state of Greek public sector management and fiscal reporting were raised with Greek authorities (eg in the 2006 technical assistance report[33]) but the IMF did not undertake to warn the Eurogroup or EU institutions that a significant problem

31. See, for example, EA Article IV staff report of 2007, p19.
32. By which it is meant that member states are looked at separately from each other. In addition, because of the described problems with the mandate, insufficient attention was given to the external indicators such as external debt and balance of payments deficits.
33. IMF (2006) 'Greece: report on observance of standards and codes – fiscal transparency module', *IMF Country Report* No 06/49.

existed[34]. Conversely, broader trends in terms of monetary policy and the euro-area exchange rate were not systematically translated into advice relevant at a national level. For example, the implications of an interest rate increase, which was discussed in the euro-area Article IV, was rarely brought to the attention of national policymakers in countries where there was a significant proportion of variable-rate mortgages, such as Spain and Ireland.

36 **The euro-area Article IV missions and reports were generally felt by European policymakers to be of little help, mostly due to their set-up.** Euro-area Article IVs are typically quite general and only discuss some broad trends. Major concerns such as intra euro-area macroeconomic divergence were not raised as a significant problem until the 2008 Article IV. The role of the euro area in the global economy was typically covered but in rather general terms, essentially referring to the current account balance and whether or not the exchange rate was in line with fundamentals. Several interview partners in Europe argued that they felt that the analysis and tone of the euro-area Article IVs was too close to the official line of the Commission and the ECB. This makes it difficult to see exactly where the added value lies.

37 **A fundamental difficulty of surveillance of the euro area is that a clear counterpart to the Fund is missing.** The weakness of the euro-area Article IV appears to reflect the problems inherent in the complex governance of the euro area. In fact, in the absence of a clear central decision making entity (except for the ECB), the Fund faces a large number of interlocutors. Moreover, the Fund needs to have a view on who are the most relevant partners in the euro area with whom surveillance discussions can be most effectively held. In the euro area today, it can be argued that the identity of the best counterpart shifts relatively quickly depending on the problem and on domestic and European credentials. Indeed, on several occasions, the Fund warned that the euro area needed stronger internal governance.

38 **Close relationships between the Fund and the authorities, as well as downsizing, reduced the effectiveness of the Fund as an independent and critical observer.** Fund officials in many instances had very close contacts with European officials. Many interview partners remarked that this drew the Fund into the European policy game too much, making it more difficult to exploit its comparative advantage and to carry out independent, process-free economic analysis. The Fund placed excessive focus on fiscal policy and neglected private-sector vulnerabilities, much in the same way as the EU's own institutions did in their surveillance. In addition,

34. EA Article IV reports rarely become specific on member states.

the Fund underwent a period of significant staffing cuts during the period we survey and the effects of this downsizing should not be underestimated.

39 **A combination of self-restraint and resource constraints may also explain why the Fund failed to detect the full extent of Greek misreporting of public accounts.** Problems were spotted, and in programme conditions, Fund staff would certainly have been able to uncover the extent of misreporting. Surveillance teams, however, probably lacked the authority and the resources necessary to carry out the further investigations[35].

40 **The collaboration between staff and executive directors was not always smooth.** European executive directors were sometimes found to be more critical than staff and, pushed for greater integration of analysis. Our reading of different board meeting minutes, as well as the interviews we conducted, indicate that on occasions, executive directors appeared aware of linkages and often also came forward with a common view on issues, via the EURIMF presidency in particular. The executive board was not always active in response to events. For example, there was no board discussion after the release of revised Greek data. Moreover, staff often felt that executive directors were pushing them back on several issues, by calling in staff members and lecturing them[36]. Overall, the relationhip between staff and executive directors could be strengthened and made more effective.

35. As stated in an interview. In programme mode, many more resources are available to carry out investigations.
36. As stated in several interviews.

4. IMF surveillance of the euro area during the crisis years

41 **IMF surveillance of the euro area became more intensive during the crisis years (2008-10) and often took on a different form than in earlier years.** The frequency and importance of events in the last three years was unprecedented. The IMF acknowledged that an annual surveillance cycle would not do justice to the enormous task. It therefore increased the frequency of interaction with national and EU authorities at all levels and helped shape the policy debate in Europe. The frequency of the WEO and GFSR publications was increased while many informal and formal processes and links were established to supplement the standard twice-yearly Article IV missions.

42 **The Fund quickly changed its approach to the euro area recognising the nature and magnitude of the problem.** While in the pre-Lehman period, the general approach to the euro area was framed by a 'Europe is different' mind-set, from early 2009 onwards the Fund pointed to the problems of the euro area with increasing urgency, including the substantial interconnectedness of problems across countries. For example, the Fund quickly pointed out that financing of current accounts could become an issue in the euro area. The surveillance of the euro area thus became more realistic in terms of the challenges facing its economies.

43 **This stepped-up surveillance was a welcome adaptation to changing circumstances but complicated the task of carrying out an external evaluation.** Indeed, as surveillance increasingly took an oral form or was carried out through unpublished documents, it is difficult for the authors of this report to form a comprehensive view of IMF surveillance during the crisis.

44 **Besides the regular surveillance documents, we therefore decided to focus our evaluation on four key topics of great relevance for the euro area.** In particular, we focus on (i) the advice on the macroeconomic response to the crisis, especially the fiscal stimulus in 2008-10, (ii) the advice on dealing with the stress in the banking system in general and in Ireland more specifically, (iii) the advice on the

crisis management and resolution framework (iv) the advise on the governance reform of the euro area. The IMF has been very supportive in our quest to form a comprehensive view on these events going beyond the publicly known documents.

4.1 Regular surveillance during the crisis years

45 **Regular surveillance of euro-area countries with difficulties became more relevant during the crisis years.** Awareness of the fundamental problems that some euro-area countries face increased significantly. IMF analysis also became more relevant, pointing to the bigger problems. In Portugal, the combination of low productivity, weak competitiveness and high debt was rightly identified, and the urgency of keeping control of public finances was adequately stressed (Article IV of January 2010). In Ireland, the focus of surveillance shifted to the problems in the banking system and the need to separate banking sector woes from the sovereign. With the benefit of hindsight however, the staff report appears to have been somewhat optimistic about the prospects of dealing forcefully with such problems (Article IV of June 2010). In Spain, the issue of labour-market reform and consolidation of the banking sector was more forcefully raised. There is also an extensive discussion of private-sector balance-sheet adjustment needs (Article IV of July 2010).

