

IMF SURVEILLANCE OF THE EURO AREA AND ITS MEMBER COUNTRIES

IMF surveillance encompasses the monitoring of the economic and financial policies of its member countries and the global economy as well as the identification of possible risks to stability and the provision of advice on necessary policy adjustments. In recent years, the Fund has significantly improved its surveillance in general, including of the euro area and its constituent countries. It has responded to the shortcomings exposed by the crisis in global financial markets and in some euro area countries with several new initiatives and the strengthening of practices in key areas. These changes are the result of critical reflection exercises by the IMF, of which the 2011 review of IMF surveillance was arguably the most pivotal. At the same time, there is still scope for further enhancing IMF surveillance and for introducing additional changes to make it more effective and better tailored to the circumstances of the relevant economies, not least in view of the recent significant adjustments to the policy framework within the EU/euro area itself.

The aim of this article is to take stock of IMF surveillance of the euro area and its member countries following recent changes. In so doing, it also explores the interplay between the EU and IMF surveillance frameworks for the euro area. Since the focus is on the IMF's regular surveillance activities, it does not cover surveillance in the context of lending programmes.

I INTRODUCTION

The IMF has taken a number of steps in recent years to strengthen its surveillance framework and toolkit. Its own triennial surveillance reviews (TSR) have been instrumental in that process. The 2011 TSR, as the first comprehensive review after the start of the global financial crisis, was particularly important.¹ It identified key priorities, which IMF staff have since sought to operationalise. These concerned (i) interconnectedness; (ii) risk assessment; (iii) financial stability; (iv) external stability; and (v) traction. In addition, the legal basis for surveillance was updated in 2012 with the adoption of the Integrated Surveillance Decision (ISD), which enables the IMF to assess all policies that are relevant for a member's external and domestic stability and to take into account inward and outward spillovers and cross-country policy interactions. The adoption of a Financial Surveillance Strategy was also an important step towards improving risk identification and policy analysis in the financial sector and fostering an integrated view of financial sector risks in products and instruments.

In 2014 the IMF conducted its latest TSR², which was structured around three themes: (i) integrating and deepening risk and spillover analysis; (ii) more tailored and expert policy advice; and (iii) achieving a greater impact. Regarding the first theme, the review found that there was still significant scope to explore synergies between bilateral and multilateral surveillance. Moreover, IMF staff saw a need to deepen the understanding of how risks map across countries and how spillovers spread across sectors. As to the second theme, attention was drawn to the importance of tailoring advice to country circumstances. Also, to enhance policy advice, Fund staff saw merit in continuing to build on the IMF's understanding of macroprudential policy and highlighting the implications of macro-critical structural reforms in line with its mandate. Turning to the third theme, staff underlined the need for more client-focused and candid communication.

1 The findings of the report by the IMF's Independent Evaluation Office entitled "IMF Performance in the Run-Up to the Global Economic and Financial Crisis" (2011) are also reflected in the 2011 TSR.

2 International Monetary Fund (IMF), "2014 Triennial Surveillance Review: Overview Paper", IMF, Washington, D.C.

Drawing on a recent report by the Task Force on IMF Issues of the International Relations Committee of the European System of Central Banks³, this article looks into how IMF surveillance of the euro area and its constituent countries has changed since the pivotal 2011 TSR. Section 2 describes the IMF framework for surveying the euro area and its members and discusses how it interacts with the EU/euro area's own surveillance framework, which has also been substantially reformed in the recent past. Section 3 reviews the performance of the Fund's post-crisis surveillance of the euro area and its member countries in the priority areas mentioned above. It also covers the implications of European banking union for IMF surveillance. Section 4 looks at the specificities of IMF surveillance of the policy framework of EMU, and Section 5 concludes.