46 **Nonetheless, the urgency of problems in Greece was not properly captured in the regular Article IV of 2009.** In Greece, warnings about the need for fiscal consolidation were somewhat stepped up in the report of August 2009. However, the report mentions public-sector data problems only in passing and does not properly assess the risks stemming from further market pressure, taking a benign view that these pressures would be receding. The report is upbeat about the measures taken to stabilise the banking system but failed to account for the exposure of the banking system to the sovereign itself. With hindsight, the banking sector assessment was probably also overly optimistic given the later agreement to include a bank stabilisation fund in the Greek assistance programme agreed on in May 2010.

47 **The quality of the analysis and policy recommendations increased, but the structure of formal surveillance remained an obstacle to an integrated assessment.** The euro-area Article IV staff report of July 2010 points to the fundamental problems underlying the construction of the euro area in clearer terms than before the crisis and overall is very much to the point. We discuss some details of the euro-area Article IV's core messages in sections 4.4 and 4.5. However, regular surveillance during the crisis followed the same organising principles as before

the crisis. As before the crisis, national Article IVs remained the core of the surveillance of the euro area. The euro-area Article IV is an additional document with a focus on institutional issues, which does not (and does not intend to) take up specific problems in individual member states.

4.2 Macroeconomic policy response

48 **The IMF appropriately assessed the macroeconomic risk to the global economy.** The Fund pointed to the severity of the financial crisis and its implications. It rightly emphasised that the global deleveraging process had strong implications for global demand, and that together with the risks in the financial system and the trade decline, a repeat of a global Great Depression was a distinct possibility. In view of this global risk, the Fund urged countries around the globe to enact significant demand-side policies.

49 **As regards monetary policy, the right course for action was debated in the summer of 2008, with the Fund making a positive contribution.** While Fund staff noted that indicators of inflationary pressure and activity would likely soften, thereby justifying an easing of monetary policy, the ECB pushed back strongly on this, arguing that wage pressure was building up[37]. The ECB decision to tighten in July 2008, which in retrospect can be judged a mistake, was therefore assessed as not appropriate by the IMF. The IMF thus played a positive role in sounding a warning on the downside risks to the euro-area economy. The staff report maintained this scepticism about the monetary tightening, and stated that the case for keeping rates on hold was "compelling".

50 **As regards the aggregate fiscal policy stance, the IMF advice given to the euro area was appropriate and timely.** The Fund urged euro-area economies to enact a significant fiscal expansion. This policy advice was appropriate given the risks to the global economy. The IMF was among the first institutions to understand the severity of the crisis and to call for a strong macroeconomic policy response[38]. The advice helped to significantly shape the debate in the euro area on fiscal policy.

51 **However the Fund did not sufficiently differentiate its advice on fiscal expansion for the different euro-area countries, thereby contributing to the build-up of vulnerabilities.** The Fund made the general point that fiscal policy needs to be

37. As already noted by Watson (2008) there is always "some unease about Fund assessments of monetary policy in the euro area – seen by some authorities as failing to pay sufficient regard to the ECB's specific mandate" (p3).

38. The managing director called in January of 2008 in Davos for a new fiscal policy as an accurate way to respond to this crisis.

differentiated according to fiscal space. While the advice for the euro-area aggregate was appropriate, the differentiation message was not sufficiently broken down across countries and remained general. In the euro-area Article IVs, message on differences in fiscal space given in 2008 and 2009 were weak or absent. In the case of Spain, even the April 2009 Article IV is rather cautious, and does not sound a clear warning on fiscal difficulties. The risks stemming from implicit liabilities in the financial sector are not mentioned prominently either. In its assessment, the Fund also missed the fact that fiscal revenues in Spain were artificially high before the crisis and that the structural deficit was correspondingly larger, and significantly so (see Box 2 on the next page). This could have been seen in real time. Only in the late autumn of 2009 did the Fund shift direction and become much more cautious on fiscal policy[39]. By May 2010, very strong warnings were issued: deep and frontloaded fiscal policy retrenchment measures were called for, and it was recommended that budget plans be based on more prudent macroeconomic forecasts.

4.3 Advice on the diagnosis and treatment of distressed banks in the euro area

52 **The IMF played a positive role in the surveillance of banks in the euro area in the crisis years.** Soon after the collapse of Lehman Brothers, the IMF pointed to the significant problems in the euro-area banking sector and to the need to forcefully tackle the underlying problems. A number of facts can be brought forward in this regard.

53 **The IMF was the first institution to publish estimates of potential write-downs in the European banking system, thereby raising awareness of the problem.** The IMF was criticised for the publication of these estimates, and some commentators at the time remarked that publication could result in self-fulfilling prophecies. This criticism can, however, be dismissed. The write-downs on loans and securities were certainly driven by fundamental factors as the real economy corrected and the publication of such estimates significantly increased transparency. By publishing the numbers, the IMF significantly contributed to increasing public awareness of the underlying problem. This does not eliminate the fact that limitations in terms of access to data reduced the accuracy of the estimates.

54 **While the overall estimates were too pessimistic, this mistake derived mostly from securities.** The estimates of total losses in April were far too large. However, in

39. See for example interview 'Transcript of a Conference Call on the November 2009 Cross-Country Fiscal Monitor,' with Carlo Cottarelli, Fiscal Affairs Department Director, November 3, 2009, Washington DC. Available at: http://www.imf.org/external/np/tr/2009/tr110309.htm.

BOX 2: REVENUE WINDFALLS IN SPAIN AND THE ELASTICITY PROBLEM

In 2008, the IMF expected Spain to enter a recession in 2009, with a decrease in GDP of 0.3 percent. On the surface, this would call for fiscal stimulus. However, the deficit was 12.3 percent of GDP in 2009 and the magnitude of the recession was larger with GDP falling by 3.8 percent. This large increase in the fiscal deficit cannot be explained by the drop in GDP alone given normal elasticities. Instead, it is indicative of special factors that had artificially increased the revenue elasticity before the crisis and led to a collapse of revenues in the recession. In fact, IMF research had pointed to the problem of revenue elasticities much earlier[40].

In 2008, the structural balance and the stability of revenues were wrongly assessed. Structural revenues were deemed to be higher than they actually were. Could and should the IMF have detected that revenues were artificially boosted by booms in revenue-rich tax bases? To answer this question, we distinguish two periods in Spain's economy: 1986-99 and 1999-2007. The first covers the period between Spain's EU entry and its entry into Monetary Union. The second covers the period of EMU of low real interest rates until the collapse of the housing bubble in 2007. We run a structural break test based on a CUSUM test[41]. The result is summarised in Figure 1. This test detects elasticity instability when the cumulative sum of the recursive residuals goes outside the two confidence intervals. The structural-break test reveals that the revenue elasticity to GDP became unstable in about 1999. When estimating the elasticities of the fiscal receipts with respect to GDP in the two sub-periods, we find that the revenue elasticity was greater in the second period, with the difference being statistically significant at a 5 percent level.

The results are derived from the regression: $log(FR) = \alpha + \beta * log(GDP) + U$

FR is the fiscal receipts, α is a constant, β is the elasticity of fiscal revenue with respect to GDP, and U the error terms. Data is taken from the World Economic Outlook (WEO, 2011).

Table 1 summarises the results.

IMF fiscal policy advice did not take into account the possibility that these high

40. Jaeger and Schuknecht (2004) 'Boom-bust phases in asset prices and fiscal policy behaviour', *IMF Working Paper* 04/54.
41. The CUSUM test takes the cumulative sum of recursive residuals and plots its value against the upper and lower bounds of the 95 percent confidence interval at each point.

revenues could in fact be due to the major housing boom and the rise of domestic demand over and above that of GDP. This led to an over-estimation of Spain's ability to generate enough income even in a period of crisis and could therefore partly explain the call for undifferentiated stimulus on the expenditure side. The results also show that with the information available in 2008, a more cautious approach would have been warranted.

Figure 1: Test of the stability of Spain's fiscal elasticity

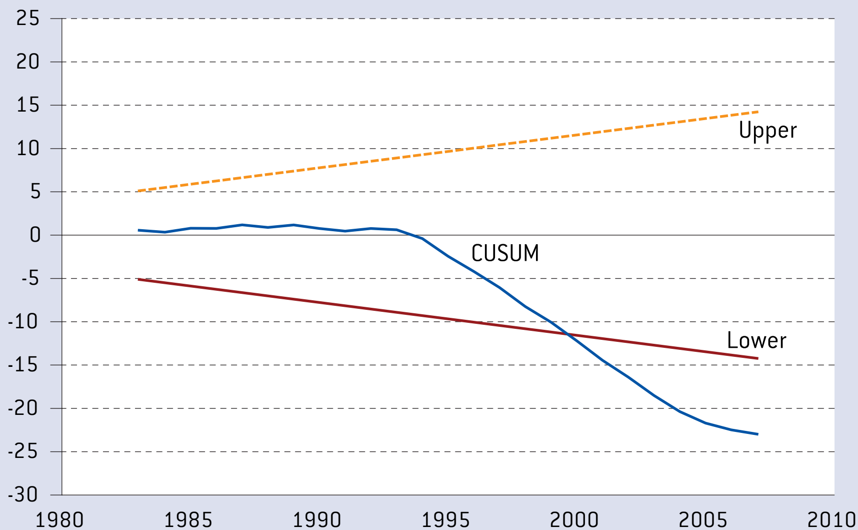

Table 1: Estimation results

The dependant variable is the logarithm of fiscal revenue; estimation method: OLS		
	(1)	(2)
GDP (in logs)	1.09***	1.15***
	[0.028]	[0.027]
Constant	-1.52***	-1.94***
	[0.168]	[0.186]
Observations	14	8
R-squared	0.992	0.997
Base sample	1986-99	2000-07

Standard errors in brackets; *** $p<0.01$

Source for Figure 1 and Table 1: Bruegel.

October 2009, the estimates were already corrected downward to reach a level much closer to the final estimates. The main mistake derived from the estimates of losses in securities. Estimated losses on loans turned out to be accurate (see Box 3).

55 **Consistent with the pessimistic estimates, the Fund rightly urged authorities to conduct a thorough assessment and tackle the problems.** The IMF all along urged EU authorities publicly and privately to undertake credible stress tests. In November 2010, after the Irish crisis proved that the first round of stress tests conducted by the Committee of European Banking Supervisors (CEBS) had been deficient, the Fund asked that the second round of CEBS stress tests be advanced and that their credibility and transparency be enhanced. After the creation of the European Banking Authority (EBA, the successor to CEBS) in January 2011, the IMF provided a note to European authorities making concrete suggestions on how to address the shortcomings of previous EU-wide stress tests. It also called on national authorities to tackle banking sector problems by ensuring adequate recapitalisation of viable institutions and orderly resolution of non-viable ones.

BOX 3: IMF ADVICE ON DIAGNOSIS AND TREATMENT OF DISTRESSED BANKS IN THE EURO AREA

Global Financial Stability Report (GFSR) estimates of potential write-downs in the European banking system were first published in April 2009. Estimates were revised in each GFSR until October 2010, after which no further revisions were added and publication was discontinued.

Table 2 gives the evaluations published in the successive GFSRs (note the data are in current dollars, so not corrected for exchange-rate changes). The first estimate for the euro area and the UK proved to be over-pessimistic, however it should be noted that this was presumably attributable to an exaggeration of estimated losses on the securities portfolio. Losses on the loan portfolio were in fact correctly estimated when first published in October 2009.

Euro-area and national authorities initially denied the accuracy of these estimates. Documents made available to the authors indicate that the Fund was harshly criticised in spring 2009 by the ECB for having released inaccurate estimates, and that there were still differences of view in spring 2010. Similarly authorities in Germany and Spain initially took a more benign view than the Fund.

Consistent with its estimates, from 2008 onwards the Fund urged national authorities throughout to conduct thorough assessments of the situation in their banking sectors and to address weaknesses forcefully and comprehensively. This was especially the case in countries such as Ireland and Spain, which were affected by the bursting of the credit bubble42. Indeed, the banking issue featured prominently in the 2009 and 2010 Article IV reports for Ireland and Spain.

The 2009 Article IV report for Ireland noted that the losses faced by banks up to the end of 2010 could be about €35 billion, or about 20 percent of GDP, and it warned that losses are likely to extend beyond the property-development sector as the economy weakens and the design of the National Asset Management Agency (NAMA) should incorporate that possibility. It also noted that "nationalisation could become necessary but should be seen as complementary to NAMA".

In Spain, the 2009 Article IV report indicates that "Staff stress tests based on published data suggest that banks may face capital needs – Bank of Spain's results, using detailed internal data, are more benign, but the authorities are not complacent (...) Staff noted that there is a need for (fiscal) contingency plans to assist banks with capital. The authorities viewed the severe scenario by staff as too pessimistic, especially regarding the assumption of loan impairments rising rapidly to double digit NPL-ratios".