2 THE FRAMEWORK OF IMF SURVEILLANCE OF THE EURO AREA AND ITS MEMBER COUNTRIES

2.1 A NEW LEGAL FRAMEWORK

A new legal framework for IMF surveillance was put in place with the adoption of the Integrated Surveillance Decision in 2012. The legal basis for Fund surveillance is set out in Article IV of the IMF's Articles of Agreement, which distinguishes between bilateral and multilateral surveillance.⁴ The ISD updated the surveillance framework by enabling the IMF to engage more effectively with members on their domestic economic and financial policies and by making Article IV bilateral consultations a vehicle for multilateral surveillance as well. In particular, the ISD allows the IMF to discuss with its members the full range of spillovers from their policies when these may have a significant impact on global stability.

While the ISD also provides the basis for better surveillance of monetary unions, the paragraph in the ISD concerning currency unions changed little compared with the 2007 Decision on the Bilateral Surveillance over Members' Policies. The text has been improved by placing emphasis on ensuring not only the balance of payments stability of the union, but also its domestic stability. Helpfully, the ISD has been translated into operational guidance on the surveillance of currency unions in which staff are explicitly advised to assess the extent to which economic and financial policies at the level of the currency union (exchange rate, monetary, fiscal and financial sector policies) are promoting the union's domestic and balance of payments stability and global stability. Despite the fact that EU/EMU decision-making structures have been strengthened, the legal basis remains constrained by the country-based membership of the IMF. The ISD repeats the 2007 Decision in explicitly noting that members of currency unions "remain subject to all of their obligations under Article IV section 1, and accordingly, each member is accountable for those policies that are conducted by union level institutions on its behalf" (ISD, paragraph 8). This corresponds to the fact that countries themselves retain all the resulting rights and obligations of IMF membership, even though the institutional and governance set up is different for euro area countries in that there is an independent central bank and joint decision-making in some policy areas. None of the European institutions or fora are members of the IMF, and their cooperation with the Fund is not mandatory. The European Central Bank was granted observer status under IMF

3 Task Force on IMF Issues of the International Relations Committee of the European System of Central Banks, "IMF Surveillance in Europe", *Occasional Paper Series*, No 158, ECB, Frankfurt am Main, January 2015.

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

Decision No 11875-99/1 of 21 December 1998 and is accordingly permitted to participate in IMF Executive Board meetings on specified topics and topics relevant to the mandate of the ECB.⁵

2.2 SURVEILLANCE IN PRACTICE: BILATERAL, REGIONAL AND MULTILATERAL

The IMF conducts consultations with individual euro area countries (resulting in country reports covering national policies), as well as with the authorities representing the euro area as a whole (resulting in a report on euro area policies). It also conducts a Financial Sector Assessment Programme (FSAP) every five years for those euro area members with systemic financial systems⁶, and on request for the other euro area countries. In addition, the first FSAP for the European Union was concluded in March 2013.

The modalities for conducting IMF surveillance within the euro area were formalised with the introduction of the euro.⁷ For individual euro area countries, there were no changes to the annual consultation under Article IV of the Articles of Agreement. As it is not a member of the IMF, the euro area as a whole does not have an Article IV consultation in its own right. Instead, IMF staff semi-annually exchange views with staff of the ECB, the European Commission and other European institutions and bodies and draw up an annual report on euro area policies to complement and better inform the Article IV consultations with individual euro area countries (not the other way round). Thus, in practice, euro area surveillance follows a dual track, with a separate surveillance exercise for the union, coordinated with national Article IV surveillance. This results in consultations with the 19 individual euro area members plus a consultation on the policies of the ECB and the European Commission, leading to 20 annual reports in total. In addition, as part of its multilateral surveillance, the IMF analyses developments in the euro area in its World Economic Outlook (WEO), Global Financial Stability Report (GFSR) and Fiscal Monitor. The Fund has also produced annual Spillover Reports and External Sector Reports since 2011 and 2012 respectively, which include a focus on the euro area as well as key euro area countries.

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

The recent crisis has also led to successive reforms of the surveillance framework of the EU and the euro area. New surveillance systems for EU Member States' budgetary and economic policies, as well as a new financial supervisory architecture mainly affecting euro area countries, have been put in place.⁸ A clear calendar has been established in the context of the European Semester, during which policy recommendations are formulated at the European level and addressed to the national level.