Table 2: Potential euro-area bank writedowns (2007-10)

$ billions	April 2009	October 2009	April 2010	October 2010
Euro area	1109	814	665	630
- Loans		480	442	442
- Securities		333	224	188
Sources: IMF GFSRs, April 2009-Oct 2010	*Table 1.15, p70*	*Table 1.2, p10*	*Table 1.2, p12*	*Figure 1.13, p13, and breakdown provided by IMF*

56 **The IMF's role in the discussion of the Irish bank guarantees and the subsequent policy response including the National Asset Management Agency (NAMA) is limited.** In the 2007 Article IV, the Fund essentially endorsed the Irish authorities' view that the Irish financial system was sound. According to the available evidence obtained, the IMF was not consulted prior to the introduction of the bank guarantees in September 2008 (see Box 4). Internal IMF documents indicate, however, that the staff were aware already in September 2008 that the size of the

guarantee to the Irish banking system could ultimately pose a problem of fiscal sustainability.

BOX 4: IRISH BANK GUARANTEES

The boom in property prices and investment that took place in Ireland during 2003-07 was fuelled by rapid credit expansion provided mainly by local banks, which in turn relied heavily on international wholesale markets for funding. Although the property sector probably passed its peak already in late 2006, it was not until the shift in global financial markets during 2007 and 2008 that Irish banks started to suffer. By early 2008, many had difficulties in maintaining access to the international wholesale market. After the collapse of Lehman Brothers, international commercial funding for Irish banks came to a stop.

Acting on the belief that the main problem of domestic banks was one of liquidity, rather than solvency, the Irish government put in place on 30 September 2008 a two-year blanket guarantee of most of their liabilities (deposits plus covered bonds, senior debt and dated subordinated debt), both existing liabilities and those issued after its introduction. The guarantee scheme introduced in September 2008 is widely regarded as having been ill-conceived[42]. Later that year the government also provided capital to the banking sector to help it overcome losses on non-performing property loans[43]. In April 2009 it established the National Asset Management Agency (NAMA) to purchase bad land and development loans from banks.

The IMF was clearly not consulted by the Irish government before setting up its bank guarantee scheme. The Irish financial authorities stressed repeatedly in September 2008 that Irish financial institutions were well capitalised and liquid with good quality assets, having passed a rather positive judgment on the Irish banking situation in its 2007 Article IV report, the last one issued before September 2008.

Once the blanket guarantee was in place, there was little the IMF or others could do to correct this 'original sin'. The 2009 Article IV report broadly supported the September 2008 guarantee scheme, stating: "With banks facing liquidity pressures and sizeable losses, the authorities have taken important steps to stabilise the

42. In an influential article written in January 2009, Patrick Honohan, the future governor of the Irish central bank, already remarked that "No public indication has been given that the authorities gave serious consideration to less systemically scene-shifting – and less costly – solutions. For instance, they might have provided specific state guarantees for new borrowings" rather than blanket guarantees for existing liabilities (Honohan, 2009).
43. See Lane, Philip R. (2011) 'The Irish Crisis', *CEPR Discussion Paper* No. DP8287.

financial system – through the blanket guarantee to depositors and creditors and the recapitalisation of banks." At the same time, the report warned that "unless aggressively managed", exiting from blanket guarantees "can be a long-drawn process€[where] weakness of the financial sector, public finances and economic growth can reinforce each other". Although no specific advice was provided in the report itself, we understand that specific recommendations were given.

The issue of bank guarantees resurfaced in November 2010 when the Irish government requested assistance from the EU and the IMF. As explained by Lane (2011), an important question in the negotiation was the appropriate scale of burden sharing by bank bondholders in the recapitalisation of the Irish banking system. Apparently there were about €32 billion in non-guaranteed bank bonds outstanding at the time of the EU/IMF deal, including €20 billion of senior debt and €12 billion of subordinated debt. These bonds were issued before September 2008 and benefited from the blanket guarantee until it expired in September 2010. The deal envisages that holders of non-guaranteed subordinated debt would not be repaid in full, whereas no such possibility was considered for holders of non-guaranteed senior debt despite the fact that, according to press report, the IMF seemed to have been open to this prospect.

4.4 Advice on the design of the crisis management and resolution framework

57 **Starting at end-2009 in the context of increasing pressure from sovereign bond markets, the design of a crisis management and resolution regime for the euro area emerged as a major challenge.** The architecture of the euro area initially relied on the primacy of crisis prevention (through the prevention and correction of excessive deficit and other surveillance procedures). There were no procedures, not even agreed principles for crisis management and resolution, and players in Europe (especially member states, the Commission and the ECB) had different interpretations of the EU Treaty, especially its so-called no bail-out clause. At the same time the euro-area member countries remained individual members of the Fund and as such were entitled to financial assistance in case of need. A major challenge was therefore to design a cooperative crisis management and resolution regime within the euro area. Beyond the specific European question, the broader, strategic issue for the Fund was to define how to collaborate with a regional entity while at the same time ensuring consistency and equality of treatment across countries.

58 **The Fund was an active participant in the search for institutional solutions.** After an initial phase of hesitation, the Europeans determined that Fund involvement was a necessary component of crisis management and resolution. The Fund thereafter contributed actively to the European discussion, both through the direct and active involvement of the managing director at ministerial and head of state and government level or through staff contributions to the design of mechanisms and procedures. The Fund provided a series of non-papers to European policymakers, as well as oral advice on the design of new mechanisms. On several occasions, it played a crucial role in fostering solutions in European decision-making bodies such as the European Council and the Eurogroup. In national debates, the intervention of the IMF also proved decisive in some cases. Leaving out the programmes themselves, which are not covered by this report, key steps were: (a) the agreement in April 2010 among euro-area member countries to provide, jointly with the Fund, financial assistance to Greece; (b) the May 2010 agreement to create the European Financial Stability Facility (EFSF); and (c) the November 2010 decision on the creation of a permanent crisis management and resolution framework for the euro area, the European Stability Mechanism (ESM).

59 **In general, the Fund pushed for more comprehensive and bolder solutions than the Europeans were willing to accept.** In spring 2010, it supported the creation of the ECB's controversial Securities Market Programme. It also advocated the sharing among euro-area member states of the burden of financing and adjustment costs; a pan-European approach to bank recapitalisation; higher borrowing limits for the EFSF/ESM; the possibility for the EFSF/ESM to engage in precautionary lending (in parallel with the granting of a low-conditionality Flexible Credit Line by the IMF); a broader mandate for the EFSF (giving it the ability to purchase debt securities on the secondary market and to intervene in the recapitalisation of ailing peripheral banks); and a more uniform approach to the seniority of official claims on peripheral countries (it was critical of the decision of choosing mid-2013 as a cut-off date)[44].

60 **Overall, there was a distinctive and positive Fund contribution to the European discussion.** First, the Fund brought the experience gained from crisis management and resolution in the emerging world. Second, distance from European power games allowed the Fund to play the role of an impartial umpire. Third, several interview partners remarked that as the Fund was much closer to the market than European policymakers, it was able to accurately point out the dangers building up in the bond markets and the risks of contagion. While it is too early to pass a final

44. See, especially, the Concluding Statement of the IMF Mission on Euro-Area Policies, 6 December 2010.

judgment on the success of the policy measures recommended by the Fund, its positive role in raising the necessary awareness of the dangers of the situation and in fostering initiative and cooperation in the search for responses is widely acknowledged in Europe.

4.5 Reform of EMU governance

61 **The crisis revealed significant shortcomings in the governance of EMU.** First, fiscal surveillance was not intrusive enough to diagnose and prevent the massive failures of fiscal policy in Greece, and was not accurate enough to help avoid the build-up of fiscal risks in Ireland and Spain. Second, financial market supervision was insufficient and systemic risk was largely neglected. Third, macroeconomic imbalances in the private sector were left essentially unchecked or unnoticed. Overall, the perverse interaction between banking risk and sovereign risk that characterises the current crisis was not adequately foreseen.

62 **Starting in 2009, European policymakers decided to reform the governance of EMU along three dimensions by overhauling financial supervision, revisiting fiscal surveillance and introducing surveillance of macroeconomic imbalances.** In early 2010, a task force at ministerial level was established under the chairmanship of President Van Rompuy to advise on reform priorities. The new system of financial supervision has been in place since January 2011. The fiscal and macroeconomic surveillance measures are at time of writing going through the legislative process. The Fund did not contribute significantly to the decision on the priorities for surveillance reform.

63 **The IMF contributed to the governance reform of financial supervision.** The new European system of financial supervision with the new European authorities and the European Systemic Risk Board was set up during 2009 and 2010. To our knowledge, the IMF did not make high-profile interventions in these discussions, by drawing parallels with financial supervision systems elsewhere in the world for example. However, the Fund was an important political ally of the Commission in the Eurogroup and the Euro Working Group (EWG) and helped convince hesitant member states of the necessity to move ahead with the integration of financial supervision[45].

64 **The IMF also contributed to the discussion on the fiscal reforms.** Interviewees remarked that the IMF had provided them with technical material on how to improve

45. Evidence given by interviewees present at the EWG meetings.

the fiscal governance of EMU. This included documents on national fiscal councils and concrete comments on the Stability and Growth Pact reform.

65 **The Fund's involvement in the debate on the design of a system for prevention of macroeconomic imbalances was limited.** The IMF is a key player in the discussion on global imbalances and also takes an active role in shaping the global governance reform debates via the G20. In the euro area, it left the issue of the governance of macroeconomic imbalances mostly untouched. In the euro-area Article IV visit of 2010, the Fund remarked on some of the shortcomings in the design of the European Excessive Imbalances Procedure. However, these criticisms were not made sufficiently public and were also not brought to the attention of key decision makers, such as those involved in the Van Rompuy task force. This limited the overall effectiveness of the criticisms.

66 **Overall, the IMF's involvement in the governance reform was limited.** While the Fund contributed to some aspects of the discussion – in particular regarding fiscal matters – it made no comprehensive effort to influence the shape the overall Van Rompuy package.

5. Recommendations for improving IMF surveillance of the euro area

67 **During the crisis, the Fund proved its capacity to provide first-rate policy expertise.** In its regular surveillance, advice typically became more relevant and outspoken. On the four key topics discussed in section 4, Fund surveillance was clearly ahead of the curve, in particular when compared to the European policy debate. This suggests that its failure to detect vulnerabilities and warn about impending problems in the pre-crisis period should be attributed either to an ill-defined mandate or to the way surveillance was structured and organised within the Fund. To ensure that it fulfills its surveillance mission more effectively and plays the role its members expect from it, significant reforms are therefore required. These reforms include revisiting the surveillance mandate, restructuring the surveillance work and ensuring greater impact. Reforms along these three paths will be necessary to better cope with the problems inherent in the surveillance of the common currency area in Europe.

68 **The steps to improve euro-area surveillance can be summarised in four points.** First, national and euro-area surveillance need to be better integrated. Second, the surveillance mandate should be supportive and move away from an exchange rate-centric model. Third, complementarity between IMF and EU surveillance should be sought. Fourth, traction to IMF surveillance needs to be improved. These points are discussed in the following subsections.

69 **In adapting to the challenges of euro-area surveillance, it will be important that the organisational structure is supportive.** Surveillance is done by teams of economists at the Fund who interact with officials in the countries of missions as well as staff colleagues. The structure organising the interaction both within the Fund and with euro-area officials is a key aspect of successful surveillance. It is beyond the mandate of this review to make concrete suggestions about this organisation. However, some key aspects are worth mentioning: well-structured

interactions between key people of national Article IV missions are certainly of key importance to form a clear view of the economic interdependencies of countries in the euro area. Good collaboration across departments is also important. Staff mobility patterns influence the depth of the level of analysis. Interactions across IMF departments and the way specialised expertise is used outside of programmes is also a key dimension for the effectiveness of surveillance. More frequent interactions with officials are likely to increase the trust of national authorities in the advice of the IMF staff, thereby increasing follow-up of recommendations. We advise the Fund to review these various dimensions with a view to remedy the deficiencies.

70 **Euro-area surveillance should aim at taking into account policies and developments in the EU as a whole.** Besides the challenges identified above, euro-area surveillance faces the challenge of operating within the EU overall framework. Important policy areas such as competition and trade are organised at the EU level rather than the euro-area level. Moreover, the EU's largest financial centre is outside the euro area. Our report does not propose concrete steps of how this can be done more effectively.

5.1 Revisit the surveillance mandate

71 **Because of their explicit reference to exchange rate policy, the Fund articles of agreement are a constraint on effective surveillance of countries in a currency union.** However, there is room for improvement both within the current legal framework and by revisiting the 2007 decision.

72 **Fund surveillance of the euro area should focus as a priority on threats to stability of the area as a whole.** Some countries in the euro area experienced a sudden stop in 2010-11 which forced the ECB to substitute the money market in providing liquidity to banking systems and EU-IMF assistance to substitute the bond market in providing funding to governments. This sudden stop represented a major threat to the stability of the euro area as a whole. The euro-area's vulnerabilities exposed in the open in the recent period are unlikely to vanish soon. On the contrary, the years ahead are bound to remain challenging as a number of member countries grapple with excessive debt, financial weaknesses, high unemployment and misaligned real exchange rates. In this context it is more than ever necessary that the Fund provides national and European authorities with a candid assessment of the risks and frank policy advice.

73 **A focus on internal dimensions should not preclude the Fund from assessing**

developments in the euro area's relationship with the rest of the world. The Fund has a clear comparative advantage in assessing the global interconnectedness of the euro area. The new spillover report for the euro area provides a natural channel for this part of surveillance. It should address the global implications of both national and euro-area policies.