The reinforced EU surveillance framework has thus far not led to any specific changes in the way the IMF conducts its surveillance of EU Member States/euro area countries, although such an avenue could be considered. On the one hand, the interplay between the reinforced EU surveillance frameworks and those of the IMF might entail specific challenges for both EU Member States/euro area countries and the IMF going forward. Firstly, with economic governance

5 While the ECB holds observer status at meetings of the IMF Executive Board, both the ECB and the European Commission hold observer status on the International Monetary and Financial Committee.

6 Austria, Belgium, Finland, France, Germany, Italy, Ireland, Luxembourg, the Netherlands and Spain.

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

8 See, for example, the article entitled "A fiscal compact for a stronger Economic and Monetary Union", *Monthly Bulletin*, ECB, May 2012, and the box entitled "The 'two-pack' regulations to strengthen economic governance in the euro area", *Monthly Bulletin*, ECB, April 2013. With regard to banking union, see the *Financial Stability Review*, ECB, May 2014.

increasingly exercised at different levels (national, joint national, euro area and EU), the way in which policy formulation is being shaped for euro area countries has changed. This requires the IMF to internalise these new EU/euro area processes properly in its surveillance, and may complicate its surveillance or even pose challenges to the consistency between assessments made in national and euro area surveillance reports. Secondly, there are differences in the scope, focus, enforcement mechanisms and traction of the two surveillance frameworks. Although IMF country surveillance is constantly ongoing, the key focal point is the annual Article IV report – a once-yearly exercise of a cooperative nature – and the Fund’s leverage is based on the strength of its arguments, peer pressure and, on occasion, its potential impact on financial markets. By comparison, EU surveillance is a continuous process with regular formal meetings, embedded in the European Semester, including monitoring of implementation in the second semester of the year and with legally binding procedures for dealing with fiscal and macroeconomic imbalances. In addition, its coverage extends further into the structural policy domain.

IMF surveillance usually results in broader, more strategic policy guidance, in contrast with the more detailed country-specific recommendations which the EU makes under its surveillance calendar. Complications may arise if, owing to differences in views on the effectiveness of certain policy tools in given circumstances, contrasting policy recommendations are made. Furthermore, IMF policy advice may not always be strictly in line with prevailing EU rules if these rules are deemed wanting by IMF staff, yet individual EU Member States/euro area countries may legally not be in a position to disregard those rules and follow the IMF’s advice. On the other hand, the IMF and EU surveillance frameworks can also complement each other. In fact, the IMF can play a helpful role as an independent, trusted external adviser. The Fund has a breadth of expertise, a wealth of experience across countries and over time, and an approach that is driven first and foremost by economic analysis, with fewer institutional constraints. As such, it has an important role to play in providing an external perspective in addition to the European view from within. IMF recommendations can provide an impetus for euro area countries to collectively deliberate and seek, if warranted, a change in national or common policies.

3 IMPLEMENTATION OF THE IMF SURVEILLANCE FRAMEWORK

Overall, the IMF has made good progress in implementing the new surveillance framework both in general and in the euro area, although there is scope for further improvement. Reviewing the Article IV reports drawn up on euro area countries in 2013 and 2014, this section looks at whether the IMF has effectively implemented changes to its surveillance framework in four of the five priority areas identified in the 2011 TSR for the euro area: (i) interconnectedness, (ii) risk assessment, (iii) financial stability and (iv) traction. Moreover, it covers the implications of European banking union for IMF surveillance of the euro area and its constituent countries.

3.1 INTERCONNECTEDNESS

3.1.1 ECONOMIC AND FINANCIAL LINKAGES

For individual euro area countries, national surveillance is now far better informed by regional surveillance. Analyses in national Article IV and Financial System Stability Assessment (FSSA) reports are systematically informed by, and put into the context of, the main economic and financial developments within the euro area as a whole.

In multilateral reports such as the WEO and the GFSR, thematic chapters or sections usually provide in-depth analysis of specific issues such as the banking, corporate and sovereign nexus. However, in past reports, the identification of key vulnerabilities and challenges for the euro area focused mainly on a narrow selection of countries, with the discussion of developments confined to the interaction between “core” and “stressed” countries.

It may also be worth considering whether to strengthen the analysis of spillovers to better understand the impact of shocks and policy decisions, building on country reports. This may mean going further than the current general summing up of spillovers within the euro area and better integrating the analysis carried out in the context of country surveillance into monetary union surveillance products. Building on the example of recent Spillover Reports, the provision of more in-depth analysis of positive inward spillovers, in addition to the negative shocks most commonly examined in country reports, could be considered.

3.1.2 POLICY LINKAGES

Improvements have been made in the treatment of policy interconnectedness within the euro area. For example, policy advice to countries appears to be more intrinsically linked to the main economic and financial developments in the euro area and is more cognisant of the euro area economic and financial policy framework. Staff now clearly distinguish between policies within the field of competence of European authorities (e.g. monetary policy), those under the responsibility of national governments (e.g. structural reforms to boost competitiveness) and those within a given EU framework (e.g. the Stability and Growth Pact (SGP)). Similarly, policy advice on financial issues now takes into account developments in the EU/euro area and at the national level in the context of a profound reshaping of the European supervisory architecture.

Mapping the main policy linkages between euro area countries is indeed important. This can take the form of holding more in-depth discussions with authorities on how euro area membership affects vulnerabilities and policy options, including, e.g., the case of euro area monetary policy coping with different national macroeconomic conditions and the role of national macro prudential policies within the euro area. Moreover, findings under the EU Macroeconomic Imbalances Procedure could be juxtaposed with the IMF’s own assessment of extra- and intra-euro area imbalances. In addition, authorities could be provided with better “maps” of financial and real linkages within the euro area. Without prejudice to the domestic stability objective, the policy options suggested to authorities could be accompanied by information on the outward spillovers they potentially generate.

There may be merit in providing stronger and more clearly formulated policy recommendations on structural reforms that are macro-critical, consistent with the Fund’s mandate in this policy area, including their estimated impact. Discussions on these issues should be more systematic when they are of critical importance for the external balance of a country, which more often tends to be the case for countries participating in a monetary union. These policy recommendations could also build on cross-country analysis. The Fund could make better use of insights from other organisations, especially the Organisation for Economic Co-operation and Development. Furthermore, it could try to quantify the effects of structural reforms in terms of their impact on economic growth and, to the extent possible, both the euro area’s external and internal balances, while recognising the difficulties of such an exercise (including, not least, data, technical and resource constraints). This would follow up on the work that the IMF has already started in the context of the G20 Growth Strategies.

3.2 RISK ASSESSMENT

Post-crisis surveillance in the euro area has stepped up risk discussions, with risks to the baseline scenario discussed for all member countries and risk assessment matrices included in most of the reports. By highlighting transmission channels and assigning probabilities to the crystallisation of risks as well as their potential impacts, the surveillance reports have provided for a sharper focus. Moreover, policy implications and responses are also covered in the bulk of cases.

Useful risk assessments sufficiently stress the limitations/caveats of the analysis (in terms of methodology and underlying data constraints) and take into account any unintended market consequences that their communication may entail, especially if these are likely to make headline news. With this in mind, while there could be merit in the Fund trying to identify all pertinent risks early on, due care would need to be taken to avoid communication pro-cyclically reinforcing trends in countries that may already be facing difficulties. There could also be room for a more structural role by improving communication on medium-term risk scenarios.