74 **For these ends to be clearly defined and stated, a revision of the 2007 decision is desirable.** In the absence of such a revision, the Fund should at least formally redefine its interpretation of its general mandate in the case of the euro area. This revision should allow other channels of instability, as well as the exchange-rate channel, to be properly taken into account.

5.2 Redefine the Fund's relationship with the euro area

75 **The Fund should not have a 'Europe is different' mind-set.** Facts have proven that countries in the euro area can experience crises of the sort that are frequent in the emerging world. In its surveillance work, the Fund should make full use of its comparative advantage, which consists of the breadth of its expertise, the wealth of its experience across countries and over time, and an approach that is driven first and foremost by economic analysis rather than by institutional constraints. In recent years, the Fund has already moved in this direction and it will be important to retain this attitude.

76 **The Fund should take notice of the EU's institutional constraints but it should not be bound by them.** The EU by nature is process-driven and this affects its own surveillance work, which is structured around institutions and procedures. Furthermore, European processes are inevitably affected by power games between national governments and EU authorities (Council, Commission, Parliament and ECB). Being outside of this game gives the Fund freedom and objectivity. These are precious assets that should not be squandered by attempts to be part of the European institutional game and to mimic European processes.

77 **Attempts to limit the scope of Fund surveillance or to tone down its assessments should be resisted.** The Fund's expertise and financial commitment to the euro area give it a duty towards its entire membership to be as thorough and comprehensive as needed. The claim that the euro area should be dealt with as a single entity only has lost its justification.

78 **While it may have been necessary in the context of the euro-area crisis and the failures of European governance, the high-profile role of the IMF in the European**

decision-making cannot be a permanent approach. The Fund under Dominique Strauss-Kahn played a crucial role in mobilising energies and breaking deadlocks over important decisions for the euro area. This was appropriate in exceptional times but can evidently not be sustained. An IMF that would become a permanent player in the European institutional game would inevitably lose its ability to be a trusted external adviser. It would also risk not being able to perform even-handed surveillance. The Fund should therefore gradually revert to its normal role and take full advantage of its external position. This does not mean, however, that traction should be weakened.

5.3 Restructure surveillance work

This section first discusses proposals to restructure surveillance more generally along dimensions useful for euro-area surveillance but also for other surveillance. It then turns to the more specific factors related to euro-area surveillance.

79 **Risk assessment should feature more prominently in surveillance work.** In the context of multilateral surveillance, the Fund has successfully developed an approach to vulnerabilities and early warnings but bilateral surveillance is still very much conducted in a first-moment framework. The added value of the Fund's short-term forecasts is questionable in the case of countries that are generally well-equipped with public and private forecasting capabilities (and for which Commission forecasts are also available). Rather, Article IV reports should borrow from Early Warning/Vulnerability Exercise for Advanced Economies (EW/VEA) methodology and results, and provide specific risk assessments. When doing so, it will be important to carefully manage communication so as to avoid market impact.

80 **A more graduated approach to surveillance would be appropriate for dealing with the situation of countries presenting evident weaknesses.** Even-handedness does not imply that the same amount of resources is invested in the surveillance of strong and vulnerable countries. The Fund should give consideration to ways of differentiating its approach depending on the perceived intensity of threats to stability, especially as both the G20 and the euro area itself are moving increasingly in this direction. For vulnerable countries, more in-depth and higher-frequency investigations are desirable. To choose vulnerable countries, one could use objective criteria thereby pre-empting criticism that Fund analysis is not even-handed. This has been done before, for example when choosing the systemically important countries for obligatory FSAPs. Bringing in technical assistance at an earlier stage to those countries would improve the technical expertise necessary.

The legal requirement that technical assistance can only be deployed at the request of national authorities should be reconsidered. It could be replaced, for instance, by the requirement that either national authorities or the Eurogroup make such a request.

81 **In fast-moving conditions, real-time reports by the staff should trigger discussion within the Board and serve to alert authorities.** Regular reports (annual if resources permit) are indispensable, but the Fund should further improve the capacity to react in real-time. Existing reports that come at a higher frequency, eg reports for Board country-matter sessions, could be more effectively used for short-term risk assessments.

82 **The Fund should strengthen the financial side of the Article IV reports.** The separation of Article IV and FSAP reports has proved to be unhelpful because it discourages full integration of financial dimensions in the Article IV reports. Instead of perpetuating the twentieth-century schism between the real and the financial economy, the Fund should allocate more resources in regular surveillance work to an integrated analysis of real and financial developments.

83 **The Fund should restructure its surveillance of the euro area and its members to better exploit its comparative advantage.** As a result of the crisis, surveillance by European authorities (Council, Commission, ECB, ESRB, etc) is widening and deepening. This does not mean, however, that IMF surveillance has no added value, but it implies that its surveillance should be restructured. While national surveillance remains at the centre of regular IMF surveillance due to its national membership, integrating surveillance at national, euro-area and global level is the unique advantage of the Fund.

84 **Surveillance of the euro area as a whole and the euro-area Article IV report should be upgraded.** Instead of focusing primarily on issues of relevance for interaction with EU institutions, euro-area surveillance should encompass all aspects of relevance for the stability of the euro area, including national policies, in particular countries and their spillovers onto other member countries. Results from the surveillance of the individual member states should become an integral part of euro-area surveillance and potential spillovers of policy developments to the euro area should be strongly emphasised when assessing national policies in the context of Article IV surveillance.

85 **Euro-area and national surveillance should be closely coordinated.** Coordination should start at the ex-ante stage: surveillance teams should consult during the

preparation for surveillance missions and coordinate on the choice of priority issues, methodologies for assessment, major policy questions, etc, so that their findings can be exploited on a cross-country basis or for the euro area as a whole. Common themes for national surveillance could include, inter alia, capital flows, competitiveness and the effectiveness of EU policy frameworks. Similarly, ex post, major results of national surveillance should feed back into the on-going surveillance of the other members as well as the aggregate, in a way that strengthens the policy messages of relevance for the functioning of the euro area as a whole.

86 **National surveillance should focus on topics of importance for a country's performance within the euro area and potential threats to the stability of the euro area.** Topics should better reflect perceived priorities for analysis and policy reform rather than the particular research interests and availabilities of IMF staff for participation in missions. Policy issues of major importance for the stability of the euro area should be clearly signaled in national Article IV reports. To achieve this, one should reconsider staff-mobility patterns to ensure more in-depth knowledge of the country.

87 **To foster the better integration of national and euro-area Article IVs, an annual 'Euro Area Surveillance Report' (EASR) should be envisaged.** This report should draw on existing multilateral surveillance (WEO, GFSR, EW/VEA) as well as on bilateral surveillance (Article IV reports for the euro area and national Article IV reports) and the spillover reports. It should provide an assessment of risks arising from developments in the euro area as a whole or in particular countries, and highlight recommendations of major importance for discussion by euro-area authorities and action by the EU, the Eurogroup or relevant national governments. It should address all major areas of spillovers in the euro area and explore linkages between the euro area and the rest of the world. The report would make reference to the different Article IVs and would serve as a basis for subsequent national Article IV assessments of links between national economies and the euro area as a whole.

88 **To avoid unnecessary duplication, one should consider discontinuing the euro-area Article IV report in its current form and fully include it in the EASR.** The Regional Economic Outlook (REO), whose policy content is limited, could also be discontinued and its analytical capacity could be used instead to reinforce the EASR analysis of the interconnectedness across the area.

5.4 Ensure greater impact

89 **Technical improvements will be of limited effectiveness unless the Fund engages policymakers at the highest level and communicates effectively with the wider policy community.** Partial evidence suggests that the report on euro-area Article IV discussions has limited impact at best and that the impact of national Article IV reports is very uneven across countries. The WEO and the GFSR are influential but by nature communication about them focuses on the broad message for the world economy, not on regional aspects. This is in principle the purpose of the REO report, but it gets barely noticed in spite of qualities.

90 **Traction should be improved by making the EASR the basis for the policy dialogue of the Fund and European policy authorities at EU and national level.** The EASR would be presented by the managing director to the Eurogroup and the European Parliament. This presentation could replace the current presentation of the narrow euro-area Article IV, which failed to point attention to national problems of relevance for the euro area as a whole. By doing so, the impact of national Article IVs would be increased because peer pressure in the Eurogroup would be added as an additional enforcement tool to the current obligations resulting from the bilateral Article IV. The role of the European Parliament should not be underestimated, and the debate on IMF surveillance would thereby be enhanced. The report would also increase peer pressure on the EU institutions, thereby increasing the effectiveness of their own surveillance. As the report would become a flagship publication, it will also receive increasing attention from non-government players. This could be fostered by targeted outreach activity, for example to trade unions and national parliaments.

91 **The Fund should press ahead with key messages on the prevention of major risks as long as they persist.** Having warned about a risk but having failed to insist on the necessity of successfully addressing it is almost as blameworthy as not having warned about it all. Again, these key risks should be highlighted in both the national Article IV and in the EASR in order to maximise impact. Repeating key messages to national policymakers is one major way of increasing impact. Repeating the same message to euro-area peers will further increase peer pressure.

Appendix I: List of interviewees

INTERNATIONAL MONETARY FUND

Bayoumi, Tamim, Senior Advisor, SPR (Strategy, Policy and Review Department)
Blanchard, Olivier, Economic Counselor and Director, RES (Research Department)
Borges, Antonio, Director, EUR (European Department)
Chopra, Ajai, Deputy Director, EUR (European Department)
Claessens, Stijn, Assistant Director, RES (Research Department)
Cottarelli, Carlo, Director, FAD (Fiscal Affairs Department)
Dauphin, Jean-François, Deputy Division Chief, SPR (Strategy, Policy and Review Department)
Daniel, James, Division Chief, EUR (European Department)
Debrun, Xavier, Deputy Division Chief, FAD (Fiscal Affairs Department)
Decressin, Jorg, Senior Advisor, RES (Research Department)
Doyle, Peter, Division Chief, EUR (European Department)
Ducrocq, Aymeric, Alternative Executive Director
Everaert, Luc, Assistant Director, EUR (European Department)
Fayolle, Ambroise, Executive Director
Garcia-Martinez, Pilar, Commission advisor seconded to the EURIMF
Gibbs, Alex, Executive Director
Gulde-Wolf, Anne Marie, Senior Advisor, EUR (European Department)
He, Jianxiong, Executive Director
Kiekens, Willy, Executive Director
Kumar, Manmohan Singh, Assistant Director, FIN (Finance Department)
Laeven, Luc, Deputy Unit Chief, RES (Research Department)
Mauro, Paolo, Division Chief, FAD (Fiscal Affairs Department)
Mody, Ashoka, Assistant Director, EUR (European Department)
Moghadam, Reza, Director, SPR (Strategy, Policy, Review Department)
Mühleisen, Martin, Assistant Director, SPR (Strategy, Policy and Review Department)
Pineau, Georges, ECB Observer at the IMF Board
Poulain, Jean-Guillaume, Senior Advisor to Executive Director
Roumeliotis, Panagiotis, Alternate Executive Director
Sadun, Arrigo, Executive Director
Schaechter, Andrea, Deputy Division Chief, FAD (Fiscal Affairs Department)
Shannon, Michele, Division Chief, SPR (Strategy, Policy and Review Department)
Spadafora, Francesco, Senior Advisor to Executive Director
Strauss-Kahn, Dominique, Managing Director

Towe, Christopher, Deputy Director, MCM (Monetary and Capital Markets)
Vegara, David, Assistant Director, WHD (Western Hemisphere Department), former Spanish State Secretary
Viñals, José, Financial Counselor and Director, MCM (Monetary and Capital Markets)
Virmani, Arvind, Executive Director
Waysand, Claire, Assistant Director, SPR (Strategy, Policy and Review Department)

NON IMF

Ahearne, Alan, former Special Advisor to Minister of Finance, Ireland
Bergsten, Fred, Director, Peterson Institute
Berès, Pervenche, Member of European Parliament, former chair of ECON Committee
Bischofberger, Karlheinz, Head of Department Financial Stability, Deutsche Bundesbank, and former Executive Director at IMF
Campa, José Manuel, Secretary of State for Economic Affairs, Ministry of Economy and Finance, Spain
Deppler, Michael, former IMF Director (European Department)
Felke, Reinhard, Head of Unit, European Commission
Fernandez, Ramon, Director-General, French Treasury (French Ministry of Finance)
Grilli, Vittorio, Director General, Italian Treasury (Italian Ministry of Economy and Finance) and Chairman of the EFC Committee
Henriksson, Jens, President, Nasdaq OMX Stockholm, former Executive Director at IMF
Johnson, Simon, Senior Fellow, Peterson Institute, and former Economic Counselor and Director of RES at IMF
Kierkegaard, Jacob, Research Fellow, Peterson Institute
Le Houérou, Philippe, Vice President for Europe and Central Asia Region, World Bank
Leandro, José, Member of Cabinet of the President of the European Council
Leipold, Alessandro, Fellow, Lisbon Council, former Deputy Director of EUR at IMF
Meyer, Eric, US Treasury
Mussa, Michael, Senior Fellow, Peterson Institute
Rajan, Raghuram, University of Chicago, and Former Economic Counselor and Director of RES at IMF
Reichenstein, Birgit, Federal Ministry of Finance, Germany
Renaud-Basso, Odile, Deputy Head of Cabinet of the President of the European Council
Schuknecht, Ludger, Senior Advisor (Directorate General Economics), European Central Bank
Sobel, Mark, Deputy Assistant Secretary for International Monetary and Financial Policy, US Treasury
Stein, Klaus, Director, Federal Ministry of Finance, Germany, and former Executive Director at IMF.
Truman, Ted, Senior Fellow, Peterson Institute
Wieser, Thomas, Director General (Economic Policy and Financial Markets), Federal Ministry of Finance, Austria, and former EFC Chair