3.3 FINANCIAL STABILITY

The widespread coverage of financial stability issues in the reports for euro area countries shows that the IMF is making progress in addressing previous weaknesses in this area. Risks to the financial system and underlying vulnerabilities are considered in all Article IV reports on euro area countries, with most of them also covering macro-financial and cross-border linkages. The analysis and discussion of linkages vary across reports, however, and there is room for further elaboration and improvements regarding linkages. In terms of financial stability policies, measures were identified in each case and over half of the reports followed up on, or at least referred to, past FSAP recommendations. The first EU-wide FSAP was an important milestone. It focused on how the EU/EMU supranational institutions interact with national institutions and put forward “high-priority recommendations” on overcoming cross-border risks and improving the financial stability framework of the Single Market. The report also contained a section on lessons from national FSAPs, which offered an overview of the main risks and vulnerabilities identified in the national FSAPs of EU countries. Some of the recommendations, e.g. on banking union, have provided important input for actual policy shaping. However, policy recommendations could potentially be enhanced by more specific advice on issues relating to financial stability/sector matters, including, for example, cross-border cooperative arrangements or reductions of cross-border barriers. By way of positive example, in the 2013 EU FSAP, IMF staff consistently argued for a supranational approach to governance arrangements in order to counter national bias and prevent fragmentation in the EU. With the prospect of further work on a capital markets union in the EU, new opportunities open up for IMF policy recommendations in this field.

The establishment of a banking union in Europe and the ensuing reshuffling of responsibilities in the areas of microprudential and macroprudential supervision are already starting to have implications for the way in which the IMF conducts its financial sector surveillance of EU Member States. This applies to both Article IV consultations and FSAPs for euro area countries. If IMF surveillance and advice are to remain effective and relevant, they will have to fully reflect the new policy-making frameworks and respective competences at EU Member State, euro area and European Union levels. For Article IV surveillance of euro area countries, banking union means that the ECB must be consulted, given its new responsibilities in the areas of microprudential and macroprudential supervision. As far as FSAPs for euro area countries are concerned, close cooperation will be

needed between the IMF and national and euro area authorities on the assessments of supervision, risks and resolution. The assignment of new policy responsibilities may also necessitate revisiting the decision governing the observer status of the ECB in the IMF. Moreover, in line with the Fund's Integrated Surveillance Decision, due attention needs to be paid to closely linking assessments made in the course of bilateral/regional surveillance with those made in the context of multilateral surveillance.

3.4 TRACTION

There is general agreement that, for IMF surveillance to be effective and relevant, the Fund has to ensure that it has adequate traction as a trusted advisor. The Fund's 2012 staff guidance note for surveillance under Article IV consultations regards traction as having two dimensions: firstly, the extent to which authorities engage with the Fund on its analysis and recommendations, and secondly, the extent to which Fund advice is reflected in policy action. However, traction also has to be assessed in the light of the Fund's role as one adviser among others; that is, authorities are not obliged to translate IMF advice into policy action. Thus, traction depends on high-quality analysis, even-handedness, candour and effective communication.

The Fund has recently taken several steps to improve the traction of its advice within the euro area. This is a particularly onerous task owing not least to the challenges posed by the architecture of the monetary union. With regard to national and supranational authorities, it has focused more on issues of core interest to authorities and following up on its previous advice. For example, macro-social issues have been discussed to some degree in nearly all of the reports for the euro area and its individual countries, with considerable emphasis placed on labour market developments and reforms, given their macro-critical role. In many cases, Fund staff have looked at the previous policy advice they have issued, but this exercise has normally focused on national authorities' response to that advice and has not assessed the quality and relevance of the IMF's own analysis and recommendations. An innovation worth noting is the "Point and Counterpoint to the Staff's Views" sections included in a few selected reports. In these sections, Fund staff put forward and respond to a series of possible counter-arguments to their own diagnosis and recommendations. This innovation could usefully be extended to all Article IV reports on euro area countries. Building on this, it might also be insightful to include a box on the quality of past IMF advice (including a review of whether and how the Fund has modified its own past advice) and the authorities' response to it. By following up on recommendations in subsequent reports, and thus providing continuity and ensuring consistency of messages, traction can be further improved.

Increasing the responsiveness of authorities to IMF advice may also be a matter of appropriate timing. For the euro area, there could be merit in better synchronising the issuance of Fund policy recommendations with the EU/euro area policy-making cycle, which would allow such recommendations to feed more effectively into EU/euro area decision-making processes. More use could then be made of IMF surveillance reports on individual EU Member States in the context of country surveillance processes conducted at the European level.

4 IMF SURVEILLANCE OF THE POLICY FRAMEWORK OF EMU

Over recent years, IMF surveillance of the euro area policy framework has improved. The 2011 report on euro area policies set a good example by exploring the aspects of the framework that had led to the euro area sovereign debt crisis. More recent reports usefully made connections

between different elements of the framework (e.g. the 2012 report on euro area policies linked banking union with fiscal integration and fiscal consolidation under the SGP). The 2013 report on euro area policies drew attention to potential risks (likelihood and expected impact) and recommended changes to some aspects of the framework in an innovative, clear and helpful “risk assessment matrix”. The reports also usefully distinguished between the relative progress in different areas of the framework of the EU and the euro area.

The stability and performance of the euro area and its members depend on good governance, and the IMF has made distinct efforts to examine this. EU/euro area governance, i.e. the design and functioning of the EMU policy framework, is continuing its shift from national towards more joint or centralised policy-making. The IMF usefully dealt with governance in 2011, for example, when IMF staff reports weighed in on discussions on strengthening the EU’s fiscal policy framework, including a critical analysis of the effectiveness of the SGP and its surveillance, decision-making, and enforcement mechanisms (such as the problem with qualified majority voting in the Council). This type of advice is helpful and could be further improved, for example, by delving deeper into some aspects, such as internal euro area surveillance, building on material IMF staff have developed on fiscal union and banking union, for instance; by following up on recommendations in subsequent reports to provide continuity and consistency in IMF messages; and by taking due account of the policy framework for reforms, including views on the appropriate balance of competences at the European and national levels.

The current format of euro area consultations produces dual-track surveillance – of supranational policies and national policies – with separate interlocutors and no single comprehensive report on the euro area.⁹ Multiparty engagement with policy authorities is an essential element of euro area surveillance. To this end, it has become standard procedure in reviewing euro area policies for the IMF to interact with the Eurogroup Working Group and the Eurogroup. This occurs at the end of the consultation process and is consequently a presentation of results rather than a consultation contributing to the substance of the surveillance exercise. As with national surveillance, there could be merit in involving policy-makers at the level of the Eurogroup Working Group at an earlier stage in the consultation process, with a focus on the functioning of the euro area as a whole, which could help enhance traction.

5 CONCLUSIONS

The IMF has significantly improved its surveillance of the euro area and its member countries along the lines suggested in the 2011 landmark triennial review of surveillance. Overall, messages have become more consistent and focused across surveillance products. For euro area countries, there is now more integration between surveillance at the bilateral and euro area-wide level, while analyses at both levels draw on multilateral exercises such as the External Sector Reports and Spillover Reports. For all euro area countries, there is better integration between Article IV reports and national FSAPs. Moreover, risk assessment matrices showing risks, channels of transmission and policy options are now used in almost all euro area Article IV reports. Follow-up on past advice has improved thanks to dedicated boxes included since 2012 in most national Article IV reports. Lastly, the Fund has also been very active in making suggestions on the institutional

⁹ There are also mixed messages on who the IMF regards as “euro area authorities”. The reports on euro area policies refer explicitly to “the authorities” as being the ECB and the European Commission, but a much wider group is also mentioned, including the European Banking Authority, the European Systemic Risk Board, the European Stability Mechanism and the European Council, the Eurogroup and the Eurogroup Working Group.

architecture of the EMU, advocating more financial and fiscal integration in each of the recent euro area reports and advising on the creation of a European banking union. Nonetheless, there remains room for improvement in the surveillance of the euro area and its individual countries. There is still some way to go in fully implementing the 2011 TSR recommendations and making IMF surveillance more effective and better tailored to the specific circumstances of the relevant economies, not least in view of the recent significant changes to the surveillance framework within the EU/euro area itself.