Appendix II
Forecasting performances: the European Commission versus the IMF

Objectives

This appendix compares the IMF's and the European Commission's fiscal-deficit and GDP forecasts. Previous literature (eg Artis, 1997) establishes that the IMF's World Economic Outlook (WEO) forecasts are optimistic. Here, we assess if the forecasts remained overly optimistic during 2005-10 compared to the European Commission's.

Data definition and methodology

We focus on two variables: the fiscal deficit and the GDP growth rate. The GDP growth forecast is the forecast of the annual percentage change of GDP in constant prices. The fiscal deficit forecast is the forecast of the government balance one year ahead. We focus on the four countries covered by this report, ie Greece, Ireland, Portugal and Spain, and on the euro area as a whole.

We employ a simple methodology, the forecast error bias which we define as the difference between the forecast value and the realised value. We use the root mean square error (RMSE) to compare the two forecasts' error bias (see the formula below). The root mean square error measures forecast accuracy by comparing the forecasted value with the realised value. Formally, it is given by:

$$RMSE = \sqrt{\sum_t (F_t - R_t)^2/n}$$

F is here the forecasted value and R the realised value, n is the number of periods.

Principles and organisation of forecasting in the two institutions

The forecasting process at the IMF is coordinated by the Research Department but the forecast data is provided by area departments. The forecasts in the WEO database are done by country teams (desks) within area departments, and their consistency is assured by the RES department. At the European Commission, the Directorate General for Economic and Financial Affairs (DG ECFIN) is responsible for the forecasts and it is primarily done by the country teams (desks). Many economic forecasts are produced using 180 variables. The main economic forecasts are published in May and November; we chose the November forecasts.

The IMF through the WEO database also produces various forecasts. The WEO is released in April and October of each year. We chose the October version to make it comparable to the European Commission's forecast, but it should be kept in mind that the Commission has one more month of data.

Discussion of the results

It is very difficult to disentangle a general pattern from the untransformed data. Overall, for the fiscal deficit and the GDP growth rate, the European Commission seems to forecast better. In six out of ten cases, the Commission out performs the IMF. And when the IMF performs better, the two forecasts are very close. The closeness between the two institutions is measured by the ratio between the two root mean square errors. The more the ratio is close to one, the more the two forecasts are similar (see, for example, the fiscal-deficit forecasts for Portugal, and the GDP-growth forecasts for Spain). Only in one case was the result different. This particular case is mainly explained by the fact that the European Commission made a huge forecasting error of the Greek deficit in 2009. The Commission forecast a government deficit of 2.2 percent while the actual value was 15.6 percent. This huge gap explains the ratio 0.73 in the Greek figure. The GDP growth forecasts, meanwhile, are very close. The IMF's 'under-performance' thus comes mainly from the fiscal side.

The IMF's forecasting accuracy improved during 2005-10 relative to 1998-2005 (see Tables II.A and II.B). During the first period (European Commission, 2007) it was clear that the IMF performed worse compared to the Commission's forecasts, whether measured by the mean error, mean absolute error or the root mean square error for the year-ahead outlook. So during the first period, according to the Commission (2007), the IMF's forecast errors were bigger than the Commission's.

During the second period, the IMF's performance seems to improve and become closer

to the Commission's. For GDP growth, the WEO forecast errors are very close to the Commission's forecast errors[46].

Table II.A: Comparison of European Commission/IMF forecasts
Forecasting error bias (2005-10)

	Government balance			GDP growth		
	RMSE(EC)	RMSE(IMF)	Ratio(IMF/EC)	RMSE(EC)	RMSE(IMF)	Ratio(IMF/EC)
Greece	6.66	4.85	**0.73**	2.27	2.35	**1.04**
Ireland	4.54	5.55	**1.22**	4.31	3.77	**0.88**
Portugal	3.23	3.02	**0.93**	1.44	1.46	**1.02**
Spain	3.99	5.25	**1.32**	1.78	1.66	**0.93**
Euro area	2.12	2.28	**1.08**	1.91	2.31	**1.21**

Source: Bruegel.

Table II.A: Comparison of European Commission/IMF forecasts
Forecasting error bias (1998-2005)

	GDP growth – year ahead			
	Ireland	Greece	Spain	Portugal
RMSE(EC)	2.88	0.54	0.95	1.19
RMSE(IMF)	2.69	0.59	1.06	1.18
Ratio(IMF/EC)	**0.93**	**1.09**	**1.12**	**1.54**

Source: European Commission (2007, p79) and Bruegel.

References

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46. It is important to highlight the fact that we compare here the two institutions by comparing their forecasts for only two variables. As we said in the main text, these two institutions forecast more than 180 variables; a more rigorous comparison would need to increase the number of compared variables. Our interest in these two variables arises from the topic of this report.

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An evaluation of IMF surveillance of the euro area

The euro-area crisis has exposed deep deficiencies in the governance of European Economic and Monetary Union. However, crisis prevention in, and surveillance of, the euro area are not only the responsibility of European authorities. As members of the International Monetary Fund, all euro-area countries are also subject to regular bilateral IMF surveillance. The currency union as a whole is also subject to regular IMF surveillance.

This report analyses the IMF's surveillance of the euro area. We find that it suffered from severe shortcomings in the run-up to the financial crisis, but after the start of the crisis in 2008, IMF surveillance of the euro area greatly improved, with the IMF correctly proposing measures to counter depression risks and warning about banking sector problems. By the time the sovereign-debt crisis hit the currency union in early 2010, the IMF was ready to play an influential role. The slow European response meant this was indispensable.

This study is based on interviews with high-level European, US and IMF officials, and on IMF surveillance documents, focusing in particular on the situations in Greece, Italy, Portugal and Spain, and in the euro area as a whole.

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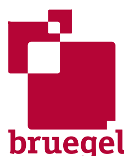

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